Global Counsel

Chasing the scooter vote: fuel subsidies in Indonesia's political economy

20 April 2012

Summary

- The failure of the Indonesian government to implement planned reform of Indonesia's massive retail fuel subsidies this month leaves Indonesia spending almost as much in subsidising vehicle use as it does building the roads to drive them on. In 2012 these subsidies are likely to consume at least 13% of Indonesian government spending.

- The uprating of Indonesia's debt to investment grade – the first such rating in the emerging world – in early 2012 was an explicit seal of approval for growth rates averaging 6% and a generally cautious fiscal stance. The fuel subsidy is by far the most important black mark on this record, and it is proving hard to erase.

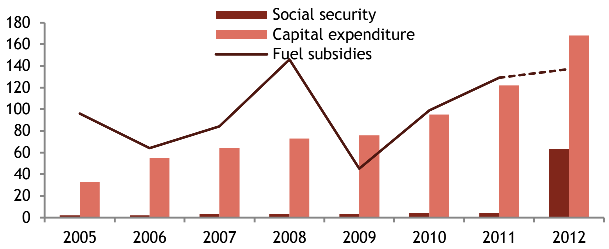
- Both for inward investors in Indonesia and for increasingly enthusiastic index-linked investors in Indonesian equities, this is a sign of the potential problems ahead. After a decade of relative consensus on incremental reform in Indonesia, the fuel subsidy debate and the approaching 2014 Presidential election signal a shift to a period in which democratic politics is likely to act as a check on needed reform.

- The parallels with India, where investors are increasingly voting with their feet, are interesting. Indonesia's fiscal governance is notably better, but its democratic politics exhibit some similar traits.

Earlier this month the Indonesian Parliament reversed government plans to raise Indonesia's subsidised fuel price by a third to around $0.65 a litre. The proposal had provoked a wave a public anger and violent protests outside the Indonesian Parliament in Jakarta, as had similar reductions in the subsidy in 2008. The Demokrat government came unstuck when its coalition partners – especially the large Golkar party - announced that they no longer supported the plan.

The compromise deal struck with Golkar and the other members of the governing coalition eliminated the planned April 1 price rise, and established that the subsidised price will only be lifted if six month average oil prices rise 15% above the government's price projections of $105 a barrel ($120.75). Indonesian crude is currently at $116. The debate could be reignited as soon as Q3 if prices continue to rise. Even then, Indonesia's most incongruous piece of public spending will continue to be a huge burden on its finances.

For much of the last decade, Indonesia has been South East Asia's star pupil in economic terms. Having clawed its way back from the massive dislocation of the South East Asian economic crisis, it is also the only member of the G20 to have lowered its debt to GDP ratio since 2009 (now 28%), and is currently running a very moderate deficit of under 2% . The uprating of its debt to investment grade – the first such rating in the emerging world - by Fitch in December 2011 and Moody's in early 2012 was an explicit seal of approval for growth rates averaging 6% and a generally cautious fiscal stance. The fuel subsidy is the most important black mark on this record.



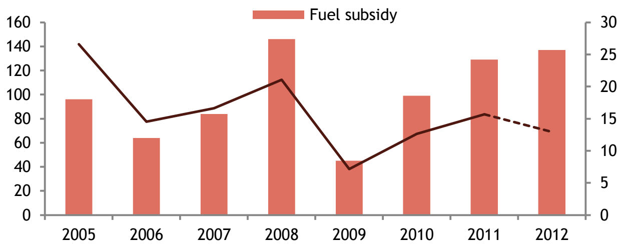


Chart 1 (Top): Fuel subsidy, capital expenditure, social security spending 2005-2012 (trillion rupiah). Chart 2 (Bottom): Indonesia fuel subsidy in absolute terms (RHS trillion rupiah) and as a percentage of total central government expenditure (LHS %) 2005-2012.

Source: Indonesian Ministry of Finance, Global Counsel calculations.

Both for inward investors in Indonesia and increasingly enthusiastic index-linked investors in Indonesian equities, it is a sign of the potential problems ahead. Much as in India, the capacity of politics to get in the way of the growth trajectory cannot be underestimated. This Global Counsel Insight note explains why.

