

Indonesia's Fiscal Space Expansion Strategy for Infrastructure Financing

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Abstract

This study uses descriptive and explorative method to examine Indonesia's fiscal space that can be formed through more efficient expenditures and innovative financing through fiscal diamond approach. The aim of this study is as follows: 1) Optimizes material expenditure to create a larger fiscal space; 2) Identifies innovative financing schemes for infrastructure development. The results suggest that wider fiscal space can be achieved through three channels. From the revenue side, the government needs to increase tax revenue and tax ratio. On the spending, the government should pursue more efficient spending through flat and cap policy approach. Using flat and cap policy, the government can create wider fiscal space of about 0.2 – 0.3 percent of GDP. Regarding financing, creative financing such as availability payment, viability gap fund, government guarantee, Rupiah global bond, perpetual bond and asset securitization can be used by Indonesia's government for infrastructure financing. Our results suggest that Rupiah Global Bond is one of the most viable options for infrastructure financing due to its high upside potential, wider investor base and lower cost of fund.

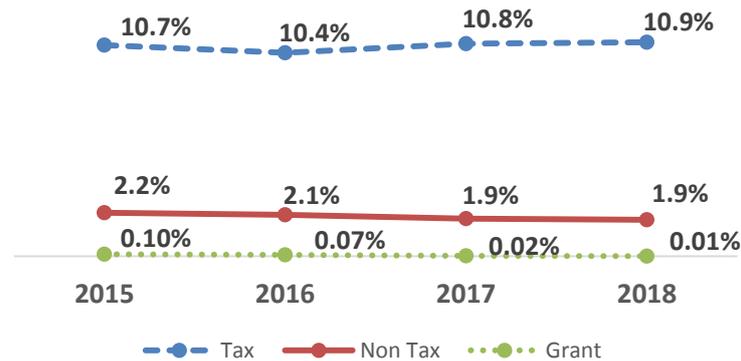
Keywords: Fiscal space, infrastructure financing, Indonesia

1. INTRODUCTION

Under the presidency of Joko Widodo, the government of Indonesia prioritizes infrastructure development to keep pace with the development goals. The government boosts the provision of public service facilities and infrastructure projects with the ultimate aim to improve country competitiveness.

In Indonesia's 2015-2019 National Medium-term Development Plan (RPJMN), the government allocates Rp4,796 trillion to support infrastructure development. Given a limited fiscal capacity (revenue-to-GDP ratio of 12.7% and tax-to-GDP 10.8% of the GDP), the government maintains to boost infrastructure projects without sacrificing medium-term macro stability. In the context financing, the government needs to provide at least 22% of total budget expenditure for infrastructure. To achieve this, the government has taken various strategies to create wider fiscal space, so that the available budget could be used more effectively and efficiently.

Graph 1: Revenue Component to GDP Ratio



Source: Ministry of Finance, data processed

Several strategies to create wider fiscal space include higher revenues and grants, more efficient expenditures, and debt and deficit managements. However, having wider fiscal space through revenue side poses some challenge. Therefore, more efficient expenditure could be used as a viable option. Also, the government may use innovative financing schemes both in short and medium-term to meet financing needs.

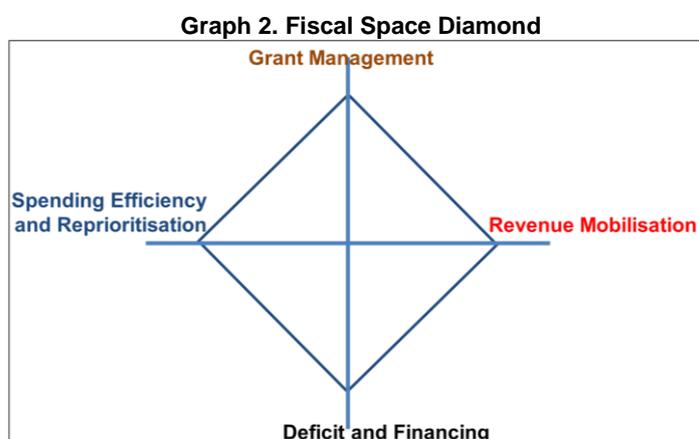
This study analyzes Indonesia's fiscal space that can be formed through more efficient expenditures and innovative financing, to achieve a manageable budget risk as mandated by the law (maximum budget deficit of no more than 3% and the debt-to-GDP ratio of less than 60%). The aim of this study is as follows: 1) Optimizes material expenditure to create a larger fiscal space; 2) Identifies innovative financing schemes for infrastructure development.

