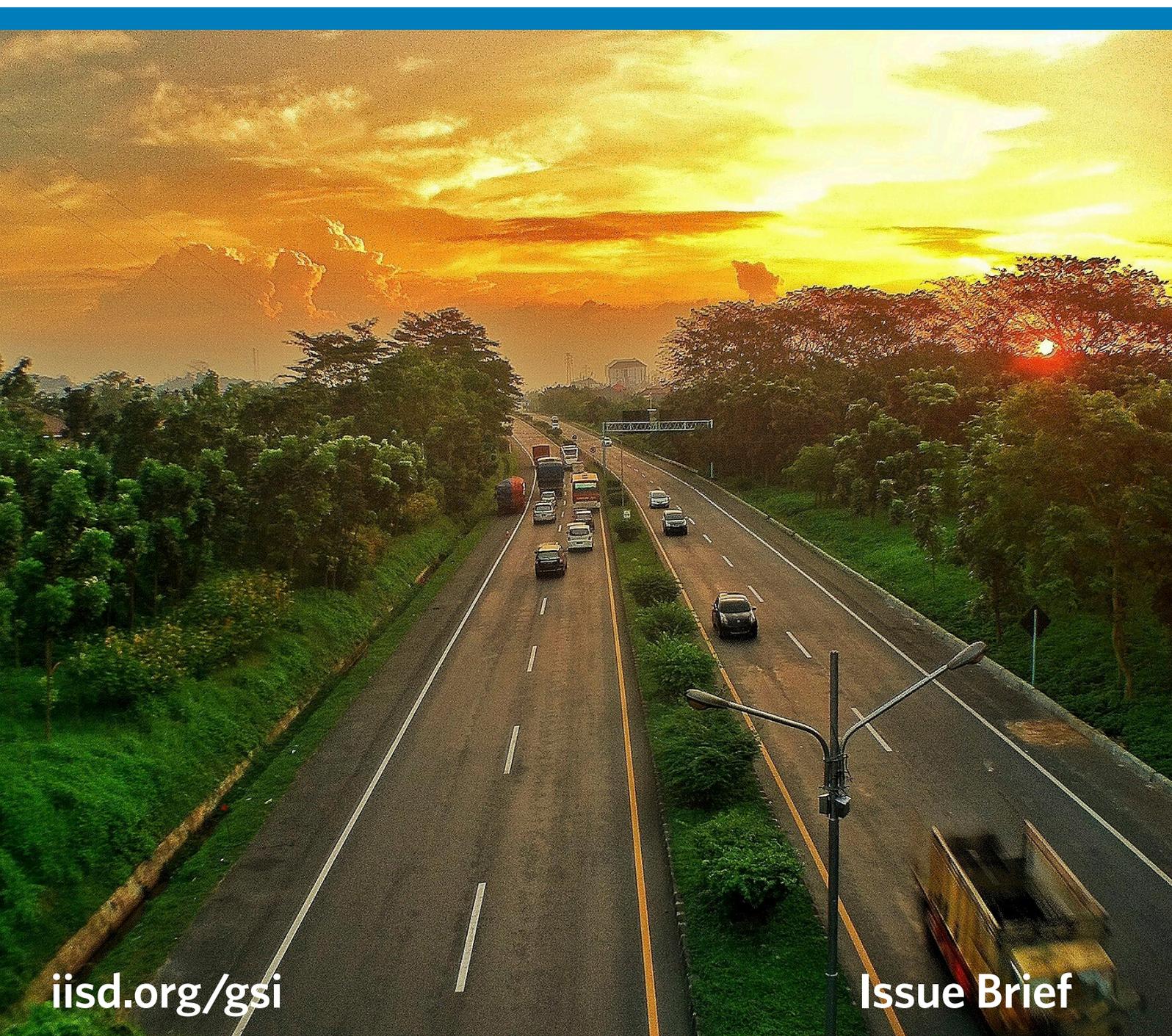


The Constitutionality of Subsidies and Legal Issues Related to Fossil-Fuel Subsidy Reform in Indonesia

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This issue brief examines the relationship between fossil-fuel subsidies and the Undang-Undang Dasar Republik Indonesia 1945 (the 1945 Constitution of Indonesia). How does the 1945 Constitution of Indonesia define “subsidy”? What does it say about the use of subsidies, and what implications does this have for changes to Indonesia’s energy subsidies, especially subsidies for gasoline and diesel? The note outlines some of the key clauses against which subsidy reforms might be held and the key differences in interpretation of how those clauses should be interpreted.



