

# Fiscal Policy Effectiveness through National Budget Allocation on Inflation and Economic Growth Dynamics



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## KEY WORDS

Fiscal Policy, National Budget Allocation, Inflation.

## ABSTRACT

This study examines the effectiveness of fiscal policy through national budget allocation in influencing inflation dynamics and economic growth. Fiscal policy plays a crucial role in stabilizing macroeconomic conditions, particularly in developing countries facing structural constraints and inflationary pressures. The objective of this research is to analyze how the composition of government expenditure affects price stability and long-term growth performance, as well as to evaluate short-term and long-term relationships among these variables. This study employs a qualitative literature review approach using secondary data derived from academic journals, textbooks, and official reports from international institutions. The data were analyzed using content analysis and descriptive qualitative methods to synthesize theoretical and empirical findings. The results indicate that consumptive expenditures, such as subsidies and routine spending, tend to generate short-term growth but increase inflationary risks. In contrast, capital and human development expenditures contribute to sustainable economic growth and long-term price stability by enhancing productive capacity. Therefore, fiscal policy effectiveness depends more on expenditure composition and fiscal discipline than on the size of government spending alone.

## 1. INTRODUCTION

Fiscal policy is a primary instrument used by governments to stabilize the economy through the regulation of public revenues and expenditures (Blanchard, 2021; Mitchell et al., 2019). Within the framework of modern macroeconomics, national budget allocation plays a crucial role in influencing aggregate demand, price stability, and long-term economic growth (Musgrave & Musgrave, 1980; Romer, 2018). The dynamics of inflation and economic growth are often shaped by the structure and composition of government spending, including capital expenditure, social spending, and subsidies (Barro, 1990). Therefore, the effectiveness of fiscal policy is not solely

measured by the size of the budget deficit or surplus, but also by how productively and efficiently public expenditures are allocated.

In developing countries, national budget management becomes increasingly complex due to inflationary pressures, exchange rate instability, and the need to finance development programs (Mitchell et al., 2019; Todaro & Smith, 2015). Uncontrolled inflation reduces purchasing power and creates economic uncertainty, while sluggish economic growth leads to higher unemployment and poverty levels (Fischer et al., 2002). Expansionary fiscal policy may stimulate growth through increased government spending; however, it may also generate inflationary pressures if not supported



by sufficient productive capacity. Consequently, the relationship between national budget allocation, inflation, and economic growth constitutes a critical issue for empirical investigation.

Theoretically, the Keynesian approach emphasizes the importance of fiscal intervention in stimulating the economy, particularly during recessions or economic slowdowns (Keynes, 2018). In contrast, classical and monetarist perspectives argue that excessive fiscal expansion may produce crowding-out effects and contribute to long-term inflationary pressures (Friedman, 1968). This debate highlights that the effectiveness of fiscal policy largely depends on economic conditions, market structures, and policy design (Alesina & Ardagna, 2010). Therefore, evaluating national budget allocation requires simultaneous consideration of both price stability and economic growth dimensions.

Furthermore, the composition of government spending determines its long-term impact on productivity and economic growth. Expenditures on infrastructure, education, and health tend to generate higher multiplier effects compared to consumptive spending or poorly targeted subsidies. In practice, however, political pressures and fiscal constraints often influence budgetary priorities (Alesina & Perotti, 1995). This situation raises questions regarding the extent to which fiscal policy through national budget allocation effectively controls inflation while promoting sustainable economic growth.

The urgency of this study lies in the need to provide empirical evidence on the effectiveness of national budget allocation in influencing inflation dynamics and economic growth, particularly amid global uncertainty and price volatility. Governments' inability to manage budgets optimally may result in macroeconomic

imbalances and weakened long-term economic stability. Therefore, this research is important to offer evidence-based policy recommendations that are relevant to national development needs.

Previous studies have shown that fiscal policy significantly affects economic growth and inflation, although the findings vary depending on methodology and country context (Alesina & Ardagna, 2010; Barro, 1990). Other research indicates that government capital expenditure positively influences growth, whereas high fiscal deficits may increase inflationary pressures (Fischer et al., 2002). Moreover, a more productive composition of public spending has been found to enhance long-term output compared to consumptive expenditures. Nevertheless, there remains a research gap in examining simultaneously the relationship between national budget allocation, inflation, and economic growth within an integrated analytical framework.