2. CONCEPTUAL FRAMEWORK

The role of the State Budget (APBN) is to improve national social welfare. To achieve this, it requires a serious commitment and effort from all stakeholders to make the APBN benefits all society. The budget should have the quality outcome, high productivity, and generate a value added for the economy. Therefore, the government should formulate prudent and appropriate policies, not only for social welfare but also for maintaining overall sustainable development.

Fiscal space defines as the accessible source of financing to the government as a result of actual policy actions for augmenting resource mobilization to materialize government objectives. It is therefore perceived as vital to look at the dynamic impact of fiscal space on growth and development to assess the sustainability of spending (UNICEF, 2014). It also describes as the amount of room a country has to increase spending (on social, infrastructure and productive sectors) to accelerate progress towards the MDGs (Action Aid, 2007). Fiscal space is a concept used to measure the flexibility of the Government in budget allocation. It does not only focus on the mobilization of domestic resources, but also alternative financing from foreign resources with the objective to have higher flexibility.

Limited fiscal space is a major challenge for government in meeting development agenda. The efforts to create a wider fiscal space can be done through four strategies: (1) Optimizes state revenue by maintaining investment and business climate; (2) Improves the quality of state expenditure through more targetted programs and more efficient infrastructure expenditure; (3) Maintains budget deficit at a safe level (of less than 3% of the GDP); and (4) A controlled debt-to GDP ratio within a manageable limit (of less than 60% of the GDP). These strategies are also known as a fiscal space diamond approach (Roy et al., 2007).



Source: Roy.Et.al (2007)

The government reinforces the APBN by balancing revenues, expenditures, and financings. The way for a government to generate income is by targetting domestic revenue mobilization. However, it is also commonly believed that disproportionate rises in tax rates, particularly for the limited number of people (middle-income group) and sector-based entities can be unfavorable for the future investment climate as well as the overall economy (Gale et al., 2014).

More importantly, the government should pursue a better quality of spending; therefore the APBN will be more effective in stimulating the economy. To support the improvement of the quality of spending, good policy design is thus required. More efficient budget allocation is critical to financing productive activities that can provide value-added and extensive benefits for the society. It has to have a strong forward and backward linkage for the economy as well. The right allocation to specific sectors that have high multiplier effects to economy is thus critical.

A limited fiscal space in the APBN could be due to inefficient expenditure allocation and discretionary expenditure rules, for instance, subsidy, personnel expenditure, operational expenditure, debt interest payment and transfer to regions. A less efficient line ministries (K/L) expenditure could be attributed to significant allocation in the material expenditure as opposed to capital expenditure that has more productive and has a more significant multiplier impact. Material expenditure is around 2% of the GDP in the last five years and currently remains the most significant expenditure allocation in the APBN compared with other spendings. On the other hand, capital expenditure is about 1.6% of the GDP with the persistent downward trend.

Through these steps, the government expects the APBN to be managed efficiently and effectively, and the effort to improve state revenues, expenditures and financing should also be continuously taken. Through more efficient and prudent fiscal policies, the government will achieve fiscal sustainability, while increasing country competitiveness and economic resilience.