Introduction¹

As a routine, at every discussion on the *Rancangan Anggaran Pendapatan dan Belanja Negara* (RAPBN, Bill of Law on the State Budget) by the government and the *Dewan Perwakilan Rakyat* (DPR, House of Representatives) it is necessary to agree the allocation of subsidies for priority sectors, among which are energy subsidies, including subsidies for fuel, and the subsidies for other sectors, such as education and health.

The government is mandated by the 1945 Constitution to act in the interests of the welfare of the nation, but opinions can differ on how it should carry out this responsibility and the role that subsidies should play. On the one hand, the purpose of subsidies is to help the people. On the other hand, they inevitably burden the *Anggaran Pendapatan dan Belanja Negara* (APBN, the State Budget), and policy-makers often debate the efficiency and fairness of individual subsidy policies. Could the same money be used in a different way, but better? Disputes over the cost-effectiveness of state expenditure exist in all countries and are enduring.

In the past decade, Indonesian policy-makers have focused in particular on subsidies for fossil fuels, and the constitutionality of changing these subsidies is often raised. How does Indonesia's 1945 Constitution define subsidies, and what implications might it have for attempts to change or entirely remove fuel subsidy policies? This briefing note is dedicated to analyzing the constitutionality of subsidy policy within the Indonesian constitution and state administration law. Four issues are addressed. First, it reviews international definitions of a subsidy. Second, it looks at the legal and constitutional concept of "subsidy" in Indonesia, based on the visible provisions within the formal constitution and the verdicts of the Constitutional Court in constitutional adjudication. Third, it analyzes constitutional issues pertaining to the distribution of subsidy in Indonesia, particularly the fuel subsidy line. Finally, it covers the legal and constitutional concepts that could be strengthened.

What Is a Subsidy?

Subsidy is a widely used term that is challenging to define precisely and universally. In simple terms, a subsidy is government support. In *Contemporary Economics*, economists Milton H. Spencer and Orley M. Amos, Jr. (1993), define a subsidy as a payment provided by the government towards corporations or households in order to accomplish certain objectives that would enable them to produce or to consume a product in greater quantity or at a lower price.

At the international level, the World Trade Organization (WTO) defines that a subsidy exists if "there is a financial contribution by a government or any public body within the territory of a member government... [or] there is any form of income or price support" (Agreement on Subsidies and Countervailing Measures, 1994, p. 229). Moreover, it sets out four exemplary categories of what may be considered a "financial contribution," including: i) a direct transfer of funds (e.g., grants, loans) or direct transfers of liabilities (e.g., loan guarantees); ii) revenue that is foregone or not collected (e.g., tax breaks); iii) government providing or purchasing goods or services; and iv) a government making payments to a funding mechanism, or entrusting or directing a private body to carry out one of the aforementioned categories of subsidy. This definition is accepted by all 160 WTO member countries.

Other definitions also exist at the level of individual institutions. The Food and Agricultural Organization (FAO), for example, separates subsidies into four categories, as set out in Box 1. (Jakarta Post, 2015a); while it is thought to have had a chilling effect on some of the additional inflation that was predicted after the November 2014 price rises (Jakarta Post, 2015e; Jakarta Post, 2015d). The prices of other goods and services, however, have been slow to decrease as a result of declining fuel prices (see Box 1).

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BOX 1. FAO CATEGORIZATION OF SUBSIDIES

1. Direct financial transfers (investment grants, grants for safety equipment, vessel decommissioning programmes, equity infusions, income guarantee schemes, disaster relief payments, price support, direct export incentives, etc.);
2. Services and indirect transfers (investment loans on favourable terms, loan guarantees, ports and landing site facilities, payments to foreign governments to secure access to fishing grounds, government funded research and development programmes, international cooperation and negotiations, fuel tax exemptions, etc.);
3. Regulations (import quotas, direct foreign investment restrictions, environmental protection programmes, gear regulations, chemicals and drugs regulations, fisheries management, etc.); and
4. Lack of intervention (free access to fishing grounds, lack of pollution control, lack of management measures, non-implementation of existing regulations, etc.)."