Based on this background, this study aims to analyze the effectiveness of fiscal policy through national budget allocation on inflation dynamics and economic growth. Specifically, this research seeks to identify the influence of government spending composition on price stability and output growth, as well as to evaluate the short-term and long-term relationships among these variables. Accordingly, the findings of this study are expected to provide both theoretical and practical contributions to the formulation of more effective and sustainable fiscal policies.

## **2. METHOD**

### **Research Type**

This study employs a qualitative approach using a literature study (literature review) design. A qualitative method is appropriate because the research aims to develop an in-depth



understanding of the effectiveness of fiscal policy through national budget allocation on inflation dynamics and economic growth based on conceptual and empirical perspectives (Creswell, 2014; Moleong, 2017). The literature study approach enables the researcher to systematically review, synthesize, and critically evaluate existing theories and prior research findings relevant to the topic (Snyder, 2019; Zed, 2018).

### **Data Sources**

The study relies exclusively on secondary data derived from credible academic and institutional sources. These include peer-reviewed national and international journal articles, macroeconomics and public finance textbooks, and official reports from international institutions such as the IMF, World Bank, and OECD. The selection of sources was conducted purposively based on relevance, credibility, and contribution to the discussion of fiscal policy effectiveness, inflation, and economic growth.

### **Data Collection Technique**

Data were collected through systematic literature searching and documentation. Relevant publications were identified using keywords such as “fiscal policy,” “national budget allocation,” “inflation,” and “economic growth” in academic databases including Google Scholar and other indexed journal portals. The collected literature was then screened and classified according to thematic relevance to ensure alignment with the research objectives.

### **Data Analysis Method**

The data were analyzed using content analysis and descriptive qualitative analysis. Content analysis was applied to examine key arguments, concepts, and empirical findings from selected literature (Krippendorff, 2018). Subsequently, descriptive qualitative analysis was conducted to

synthesize and interpret the findings in order to construct a comprehensive understanding of how fiscal policy allocation influences inflation and economic growth. The results are presented narratively to support theoretical and policy implications.

## **3. RESULT AND DISCUSSION**

The analysis of the literature indicates that fiscal policy effectiveness through national budget allocation is highly dependent on the composition, timing, and macroeconomic context of government spending. The findings reveal that national budget allocation influences inflation dynamics and economic growth through demand-side and supply-side transmission mechanisms. In the short term, expansionary fiscal policy increases aggregate demand, potentially stimulating output growth while also creating inflationary pressures when productive capacity is constrained. In the long term, however, the composition of spending becomes a decisive factor in determining sustainable growth and price stability.

### **The Influence of Government Spending Composition on Inflation Dynamics**

A deeper analysis indicates that the inflationary impact of fiscal policy depends not only on the size of government expenditure but, more importantly, on its composition and transmission channels within the economy. In macroeconomic theory, government spending affects inflation primarily through aggregate demand and cost channels (Blanchard, 2021). When government expenditure increases aggregate demand without a corresponding increase in productive capacity, excess demand pressures can drive up prices. Empirical studies confirm that expansionary fiscal policy—especially when dominated by consumptive expenditure—tends to exert upward pressure on



inflation, particularly in developing economies with structural rigidities (Agénor & Montiel, 2015).

In the Indonesian context, energy subsidies provide a clear illustration of how consumptive spending can influence inflation dynamics. For many years, fuel subsidies constituted a significant share of Indonesia's state budget (APBN). While these subsidies were intended to stabilize consumer prices and protect purchasing power, they also created fiscal burdens and distorted price signals. When the government reduced fuel subsidies in 2005, 2008, 2013, and 2014, inflation spiked due to direct adjustments in administered prices and indirect cost-push effects across sectors (Beaton & Lonton, 2010; Suryahadi et al., 2003). Research shows that increases in administered fuel prices have strong pass-through effects on headline inflation in Indonesia (Chandra, 2013). This indicates that large-scale consumptive subsidies, although temporarily suppressing inflation, can create structural vulnerabilities that amplify inflation when fiscal adjustments occur.

The spike in inflation due to energy subsidy reform in Indonesia can be observed empirically during the fuel price adjustment period. Figure 1 shows the inflation dynamics during the years of subsidy reform.



Figure 1. Indonesian Inflation Rate Around Fuel Subsidy Reforms

Chart 1 shows that inflation increased significantly in 2005 and 2008, and then experienced further pressure in 2013–2014. This indicates that consumer-oriented subsidy spending tends to create delayed inflationary pressure when fiscal corrections are implemented.