However, several prior research suggests that fiscal space is challenging to be implemented. IMF (2016) finds that most countries fiscal space are directed by some notion of debt sustainability, defined as the difference between the current level of public debt and some specified threshold. The threshold is determined, by future fiscal balance adjustments needed to ensure debt sustainability (e.g., to stabilize the debt over the medium/long term), inherent vulnerability to economic shocks (usually proxied by income levels), as well as the realism of the needed adjustments based on the country's track record. In

other contexts, fiscal space is formulated concerning the scope for financing the deficit, without incurring a sharp spike in funding costs or excessive crowding-out of private investment. Practically speaking, fiscal space is difficult to pin down purely through a mechanical rule or threshold and judgment is required based on analysis of a variety of metrics, as debt sustainability thresholds, likely shocks, and economic institutions differ from country to country.

Given those challenges, the government aims to create wider fiscal space by optimizing revenues and more efficient spending that geared towards more productive activities such as infrastructure development. Through these steps, it is hoped that the government could boost higher economic growth, more job opportunities, lower poverty and better social welfare.

3. DISCUSSION OF RESULTS

3.1 Current Situation

The budget allocation for infrastructure and social protection has been increasing in the past few years. However, it is not followed by increased state revenues. Although the government maintains budget deficit and debt-to-GDP at a manageable level, a limited state revenue generation is a significant impediment for the government.

Table 1. 2014 - 2018 State Budget

ITEMS (IDR Trillion)		2014 Realized Budget	2015 Realized Budget	2016 Realized Budget	2017 Revised Budget	2018 APBN
A.	Revenue and Grant	1,550.5	1,508.0	1,555.9	1,736.1	1,894.7
I.	Domestic Revenue	1,545.5	1,496.0	1,546.9	1,733.0	1,893.5
1.	Taxation	1,146.9	1,240.4	1,285.0	1,472.7	1,618.1
2.	Non Taxation	398.6	255.6	262.0	260.2	275.4
II.	Grant	5.0	12.0	9.0	3.1	1.2
B.	Expenditure	1,777.2	1,806.5	1,864.3	2,133.3	2,220.7
I.	Central Govt. Expenditure	1,203.6	1,183.3	1,154.0	1,367.0	1,454.5
	Line Ministries	577.2	732.1	684.2	798.6	847.4
	Non Line Ministries	626.4	451.2	469.8	568.4	607.1
II.	Regional Transfer and Village Fund	573.7	623.1	710.3	766.3	766.2
C.	Primary Balance	(93.3)	(142.5)	(125.6)	(178.0)	(87.3)
D.	Surplus/Defisit	(226.7)	(298.5)	(308.3)	(397.2)	(325.9)
	% to GDP	(2.2)	(2.6)	(2.5)	(2.9)	(2.2)
E.	Financing	248.9	323.1	334.5	397.2	325.9
I.	Debt	255.7	380.9	403.0	461.3	399.2
II.	Investment	(8.9)	(59.7)	(90.8)	(59.7)	(65.7)
III.	Lending	2.5	1.5	3.3	(3.7)	(6.7)
IV.	Guarantee	(1.0)	0.0	(0.7)	(1.0)	(1.1)
V.	Other	0.5	0.3	19.6	0.3	0.2
	Residual	22.2	24.6	26.2	0.0	0.0