Source: Cited in Westlund (2004).

In reference to the above definitions, it can be briefly concluded that a subsidy is provided by the government to help people or industries and, in terms of implementation, that it may involve both central and regional governments.

In a welfare state model, some form of subsidization is inseparable from the state's framework. Even in countries that follow a pure liberal model, subsidies exist in various ways (for example, related to health and education) that are tightly controlled and based on principles of good governance. In other words, subsidies are a fundamental tool in the structure of any state, including Indonesia.

The Legal and Constitutional Concept of "Subsidy" in Indonesia

Kamus Besar Bahasa Indonesia, KBBI (The Grand Dictionary of Bahasa Indonesia), defines "subsidy" as "support in money or other forms to foundations, associations, and so forth (commonly from the government)."

There is no regulation that explains the definition of "subsidy" in Indonesia. Each Law on the State Budget only regulates that the government should classify subsidies into two categories, i.e., energy subsidies and non-energy subsidies. The category "energy subsidies" covers subsidies for petroleum fuels, biofuels, liquefied petroleum gas (LPG) (3-kg pack), LGV and electricity. The category "non-energy subsidies" covers agricultural subsidies that include food, seed and fertilizer, as well as the Loan Interest Program Subsidy, Public Service Obligation (PSO), Tax Subsidy/DTP and other policies.

In the introductory memorandum of RAPBN of 2014 (Ministry of Finance, 2014), subsidies are described as one of the mechanisms used to implement the government's "distribution" function. The distribution function relates to the government's responsibility to create a society in which people's welfare is equal. Hence, subsidies are spent by the government to support social welfare. The State Budget Memorandum explains that subsidy expenditure is aimed at maintaining the stability of the domestic price of goods and services, providing protection to people on low incomes, increasing agricultural production and providing incentives for business and society. Moreover, subsidy expenditure is allocated for the sake of alleviating citizens' economic burdens in meeting their basic needs, and also maintaining producers' ability to produce goods, especially to supply society its basic needs at an affordable price.

The government's responsibility to ensure the people's welfare is set out in the preamble of the Indonesian 1945 Constitution, which states that it forms a government that "protects all Indonesian people and the entire land of Indonesia and to develop the welfare of the people, the life of the nation, and participate in the world orderliness based on freedom, eternal peace and social justice." Consequently, the 1945 Constitution defines strongly the ideals of the state. Reflecting the fact that Indonesia had 28.28 million poor people in 2014 (around 11.25 per cent of the total population), the government provided subsidies totalling IDR333.7 trillion (US\$25.8 billion).

In the 1945 Constitution, there are at least three concepts that confirm the significance of subsidies. First, the strong

role of the concept of human rights. From a state of being barely in existence, provisions on human rights in the Constitution became very intense after four amendments were made. There are now more than 30 kinds of rights that are acknowledged. Related to subsidies, Article 28H of the 1945 Constitution regulates that:

- (1) Everyone shall be entitled to be prosperous, reside, and obtain proper **and sound environment and medical services.**
- (2) **Everyone shall be entitled to receive facility and special treatment to obtain equal opportunity and benefits to attain equality and justice.**
- (3) Everyone shall be entitled to **social security enabling to develop themselves on the whole as dignified human being.** (Emphases added)

Such concepts may well be conceived as the state's constitutional assurance that everyone should obtain services that are the target of subsidies, such as health care. In order to fulfil its human rights assurances, it is an imperative for the Indonesian government to allocate its budget in a way that ensures that people can access and afford key goods and services.

Second, besides the human rights perspective, the Indonesian Constitution requires the state to create an economic model where state wealth is used to optimize people's prosperity. Article 33 of the 1945 Constitution is the key article to hold the sacred constitutional oath of the state to guarantee that:

1. The economy shall be prepared as joint efforts based on family principle;
2. **Production branches significant to the state and anything controlling the life of many people shall be controlled by the state;**
3. **Soil and water and natural wealth contained therein shall be controlled by the state and used for the welfare of the people to the utmost.** (Emphases added)

The Indonesian constitution embraces the concept of "economic democracy" in the form of a relation between the state and its people. As the owners of a state, people mandate the management of the state to state officers. Consequently, state officers must aim their management at the greatest benefit of the people. This concept becomes the central point supporting the statement that the state should provide its efforts purported to realize prosperity for all Indonesian people. In this regard, granting a subsidy is one effort, among others, that the state can provide to realize the prosperity of all Indonesian people.