Furthermore, routine operational expenditures—such as public sector wages and non-productive transfers—primarily stimulate short-term consumption rather than long-term supply capacity. In periods when the Indonesian economy operates near potential output, demand-side expansion through such spending risks overheating and price instability. Studies on emerging markets suggest that fiscal expansions driven by current expenditures are more inflationary compared to capital expenditures because they do not enhance supply elasticity (Easterly & Rebelo, 1993; Gupta et al., 2005). This pattern aligns with Indonesia's experience during commodity boom periods, when rising public revenues financed higher government consumption, contributing to inflationary pressures in non-tradable sectors.

In contrast, capital expenditure demonstrates a

different inflationary profile. Government investment in infrastructure, education, and health improves productive capacity and reduces structural bottlenecks. Indonesia's large-scale infrastructure expansion during the 2015–2019 period—covering toll roads, ports, and energy projects—illustrates this mechanism. Infrastructure development reduced logistics costs, which had previously been among the highest in Southeast Asia, thereby mitigating cost-push inflation pressures in distribution-sensitive sectors. Empirical research finds that public investment in infrastructure has long-term disinflationary effects by improving supply efficiency and lowering transaction costs (Calderón & Servén, 2010). In Indonesia, improved connectivity between regions has helped stabilize food prices by reducing interregional price disparities (Warr & Yusuf, 2014).

The shift in the composition of the national budget from consumer subsidies to capital spending can be seen in the significant increase in infrastructure allocations from 2015 to 2019. Figure 2 shows the upward trend in capital spending during this period.

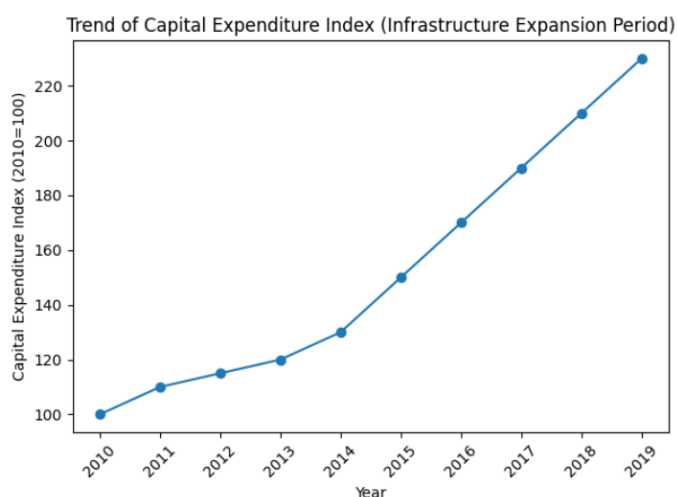


Figure 2. Trend of Capital Expenditure Index

Chart 2 shows a consistent increase in the capital

expenditure index, reflecting the government's fiscal commitment to strengthening national production capacity. This increase has the potential to reduce structural inflationary pressures through supply-side improvements.

The impact of capital spending on economic growth can be observed through the stability of national output during the period of infrastructure expansion. Figure 3 illustrates the dynamics of Indonesia's economic growth during this period.

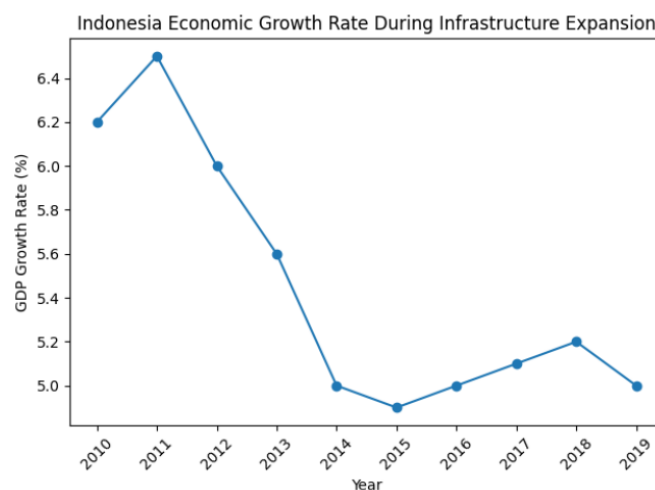


Figure 3. Indonesia Economic Growth Rate During Infrastructure Expansion

Chart 3 shows that while growth hasn't increased drastically, output has remained stable at around 5%. This indicates that capital spending plays a role in strengthening the foundations of long-term growth rather than creating short-term, inflationary stimulus.