Source: Ministry of Finance, processed data

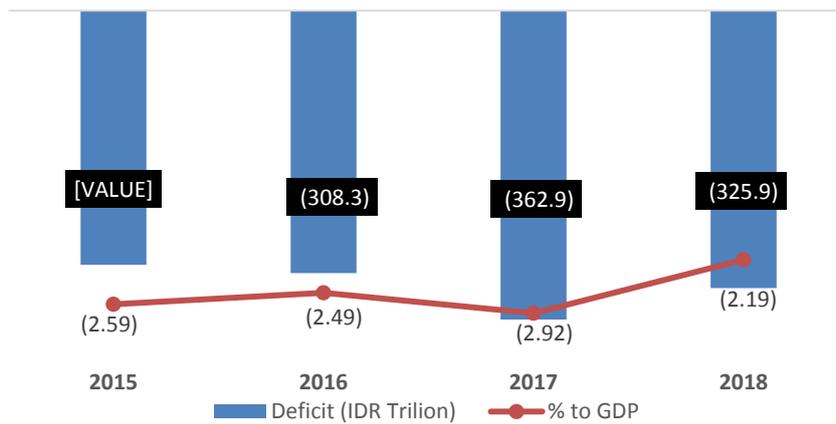
To optimize the role of the APBN in stimulating the economy and creating social welfare, the Government adopts expansive fiscal policies in 2017. In 2017 APBN-revised, the Government and the Parlement agree to set the budget deficit at 2.92% of the GDP or about Rp397.2 trillion. However, with more efficient expenditure policies, the realization of the budget deficit is much lower at 2.57% of the GDP or nearly Rp362.9 trillion.

The Government takes efforts to control budget deficit by maintaining a low primary balance and manageable level of debt-to-GDP ratio. This is a part of the government strategy to support fiscal sustainability in short and medium terms. With regards to state revenues, the tax revenues remain the most significant contributor given a prolonged global economic uncertainty, geopolitical issues, overprotection, Chinese economy rebalancing and EU post-Brexit.

Regarding fiscal management, the government should increase tax revenues, especially from non-oil and gas revenues to maintain budget deficit within the safe limit. Along with the tax revenue efforts, the efficiency of expenditure should also be improved in particular central government expenditure, transfer to regions and village funds. The budget deficit in 2017 is expected to fulfill the government budget outlook of 2.67% of the GDP.

To maintain the budget deficit of less than 3%, the government implements various austerity measures specifically for material expenditure. The government releases Presidential Instruction (Inpres) Number 4 of 2017 to increase the budget efficiency on material expenditure for all line ministries. The material expenditure includes government official travels, meeting packages, honorarium, office expense, service expense, maintenance expenditure, and other operational and nonoperational material expenditures. The line ministries are expected to reduce material expenditures up to Rp 16 trillion in the Fiscal Year 2017, and they are also required to identify material expenditure for every programs and activity while ensuring the budget saved are not disbursed (self-blocking). In Q3/2017, the realization of material expenditure reaches 69.46% and is projected to reach 94.6% at the end of 2017.

Graph 3. Development of Budget Deficit



Source: Ministry of Finance, processed data

In 2018, state revenues are projected to reach Rp1.894.7 trillion. This amount consists of tax revenues (Rp1.618.1 trillion); and Non-Tax State Revenue (PNBP) which amounts to Rp275.4 trillion; and grant revenues of Rp1.2 trillion. To meet this target, the Government continuously carry on tax reform. This is done through several strategies, such as Automatic Exchange of Information (AEoI) and tax erosion prevention through the transfer of profit (Base Erosion Profit Shifting). In the PNBP, the government optimizes oil and gas revenues, separated state assets and Public Service Agencies (BLU) revenues. The view of state expenditures, total state expenditure in 2018 is about Rp2.220.7 trillion. This amount includes central government expenditure of about Rp1.454.5 trillion and transfer to regions and village funds of about Rp766.2 trillion. The budget deficit in 2018 is expected to stay below 3 percent or about Rp325,9 trillion (2.19 percent of the GDP) and much lower than the 2017 Revised State Budget which is 2.67 percent of the GDP. Concerning infrastructure financing, considering partial infrastructure development progress, the budget allocation for infrastructure is expected to be at Rp388,2 trillion in 2018 (AIPEG, 2017). There are currently 13 projects being implemented and four projects being auctioned.