Cheap gas, bad roads

Indonesia has been subsidising the retail cost of fuel since 1967. Its subsidy is the most generous in the world and ruinously expensive. By capping fuel prices, the Indonesian government aims to increase disposable income and reduce input costs for producers and businesses. However, just over half of the subsidy flows to commercial transport businesses and about two fifths of the remainder goes to the wealthiest 10% of households. Around a quarter of Indonesian households use no vehicle fuel at all.

No less importantly from a fiscal point of view, and from the point of view of Indonesia's growth prospects, the subsidy has a huge opportunity cost attached to it. The Indonesian government projects that it will spend almost as much on the fuel subsidy in 2012 as on capital expenditure: for much of the last decade the subsidy has dwarfed such spending (Chart 1). Around 13% of all Indonesian central government expenditure is projected to be absorbed by the subsidy this year (Chart 2). A 2011 study released by the Jakarta Transportation Agency estimated that traffic congestion costs the city up to 46 trillion rupiah a year. Yet Indonesia is using the money it could spend on building roads or improving public transport to subsidise vehicle use.

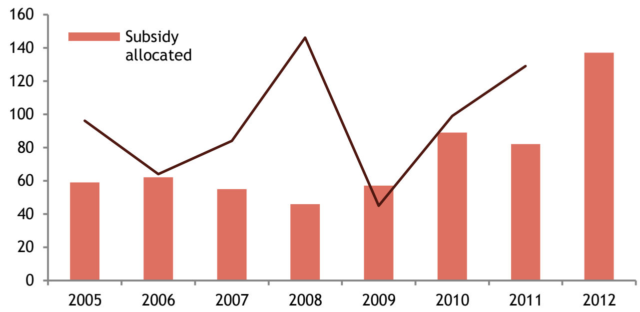


Chart 3: Fuel subsidy allocated and actual 2005-2012 (trillion rupiah).

Source: Indonesian Ministry of Finance

The subsidy also injects a huge element of uncertainty into Indonesia's fiscal planning. In six out of the last seven years, government projections of the underlying oil price and expected level of demand have both been wrong on the downside, resulting in large levels of unplanned expenditure (Chart 3). Indonesia's borrowing costs, especially after the dramatic miscalculations of 2008 which saw the government underestimate the subsidy cost by a factor of three, have typically correlated with this uncertainty.

If the Indonesian government's projection of an average oil price of $105 is out, or Indonesian demand rises faster than projected, the cost of the subsidy could rise sharply. If current oil prices are sustained, it is probable that the costs of the subsidy will add 250-500bps to the Indonesian government’s 2012 deficit. This in itself is unlikely to be sufficient to put Indonesia’s credit rating in play, but it is a sign of deeper problems that may yet erode the optimistic outlook. The biggest of these problems is the obstacle it represents to serious investment in Indonesia’s massive infrastructure bottlenecks, which are arguably the county’s biggest check on sustained growth rates.

Chasing the 'scooter vote'

Like most subsidies, this one has created its own constituency of defenders. One of its key beneficiaries has been the Indonesian motorcycle market and its customers. With small cars impractical on Indonesia’s rough, traffic-clogged or easily flooded roads, the Indonesia scooter market has boomed in the last decade (Chart 4), assisted by easy access to credit for scooter purchases. Most of Indonesia’s 50 million middle class probably own a motorcycle and they are highly sensitive to even small changes in the price of fuel.

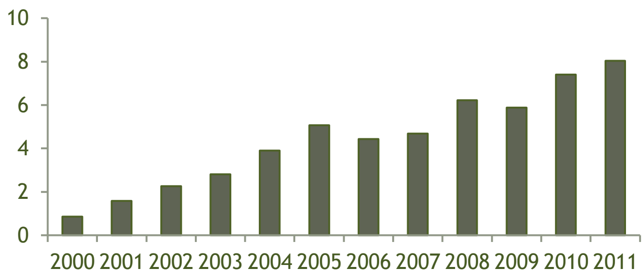


Chart 4: Annual new sales, Indonesian motorcycle market 2000-2011 (million).