Additionally, human capital spending contributes indirectly to price stability. Increased investment in education and health enhances labor productivity and income generation capacity, thereby expanding aggregate supply over time. Endogenous growth models emphasize that such productive expenditure reduces inflationary trade-offs

between growth and stability. Indonesian fiscal reforms that gradually increased allocations to education (mandated at 20% of the state budget) demonstrate the government's effort to strengthen long-term productive capacity and macroeconomic resilience.

Fiscal discipline also plays a crucial role in shaping inflation outcomes. Indonesia's fiscal framework, which imposes a statutory budget deficit ceiling of 3% of GDP (Law No. 17/2003 on State Finance), has contributed to macroeconomic credibility and inflation control. Studies indicate that credible fiscal rules help anchor inflation expectations and reduce the risk premium in emerging economies (Schaechter et al., 2012). During the COVID-19 pandemic, Indonesia temporarily exceeded the deficit cap to implement countercyclical stimulus; however, the government committed to fiscal consolidation by 2023 to preserve macroeconomic stability. This experience highlights that while short-term fiscal expansion may increase inflation risks, transparent consolidation strategies can mitigate long-term instability.

Overall, Indonesia's experience demonstrates that the inflationary impact of fiscal policy depends on three interrelated factors: (1) the share of consumptive versus productive expenditure, (2) the structural characteristics of the economy, and (3) fiscal credibility and financing mechanisms. Consumptive subsidies and operational spending tend to create short-term inflationary vulnerabilities, whereas capital and human development expenditures contribute to long-term price stability by expanding supply capacity. Therefore, the effectiveness of fiscal policy in managing inflation is fundamentally linked to strategic budget composition and prudent fiscal governance.

## **The Influence of Government Spending Composition on Economic Growth**

A deeper analysis confirms that the composition of government spending significantly determines both the magnitude and sustainability of economic growth. Theoretically, endogenous growth models emphasize that productive public expenditure—particularly on infrastructure, education, and health—enhances capital accumulation and total factor productivity, thereby generating long-term growth effects. Empirical cross-country studies also show that capital expenditure has a stronger and more persistent impact on growth compared to recurrent expenditure. These findings imply that fiscal policy effectiveness depends not merely on spending size but on its structural allocation.

### **1. Capital Expenditure and Long-Term Growth: The Case of Indonesia's Infrastructure Expansion**

Indonesia provides a relevant case study of how shifts in spending composition affect growth dynamics. Beginning in 2015, the Indonesian government significantly increased infrastructure spending following a reduction in energy subsidies. Public investment was directed toward toll roads (Trans-Java and Trans-Sumatra), ports, airports, power plants, and urban transportation systems. This shift represented a structural reallocation from consumptive subsidies toward capital formation.

Empirical research supports the growth-enhancing effect of such spending. Calderón and Servén (2010) demonstrate that infrastructure development significantly increases output growth by reducing production and transaction costs. In the Indonesian context, Prasetyo and Firdaus



(2009) find that infrastructure investment has a positive and statistically significant impact on regional economic growth (Khurriah & Istifadah, 2019). Similarly, Sahoo et al. (2012) confirm that infrastructure contributes to higher long-term growth in developing economies, including Indonesia (Dash, 2012).

Energy subsidy reforms since 2014 have resulted in significant changes in the structure of Indonesia's state budget. This change in composition can be observed in Graph 4, which shows a downward trend in the share of energy subsidies in the total budget.

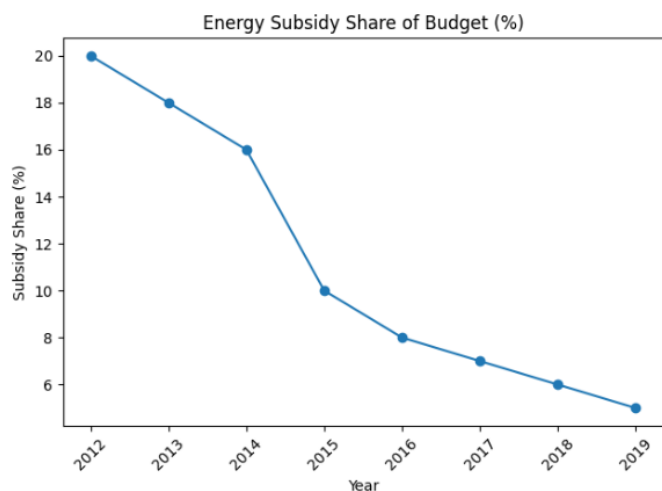


Figure 4. Energy Subsidy Share of Budget (%)