Third, the concept of protection to specific groups, i.e. Article 34 of the 1945 Constitution states that "The indigent and abandoned children shall be raised by the state" and "The state shall develop a social security system to all people and empower the weak community and the poor in accordance with human values." This concept implies that the state has a duty to protect and provide special treatment to impoverished persons through poverty eradication programs.

The above-mentioned concepts-human rights, economic democracy and welfare and the protection of specific groups-describe how the 1945 Constitution of the Republic of Indonesia interacts with the issue of subsidies for the purpose of people's prosperity. These three concepts create two different interpretations pertaining to whom subsidies should be provided.

The first interpretation sees the Constitution as providing a legal framework for granting subsidized goods and services to all citizens. In this view, the Constitution does not limit the recipients to whom such subsidized goods and services have to be granted. The second interpretation sees that subsidized goods and services are only to be distributed to certain groups, namely the impoverished. Therefore, in this view, subsidies should only be provided to assist the poor, and the rich should not be able to receive subsidies. These two interpretations consequently influence how subsidies are distributed in Indonesia.

Verdicts reached by the Constitutional Court provide several key constitutionality corridors of interpretation in relation to the provision of subsidies in Indonesia. In several verdicts on judicial review on Law No. 22 of 2001 on Petroleum and Gas, registered as Case No 002/PUU-I/2003, the Constitutional Court provides limitations on the state's duties that must not be violated. First, the concept of "controlled by the state" in Article 33 (3) of the 1945 Constitution is a concept of public law related to the principles of people's sovereignty as regulated in the 1945 Constitution, both in politics (political democracy) and the economy (economic democracy). In the tenet of people's sovereignty, the people are acknowledged as the "source, by the people, and for the people." The meaning of "highest power" also includes public ownership by the people collectively: that the earth, water, and natural resources within the legal territory of the state basically belong to the public collectively mandated to the state for the greatest benefit of the collective prosperity.

Second, if the phrase "controlled by the state" is interpreted as ownership in private law, then it will not be adequate in utilizing the power to achieve "the welfare of the people to the utmost". However, the concept of ownership in private law should be recognized as one of the logical consequences of state control, which includes the meaning of public ownership by people's collectivity on said resources.

Third, the meaning of "controlled by the state" must be comprehended to include the meaning of a wide-ranging state occupation, as a result of the people's sovereignty concept. The people, collectively constructed by the 1945 Constitution, provide a mandate to the state to conduct policy (*beleid*) and functions of administration (*bestuurdaad*), regulation (*regelendaad*), management (*beheersdaad*) and supervision (*toezichthoudensdaad*) for the greatest prosperity of the people. The administrative function is performed by the government through its authorities to issue and revoke permit (*vergunning*), license (*licentie*) and concession (*consessie*) facilities. The regulation function (*regelendaad*) is performed through the legislative authority of the DPR with the government. The management function (*beheersdaad*) is performed through a shareholding mechanism and/or through direct involvement within the management of state-owned enterprises, or state-owned legal entities, as institutional instruments, on behalf of the government, to empower the usage or cultivation of occupied resources for the greatest prosperity of the people. As for the supervision function (*toezichthoudensdaad*), it is performed by the government on behalf of the state in the course of supervising and ensuring that the control of resources by the state is truly conducted for the greatest prosperity of Indonesian people.

By considering the concept "controlled by the state" in Article 33 (3) of the 1945 Constitution, the Constitutional Court's verdict provides limitation to paragraphs (2) and (3) of Article 28 of Law No. 20 of 2001 on Fuel and Gas regarding the pricing system, which stated that "The price of fuel oil and natural gas is surrendered to a fair and reasonable business competition mechanism" and "The implementation of the price policy as intended in Paragraph (2) does not negate the social responsibility of the Government towards specific community groups." According to the Constitutional Court's verdict, Article 28 was found to be in conflict with the Constitution. It ruled that the pricing system should involve decision making by the government because fuel is an important good that affects the lives of all Indonesians and the government must meet its social responsibility to the people, particularly towards impoverished people, though it may take into account healthy and proper business competition in order to set prices.