3.2. The Efficiency of Material Expenditure

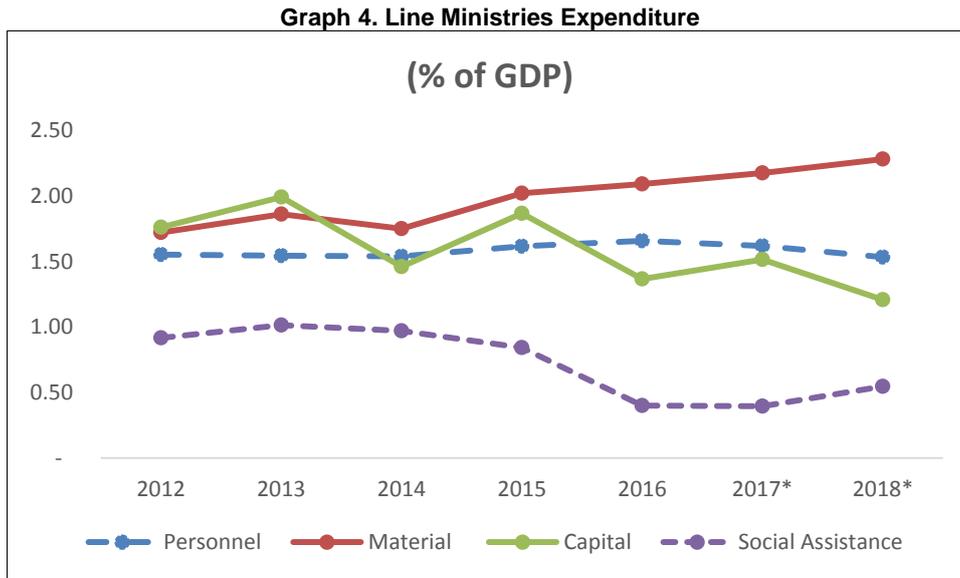
Using fiscal diamond approach, there are several strategies that can be taken to increase wider fiscal space in the APBN including redesigning state revenues, expenditures, financing and budget deficit. State revenues itself have several main components, i.e., tax revenue, non-tax state revenue (PNBP), and grant. The grant is not depended on the revenues, so fiscal space expansion strategy can only be performed on the tax revenues and PNBP.

In the past years, Indonesia’s tax ratio is about 9-11% of the GDP, while in 2018 APBN the tax ratio is expected to achieve 10.8% of the GDP. To increase fiscal space in the APBN, the Government has taken several policies including tax holiday (2008-2009) and tax amnesty (2016-2017). The short-term tax amnesty program has been successfully increased state revenues by about Rp150 trillion or about 1% of the GDP. In the long term, supported by AEOI (Automatic Exchange of Information) with foreign tax authorities, higher tax compliance and wider tax bases, it can contribute positively to Indonesia’s fiscal space expansion strategy.

Looking at the latest development of the state revenues, tax amnesty has not been able to increase Indonesia’s tax ratio. After the completion of tax amnesty program in 2017, the tax revenue has a tax shortfall of about Rp100 trillion. In other words, the impact of tax amnesty on increased state revenue is only temporary. The “stick and carrot strategy” is suboptimal, as there is no deterrent effect on tax avoiders. Other challenges to increase tax ratio is the shifting of corporate strategy from offline to online business, reducing the collection of traditional tax revenues. The government is also in the discussion to amend the tax law to facilitate rapid changes in the business tax practices.

The nontax revenue (PNBP)-to-GDP is merely 1-2% of the GDP with the primary source revenues from the commodity (oil, gas, and minerals), SOE and BLU profits. Most of the PNBP revenues are determined by global commodity prices. With limited domestic production and lower commodity prices, PNBP revenues should be boosted using other sources of revenues, such as BLU revenues from State Asset Management Agency (LMAN) or through tariffs adjustment. The revenues from LMAN and tariff adjustment may be very small or less than Rp1 trillion in the short-term, but the government is very optimistic to increase revenues from those sources in the medium and long-term.

In recent years, it is interesting to note that material expenditure allocation has been higher than other expenditure (capital, social protection, and personnel expense). The material expenditure has been consistently increased every year both in nominal term or as a ratio of the GDP amidst a limited state budget. For example, in 2018 material expenditure is about 2.28% of the GDP or twice the amount of capital expenditure (1.21% of the GDP).