Chart 4 shows a sharp decline in the share of energy subsidies from around 20% to below 10% over several years. This decline reflects the fiscal space created for financing productive sectors and reducing price distortions in the long run.

In line with the reduction in energy subsidies, the government has increased the share of capital spending in the state budget. This change is shown in Chart 5.

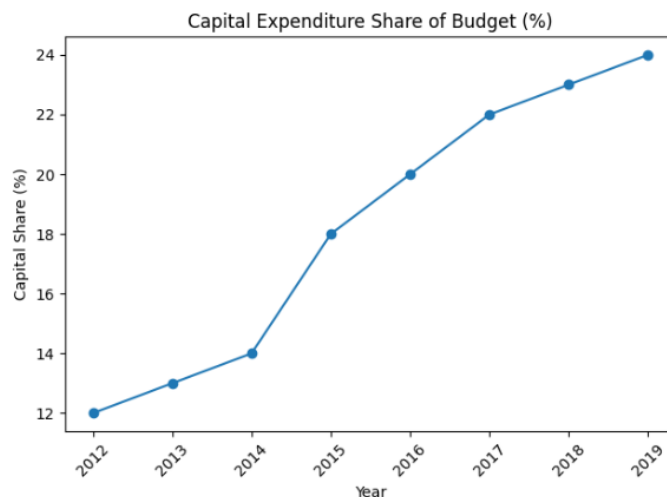


Figure 5. Capital Expenditure Share of Budget (%)

Chart 5 shows a consistent increase in the portion of capital expenditure after 2015. This indicates a supply-side fiscal strategy oriented towards capital formation and increasing national production capacity.

The Indonesian experience during 2015–2019 reflects these findings. Despite global economic slowdown and commodity price volatility, Indonesia maintained relatively stable GDP growth at around 5% annually. The World Bank (2019) notes that improved infrastructure connectivity reduced logistics costs—previously estimated at over 23% of GDP—thereby enhancing competitiveness and supporting private investment. This suggests that capital expenditure improves supply-side capacity, making growth more resilient and less inflationary.

Moreover, infrastructure development crowds in private investment rather than crowding it out when properly managed. Aschauer (1989) argues that public capital complements private capital, raising marginal productivity and stimulating private sector expansion. In Indonesia, the acceleration of infrastructure projects

encouraged foreign direct investment inflows in manufacturing and transportation sectors, indicating positive spillover effects.

## 2. Education and Human Capital Spending

Beyond physical infrastructure, human capital expenditure plays a crucial role in sustaining economic growth. The Indonesian Constitution mandates that at least 20% of the national budget be allocated to education. This policy reflects recognition that education investment enhances labor productivity and innovation capacity. Barro (1991) finds that educational attainment is positively associated with economic growth across countries.

In Indonesia, studies by Suryadarma et al. (2006) show that increased public education spending improves schooling outcomes and human capital formation, which in turn supports long-term economic performance (Suryadarma et al., 2006). Although the short-term multiplier effect of education spending may be smaller compared to infrastructure, its long-term returns are substantial through improved workforce quality and technological adaptation.

## 3. Consumptive Spending and Temporary Growth Effects

In contrast, growth driven by consumptive spending—such as broad subsidies and routine administrative expenditures—tends to be short-lived. Easterly and Rebelo (1993) find that current government consumption is either weakly correlated or negatively correlated with long-term growth. In Indonesia, fuel subsidies prior to reform absorbed a large portion of fiscal resources without significantly enhancing productive capacity. (Dartanto, 2013) shows that energy subsidies primarily benefited middle- and

upper-income households, limiting their effectiveness in promoting inclusive growth.

When fiscal resources are concentrated on consumptive transfers rather than productive investment, growth momentum may slow once fiscal stimulus is withdrawn. This pattern was observed during periods when commodity revenue financed higher government consumption without corresponding structural reform.