The other important Constitutional Court verdict is Verdict No. 43/PUU-X/2012 on the judicial review on Article 7 Sentence (6)a of the Law No. 4 of 2012 on the Amendment of Law No. 22 of 2011 on the State Budget of 2012, which regulated the government's authority to set fuel prices. Complaints were brought against a clause that allowed the government to increase subsidized fuel prices if the Indonesian Crude Price exceeded the assumed price by at least 15 per cent for six months. It was perceived that this ran in contradiction to the Court's earlier ruling that oil and gas prices should not be left to the market to determine (Sahbani & Arkyasa, 2012). The Court affirmed that the discussion between the government and the DPR to determine the price of subsidized fuel was not setting prices solely by a market mechanism or business competition, since determination of the price had been deliberated by the lawmakers. In other words, it cannot be concluded that the fuel price is only based on a market mechanism and business competition if it has been the subject of discussion during the legislative process.

In sum, based on the Constitution in Indonesia, allocating subsidy is one approach—among other possible approaches—that the state can provide to realize the prosperity of all people. Both constitutional rules and the constitutionality constructed by the Constitutional Court provide a corridor for interpretation that it is the role of a state to determine the form of subsidy in order to achieve its welfare mandate. Moreover, the constitutional provisions and constitutionality established by the Constitutional Court also leave an open interpretation regarding to whom subsidies are targeted, either to all people or only to certain groups of people.

Issues Related to Fuel Subsidy in Indonesia

In general terms, the policy of subsidy in Indonesia is aimed at maintaining the stability of goods and services, providing protection to low-income groups, improving agricultural production and providing incentives to businesses and the people.

One question that arises from this is whether the objective of subsidy distribution in Indonesia has to be set in a short-term or a long-term framework. This is a difficult question because, as mentioned earlier, discussion on subsidy policy is held annually by the government and the DPR based on the Law on State Budget. For example, in 2013, the policy on subsidized goods and services was focused on providing efficient subsidies complemented with targeting subsidies to suitable beneficiaries. The policy was therefore set by controlling the amount of energy and non-energy subsidies, and providing additional budget for non-energy subsidies with suitable beneficiaries. Meanwhile the focus of policy on subsidized goods and services in 2014 was to improve the efficiency of energy subsidies and the suitability of targeting to increase expenditure quality. It is therefore difficult to have a rigid objective for subsidy distribution in Indonesia since it can vary from year to year.

Another question that arises is fairness. In Indonesia, subsidies are typically associated with lowering the cost of goods or services in a way that is enjoyed by the rich and poor alike. In principle, it is somewhat unfair that the rich enjoy the same access to subsidies as the poor. For instance, in the area of fuel, both the rich and the poor can have the same access to fuel at a similar price, despite the fact that there is a great difference in the buying power of the two groups. By one estimate, only 1 per cent of subsidies to gasoline are enjoyed by the poorest 10 per cent of the population, while over 40 per cent of the same subsidies benefit the richest 10 per cent (Agustina, del Granado, Bulman, Fengler, & Ikhsan, 2008).

Another issue is the availability of the Indonesian budget, which has very little fiscal space. The targeted revenue of Indonesia each year is approximately IDR2 quadrillion (around US\$ 155 billion). This amount has been allocated to a number of predetermined categories such as education. According to the constitution, the budget for education must receive 20 per cent of the total amount of state budget allocations. Therefore, IDR400 trillion is allocated for education. At the same time, fuel and electricity subsidies take up around another IDR 350 to IDR400 trillion. It could be argued that the dedication of scarce fiscal resources to subsidies might compromise the government's capacity to promote the greatest welfare for the Indonesian people.

Another important and inseparable issue related to the controversy of subsidy reform in Indonesia is the legal basis for revoking fuel subsidies. Historically, the fuel subsidy has been raised and cut using presidential *beleid*, or Presidential Decree, as the legal basis. The President is elected and mandated by the people, who own the state. In consequence, the President is entitled to authorize the setting of the fuel price.