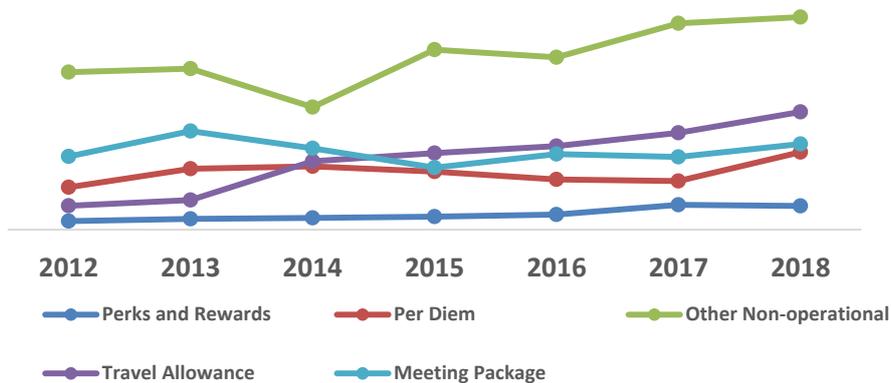
Source: Ministry of Finance, processed data

Material expenditures can be considered as a consumption expense. They are consumed in one fiscal year and also not increase government assets (except for material expenditure handed to the local governments). To improve budget efficiency, the government has released Presidential Instruction Number 8 of 2016 and Presidential Instruction Number 4 of 2017. The multiplier effect of the material expenditure also tends to be smaller than capital spending. As the ratio of capital expenditure to the GDP ratio tends to lower in recent years, the government is boosting infrastructure budget allocation to meet considerable infrastructure demands.

The structure and composition of material expenditure in the APBN have shifted in recent years. The proportion of material expenditure handed to the local governments has increased 16% in 2018 compared with 2013 (6%) due to the reclassification of social protection, and BLU expenditure has risen to 11% due to the establishment of new agencies. The operational spending, however, remains low due to flat policy.

While the government encourages an increase in more productive expenditures such as infrastructure, material expenditures persist to increase. However, there is no regulation or clear indicator in place to determine the maximum level or threshold in material expenditure increase. This is the main challenge government has to face.

Graph 5. Graph Expenditure Per Type of Spending



Sumber: Ministry of Finance, processed data

In material expenditure, some components are less productive, but they keep increasing. They are 1) Perks and Rewards; (b) Per diem; (c) Other nonoperational spending; (d) Travel allowance; and (e) meeting package. The growth of Perks and Rewards remains high in 2017 at about 64.7% (y.o.y), but it is expected to be much lower in 2018 with negative growth of 4.6%. The per diem has a negative growth in 2017 by -3.1% (y.o.y) but increases significantly by 59.4% in 2018. The allocation of other nonoperational spending has high growth in 2017 at 19.8% (y.o.y) and grows in 2018 by 3% (y.o.y). The

travel allowance also consistently increases in the last five years, with the highest growth recorded in 2014. In 2017, the travel allowance increases by 15.8% (y.o.y) and continues to increase in 2018 by 21.7% (y.o.y). In 2017, the meeting package grows by 2.2% (y.o.y), and in 2018 it increases dramatically by 30.2%. These components need to be efficiently allocated, and the government should have policy instruments in place to control the excessive growth of those expenditures to support more productive and quality spendings. This study investigates the efficiency of material expenditure using flat and cap policy approach for all spending with the objective to create wider fiscal space in 2018.

The flat policy is a policy approach to limit the increase of material expenditure align with the inflation growth. This study adopts the flat policy for material expenditure by using the inflation rate of 3.5% (2018); therefore the growth of material spending for all line ministries should be uniformly leveled at 3.5%. Using flat policy, the government has generated wider fiscal space of Rp 34.8 trillion through more efficient material expenditure or about 0.23% of the GDP. With the cap policy, this approach suggests all line ministries adopt budget allocation as the same level as the previous year. Using this approach, the government yields Rp 42.7 trillion wider fiscal space in 2018 that equals to 0.29% of the GDP.