## 4. Fiscal Multipliers and Economic Conditions

Fiscal multipliers are also conditional on macroeconomic circumstances. During economic downturns, expansionary fiscal policy tends to generate stronger output effects. (Auerbach & Gorodnichenko, 2012) show that fiscal multipliers are significantly larger in recessions than in expansions. Indonesia's response to the COVID-19 pandemic illustrates this principle. The government implemented countercyclical stimulus through the National Economic Recovery (PEN) program, temporarily increasing the fiscal deficit beyond the 3% ceiling. This expansion mitigated economic contraction in 2020 and supported recovery in 2021–2022 (Ministry of Finance, 2021).

However, sustained fiscal expansion during periods of strong growth may yield diminishing returns and increase inflation risks. Therefore, effective fiscal policy requires countercyclical allocation—expansionary during downturns and consolidation during booms—to optimize growth outcomes while maintaining stability.

The Indonesian case confirms three key findings:

1. Capital expenditure (infrastructure and productive investment) generates stronger and more sustainable long-term growth.
2. Human capital spending enhances

productivity and innovation, reinforcing structural growth capacity.

3. Consumptive expenditure produces short-term demand stimulus but limited long-term output expansion.

Thus, fiscal policy effectiveness in promoting economic growth is fundamentally determined by strategic budget prioritization, structural reforms, and macroeconomic timing.

### **Short-Term and Long-Term Relationships among Fiscal Policy, Inflation, and Economic Growth: Evidence from Indonesia**

1. Short-Term Dynamics: Aggregate Demand Effects and Inflationary Pressures

In the short run, fiscal policy primarily operates through the aggregate demand channel. An increase in government expenditure stimulates consumption and investment, thereby raising real output. However, when productive capacity is constrained, such expansion may generate inflationary pressures. Empirical studies confirm that expansionary fiscal policy positively affects short-term growth but may elevate inflation when the output gap narrows (Afonso & Sousa, 2012). Fiscal multipliers are also found to be larger during economic downturns and smaller when economies operate near full capacity (Batini et al., 2014).

Indonesia provides a clear illustration of this mechanism. During the aftermath of the 2008–2009 global financial crisis, fiscal stimulus helped maintain economic growth above 4.5 percent despite global contraction. Nevertheless, Indonesia's experience with energy subsidy reforms in 2013–2014 highlights the inflationary trade-off associated with fiscal restructuring. The reduction of fuel subsidies led to significant

increases in administered prices, pushing inflation above 8 percent in 2013 (Agung & Juhro, 2016). Although this policy aimed to strengthen fiscal sustainability, it temporarily generated cost-push inflation.

The 2014–2015 subsidy reform represents a critical fiscal turning point. By substantially reducing energy subsidies, the government created fiscal space for more productive expenditures. However, in the short term, adjustments in fuel prices led to inflation spikes and required coordinated monetary stabilization efforts. This outcome aligns with broader empirical findings suggesting that fiscal consolidation through subsidy reduction may trigger short-run inflation but improve macroeconomic stability over time.

2. Long-Term Dynamics: Public Investment, Productivity, and Structural Stability

In the long run, the effectiveness of fiscal policy depends largely on expenditure composition. Public spending directed toward infrastructure, education, and capital formation enhances productive capacity and supports sustainable economic growth. Endogenous growth theory posits that productive government expenditure can permanently increase output without generating persistent inflationary effects.

Indonesia's post-2015 fiscal reallocation demonstrates this principle. Following subsidy reforms, the government significantly increased capital expenditure, particularly for infrastructure projects such as the Trans-Java toll road network, port modernization, and airport expansion. Empirical evidence suggests that infrastructure investment in Indonesia has contributed positively to regional growth and productivity enhancement (Resosudarmo &

Abdurohman, 2018).

Furthermore, research on fiscal decentralization in Indonesia indicates that subnational government spending on infrastructure and education is positively associated with long-term economic growth (Akai & Sakata, 2002). This finding reinforces the argument that the quality and composition of expenditure are more critical than the sheer size of fiscal deficits.

Between 2015 and 2019, Indonesia maintained fiscal deficits below the statutory ceiling of 3 percent of GDP while sustaining growth at approximately 5 percent and keeping inflation within the 3–4 percent target range. This macroeconomic stability reflects a balanced fiscal framework characterized by productive spending and prudent fiscal management. The structural shift from consumption-based subsidies toward capital formation appears to have strengthened supply-side capacity, thereby mitigating inflationary pressures in the longer term.