Legal complications could arise if the absolute authority of the President to increase or decrease fuel prices is questioned. A prominent interpretation says the President does not individually have the authority to raise or cut fuel prices that would greatly affect the state, since resources come from the state, belong to the state and, imported to the state, will be used by the state for the benefit of its people. The basic concept in the 1945 Constitution provides space to the President to take certain measures, yet there must be public involvement (at least through the DPR) in any decision-making process that would be imperative to the state and affect the life of the people. Furthermore,

similar arguments regarding the involvement of local governments in the provision of subsidies have appeared. The argument discusses the responsibility to ensure subsidies targeted to suitable beneficiaries, whether it is the responsibility of the central or the local government. The argument states that local governments are believed to best understand local conditions. Hence, they should be involved in the process of subsidy distribution.

In sum, there are four major issues pertaining to the subsidies and their distribution. First, the problem of determining the objective of subsidy distribution. Second, whether the targets of a subsidy should be all Indonesian people or to certain groups. Third, whether reforms to the fuel subsidy in particular could be made upon the basis of the need to enlarge fiscal space in the State Budget, or upon the relative effectiveness and efficiency of fuel subsidies in promoting the people's welfare. Fourth, the degree of government intervention required in fuel pricing mechanisms, including the degree of consultation required over fuel-price increases and the involvement of local governments.

Resolving Legal Issues Regarding the Fuel Subsidy and Distribution of Subsidies More Generally

The constitutional issues identified in this paper derive from the fact that there is no clear legal guidance on the issue of subsidies. This lack of guidance could be set out in two "blueprint" documents that are designed to provide guidance for policy-makers and lawmakers: first, a blueprint of the overall system of subsidized goods and services and all surrounding issues; and second, a blueprint for implementation equipped with strong and clear legal frameworks. The existence of such blueprints might help solve various existing problems of fuel subsidies.

In order to create such a blueprint, there would be several aspects to consider. First, a clear concept is needed of how subsidies relate to people's welfare, particularly if the concept of people's welfare should include all Indonesian people, or only certain groups. For example, this might mean that for the rich, welfare is provided by ensuring that goods and services are available, while for the poor that they are able to afford goods and services. This would make it easier to determine suitable subsidy beneficiaries.

Second, there should be clear regulation under a solid legal framework on the contents of laws pertaining to civil rights. This would include amendment and adjustment in the State Budget Act (annually passed) to maintain clauses that would enable various possible subsidies to be implemented and legally protected. These regulations will list types of subsidies, revocation or even cutback mechanisms and implementations, as well as a tightly defined list of criteria for beneficiaries. Converting subsidies into cash should be legally strengthened to avoid future controversies.

Third, there should be greater controls to ensure subsidy accountability. This might include stronger involvement of the public and local governments, alongside better practice for data collecting and reporting. The subsidy policy should be linked with the census-and ideally an integrated and complete population database-in order to obtain clear and detailed data to ensure the suitability of beneficiaries and to minimize leakage.

Fourth, there should be a firm attempt to ensure that no corruption takes place for all subsidies, including goods, services and cash. Should subsidies be converted to cash, the buildout of supporting structures and infrastructure is required. When the cash distribution is conducted through bank accounts, this choice will still require supporting structures and infrastructures to ensure direct usage, even by people in remote areas.

Fifth, having greater public involvement in fuel subsidy issues. For instance, an appropriate clause in the joint discussion of the APBN Bill between the President and the DPR. The view coming from the DPR, or in some cases local governments, can offer considerations for the President in setting the fuel price and the amount of fuel subsidy.

Summary

Fuel subsidies in Indonesia are a problem due to the absence of clear legal principles regarding the purpose of subsidies, their targeted beneficiaries and how they should be implemented. In the current form of subsidies, the 1945 Constitution basically provides a “blank cheque” with respect to subsidy mechanisms and procedures, while the Constitutional Court provides some further guidance in terms of implementing the constitutional regulations. Consequently, the issue of subsidies tends to be used by politicians as a tool for enhancing their political positions, instead of doing what is purposed, i.e., for the best interests of the Indonesian people. Some forms of legal principles become crucial, therefore, in order to implement the ideals of the 1945 Constitution: achieving a prosperous society and caring for the impoverished. Our duty now is to construct a creative and innovative blueprint in order to avoid problems and issues related to the management of subsidies.

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