Source: Indonesian Motorcycle Association 2012

The Golkar party’s opportunistic decision to disown from the subsidy cut is a taster of the likely mood of the two years between now and the Presidential election of 2014. Golkar leader, Aburizal Bakrie, has not yet declared his Presidential candidacy for 2014, but his decision to ally himself to opponents of a fuel subsidy cut is something of an informal declaration. Not only is the ‘scooter vote’ a key constituency for the Presidential elections in 2014, but they are an important political market for Golkar’s bid to win the Jakarta gubernatorial election from the Demokrat party incumbent in July. With President Susilo Bambang Yudhoyono’s popularity waning, Golkar believe they have everything to play for.

What this implies for the governing coalition is not promising. President Yudhoyono’s decision not to expel the Prosperous Justice Party (PKS) from the coalition despite its having voted against the subsidy cut is partly a personal instinct to support a party that is a connection to vital Muslim voters and which backed his Presidential campaign in 2009. But it is also a pragmatic insurance policy against future Golkar trouble-making. With the PKS on board, Yudhoyono has at least a chance of a majority in the Parliament without Golkar’s support. Without both Golkar and the PKS, the government loses it majority (Table 1).

This leaves the Yudhoyono government badly weakened; unable effectively to discipline the PKS and in an uncomfortable partnership with a Golkar party that will increasingly see all policy decisions through the prism of the Presidential election in 2014. The Yudhoyono coalition has provided Indonesian politics with a broad political church for the last three years. It has used that platform to push through important reforms in areas such as a land ownership law, which is key to infrastructure development. That platform is now giving way to electoral calculus and populism.

For reform in Indonesia, this suggests at least two years of potential stasis. Given the likely impact on prices and inflation, and thus on growth, a serious rise in the fuel price looks less likely the closer we get to the election. In 2005, the Indonesian government handled a large rise in the cost of fuel with a single large cash transfer to poorer households. Such a strategy remains an option for a revisiting of the subsidy later in 2012 or in 2013, but it would largely miss middle income scooter voters. For these reasons, government plans to remove the subsidy altogether by 2014 are now seriously in question.

The emerging politics of emerging economies

An important part of Indonesia’s success has been a general political consensus that has provided the foundation for reform and economic takeoff over the last decade. Indonesia's political culture and power structure is a mix of conventional (if fairly rambunctious) parliamentary politics and opaque ethnic and elite networks. These two systems have tended to work together over the last ten years to emphasise consensus building, and a model of democratic representation strong on patronage and personality and vulnerable to eruptions of corruption. The incrementalism of this system is something that has often frustrated Western observers, but which is probably inevitable in such a diverse and complex state and society.

Governing coalition		**Opposition**	
Demokrat	148	PDI- P	94
Golkar	106	Gerindra	26
PAN	46	Hanura	17
PKS	57		
PKB	28		
PPP	38	**Seats in Parliament:**	**560**

Table 1:Indonesian Parliament, seats by party, 20 April 2012.

Indonesians often talk about the period since 1998 and the fall of the Suharto regime as the Reformasi period. One key product of this period is an engaged democratic culture combined with a high level of political populism. The parallels with India are interesting and instructive. Indonesia does not have India's deficit or debt (see Global Counsel Insight *Will India's political monsoon season drown the next push for reform?* 28 November 2011) and it has not picked the kind of direct fights with inward investors that India has recently done with Vodafone. But it has the same political addiction to subsidies, the same massive infrastructure problem and a similar weakness for policy capture by political interest groups. Both have electorates intensely sensitive to even small cuts in discretionary income or rises in the costs of basic commodities.

Both also have the same exposure to the vagaries of coalition politics. There is little difference in political terms between the fiasco of reversed Indian retail sector reform in January and Indonesia's fuel subsidy troubles. Both involved power struggles not with a political opposition, but an inability to corral political allies. No version of the electoral mathematics suggests Indonesia will have anything other than another complicated coalition in 2014. Rupee and Indian equity valuations suggest international investors are drawing very different conclusions about the prospects for India and Indonesia, but their shared potential for political bottlenecking needs to be properly appreciated.

Indonesia's rise to investment grade credibility is built on a strong growth record and relative fiscal probity. In this respect it remains in a different class to India. However, the fuel subsidy is by far the biggest black mark on this record and it is proving hard to erase. For investors with exposure to Indonesia the key significance of the failure to tackle fuel subsidies lies in what it tells us about the way politics in emerging economies can act as a check on reform. At least on this issue, Reformasi looks stuck in the political traffic.

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