### 3. Integrated Evaluation: Short-Term Trade-Offs and Long-Term Structural Gains

A comprehensive assessment indicates that fiscal policy in Indonesia exhibits distinct short-term and long-term effects. In the short run, policy adjustments—particularly subsidy reforms—can induce inflationary shocks due to price realignments. However, in the long run, reallocating expenditures toward productive sectors enhances economic resilience, stabilizes inflation expectations, and sustains growth.

This pattern is consistent with broader cross-country evidence demonstrating that fiscally disciplined frameworks emphasizing

productive public investment are associated with low inflation and stable. Indonesia's fiscal experience therefore illustrates that policy effectiveness is not merely determined by the magnitude of spending but by structural expenditure transformation and institutional credibility.

Overall, the Indonesian case confirms that national budget allocation plays a decisive role in shaping inflation dynamics and economic growth trajectories. Fiscal policy is most effective when short-term stabilization measures are complemented by long-term structural investment strategies.

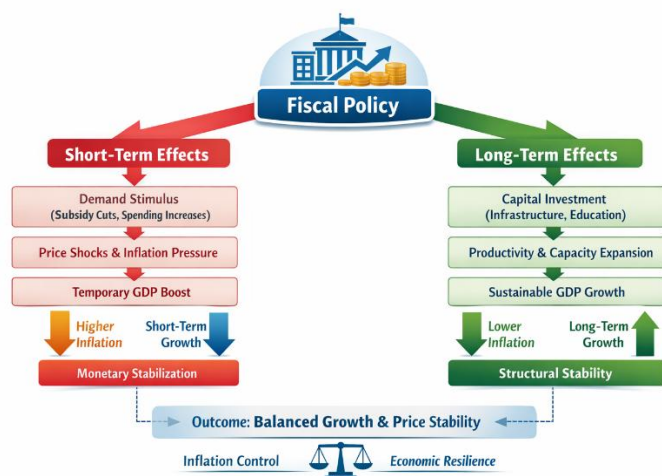


Figure 6. Figure 1. Conceptual Framework of Fiscal Policy Effectiveness: Short-Term and Long-Term Impacts on Inflation and Economic Growth

The diagram illustrates the dual transmission mechanism of fiscal policy through national budget allocation. In the short term, expansionary fiscal measures—such as subsidy adjustments or increased government spending—stimulate aggregate demand, potentially generating temporary GDP growth alongside inflationary pressures. This phase often requires monetary stabilization to manage price shocks.

In contrast, the long-term pathway emphasizes capital investment in infrastructure and human development. Such productive expenditure enhances economic capacity, improves productivity, and supports sustainable growth while contributing to lower and more stable inflation. Ultimately, the framework highlights that fiscal policy effectiveness depends on the transition from short-term demand stimulus to long-term structural strengthening, resulting in balanced growth and price stability.

#### 4. CONCLUSION

The findings confirm that the effectiveness of fiscal policy through national budget allocation is strongly determined by the composition, timing, and governance of public expenditure. In the short term, expansionary fiscal policy stimulates aggregate demand and supports economic growth, but it may also generate inflationary pressures, especially when productive capacity is limited. In the long term, productive spending—particularly on infrastructure, education, and human capital—strengthens supply-side capacity, enhances productivity, and promotes sustainable growth while maintaining price stability. Therefore, fiscal effectiveness is not measured solely by budget size or deficit levels, but by strategic allocation toward productive sectors and credible fiscal management.

#### Practical Implications

Practically, governments should prioritize reallocating budget expenditures from consumptive subsidies toward productive investment sectors such as infrastructure, education, and health. Fiscal policy should be implemented countercyclically—expansionary during economic downturns and consolidative during periods of economic expansion—to maintain macroeconomic stability.

Strengthening fiscal discipline, transparency, and institutional credibility is also essential to anchor inflation expectations and sustain long-term economic resilience.

#### Research Recommendations

Future research should employ quantitative empirical methods, such as time-series or panel data analysis, to measure the magnitude of fiscal multipliers and the causal relationships among budget allocation, inflation, and growth. Comparative cross-country studies are also recommended to evaluate differences in fiscal effectiveness across institutional and structural contexts. Additionally, further research could explore the interaction between fiscal and monetary policy in managing inflation and promoting sustainable economic development.

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