Table 2. The Flat and Cap Policy

Items (IDR Trillion)	Revised Budget	APBN	Flat Policy (3.5%)	Cap Policy
	2017	2018	2018 - A	2018 - B
Operational	37.10	39.74	38.40	37.10
Non-operational	60.65	76.21	62.77	60.65
Service	32.27	34.44	33.40	32.27
maintenance	37.04	35.86	35.86	37.04
Travel	33.58	40.66	34.75	33.58
BLU	34.00	38.27	35.19	34.00
Referred to Local/community	45.58	55.10	47.18	45.58
Others	15.97	18.56	16.53	15.97
Total	296.19	338.83	304.08	296.19

Source: Ministry of Finance, processed data

Shifting the fiscal burden to the SOEs and BLUs is another option to create wider fiscal space in the APBN. To achieve this, the government provides state capital participation (PMN) for the SOEs with the aim to increase their financial capacity and leverage. The total PMN provided by the government within the period 2015-2017 is about Rp120 trillion, reducing fiscal burden for infrastructure financing. However, this PMN is not well spent in the first year and mostly in the form of idle cash. As a result, many infrastructure developments may be delayed.

3.3 Infrastructure Financing Options

The government utilizes several options for infrastructure financing including Availability Payment (AP), Viability Gap Fund (VGF), government guarantee, bond issuance and asset securitization.

3.3.1 Availability Payment (AP)

The AP is a part of the PPP scheme, and it is a payment disbursed by the government to the executing agencies for the provision of infrastructure projects. The AP includes capital expenditure, operational expenditure, and investment return rate, but it does not cover promotional cost and cost of managing service revenue. Regarding payment, the AP is only paid by the government during operational period and no payment made to the executing agencies during the construction period.

To support the AP scheme, the government releases Presidential Decree Number 38 of 2015 on Public Private Partnership for Infrastructure Provision and Minister of Finance Decree PMK No. 260/PMK.08/2016 on Payment Procedure for Public-Private Partnership Projects. The source of revenues of the AP is derived from the APBN and local budget (APBD). As the AP fund has to be allocated as the mandatory spending for certain periods in the APBN, this is one of the significant challenges the government has to tackle given limited fiscal capacity. When more infrastructure projects are using the AP scheme, the government needs to allocate more fund in the APBN. Therefore, there should be a maximum limit of the AP installment each year to maintain country's fiscal sustainability. The AP scheme has been piloted for Eastern Sumatra Highway with the project Value of Rp20 trillion and Trans Papua Road with the project Value Rp16 trillion. The AP scheme has been well administered and one of the most feasible options among others for infrastructure financing.

3.3.2 Viability Gap Fund (VGF)

The VGF is government support given in cash to PPP projects that already economically viable but has not had financial feasibility. It can be given when there is no other alternative to make the PPP projects financially feasible. Local Government can also contribute to the provision of this support after obtaining the approval of Local Parliament. With the VGF, feasibility support is given for the PPP projects up to 49% of the construction cost, and it is provided through the APBN in the form of cash payment.

The underlying philosophies of the VGF are:

- To enhance financial feasibility of the PPP projects and raise interest and participation from the private sectors to the Cooperation Project.
- To lower service tariff provided by the PPP projects.

To support the VGF implementation, the government releases Minister of Finance decree No. PMK 223/PMK.011/2012 on the government feasibility support for the PPP projects; and Minister of Finance Decree NO. PMK 143/PMK.011/2013 on the guideline for feasibility Support for the PPP projects. The PPP projects that have received the VGF support includes the Umbulan Drinking Water Supply System and Bandar Lampung Drinking Water Supply System.

3.3.3 Government Guarantees

Given limited fiscal capacity, infrastructure provisions through PPPs and SOEs have been used by the government for infrastructure financing. The government needs to strengthen SOEs financial resources by providing state capital participation (PMN) and government guarantees for SOEs loans.

The government guarantees aim to provide the incentive for the private sectors to take part in government infrastructure projects, as this may reduce project risks. In 2018, the government allocates project guarantee of about Rp1.13 trillion that includes the guarantee for coal-fired power plants (Rp299 billion); water utilities (Rp1.1 billion); PPP guarantees (Rp392 billion); and Sumatra Highway project (Rp284.7 billion).

3.3.4 Rupiah Global Bond

Indonesia's Rupiah global bond refers to the Masala Bond that has been previously issued globally (offshore) by the International Finance Corporation for infrastructure development in India. The Masala Bond is first issued in 2013 using local currency denomination (Rupee) with short-term tenors of 3, 5, and 7 years. The total issuance of the Masala Bond is about 62 billion Rupee or equal to USD1 billion. Until recently, the Masala Bond has issued USD 3.6 billion across the world. Another global bond is Dim Sum Bond issued by China Development Bank and the Chinese government in local Yuan denomination with a value amounting. Published by China Development Bank (CDB and some Chinese companies with the value amounting to USD37 billion. As an alternative source of financing, this instrument has large upside potential. Indonesia bond currently has a credit rating of BBB with stable outlook making Rupiah Global Bond is a financing option with the lower cost of fund.

Indonesian Government with the Asian Development Bank (ADB) have issued Rupiah Bond in the international market (IDR-Linked Bond) with domestic currency denomination with the value amounting to Rp1 trillion and 11 years tenor. The bond yield is 6.60%, within 30 bps margin higher than government bond (SUN) with the similar tenor. The Jasa Marga, Indonesia infrastructure SOE, has also issued Komodo Bond with the value Rp4 trillion. The global bond instrument has a great benefit to reduce currency mismatch risk, but other risks such as domestic inflation should also be considered. Higher domestic inflation may increase the global bond yield, resulting in a higher cost of financing.

3.3.5 Perpetual Bond

Perpetual bond (PB) is debt with no maturity date with the coupon payment paid in perpetuity. The PB usually has some modifications or special additional features, including call option from the publisher after 5 or 10 years. The PB can be issued by the government or private sectors. For example, US and UK have issued perpetual bond; and from the private sector. Total Energy and Volkswagen issued PB valuing at USD5.7 billion and USD2.6 billion respectively. With large potential upside, the PB can be used as an alternative for infrastructure financing to meet development needs. Some challenges of implementing the PB are mainly on the legal aspect and accounting recording treatment. For example, the bond is treated as debt in accounting, while the stock is treated as equity. The PB has both features.

3.3.6 Asset Securitization

Asset securitization is another option for infrastructure financing. The asset securitization is the long-term bond issuance guaranteed by some underlying assets. This asset securitization in Indonesia has huge upside potential with potential collection up to Rp157 Trillion. This financing option, however, is not yet optimal given some regulatory challenges in particular with tax, accounting treatment, and legal aspect.

4. CONCLUSION

This study uses descriptive and explorative method to examine Indonesia's fiscal space that can be formed through more efficient expenditures and innovative financing through fiscal diamond approach. The aim of this study is as follows: 1) Optimizes material expenditure to create a larger fiscal space; 2) Identifies innovative financing schemes for infrastructure development. The results suggest that wider fiscal space can be achieved through three channels. From the revenue side, the government needs to increase tax revenue and tax ratio. On the spending, the government should pursue more efficient spending through flat and cap policy approach. Using flat and cap policy, the government can create wider fiscal space of about 0.2 – 0.3 percent of GDP. Regarding financing, creative financing such as availability payment, viability gap fund, government guarantee, Rupiah global bond, perpetual bond and asset securitization can be used by Indonesia's government for infrastructure financing. Our results suggest that Rupiah Global Bond is one of the most viable options for infrastructure financing due to its high upside potential, wider investor base and lower cost of fund.

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