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Operation Name	First Indonesia Fiscal Reform DPL
Region	EAST ASIA AND PACIFIC
Country	Indonesia
Sector	Central government administration (80%); Sub-national government administration (20%)
Operation ID	P156655
Lending Instrument	Development Policy Lending
Borrower(s)	GOVERNMENT OF INDONESIA
Implementing Agency	Ministry of Finance
Date PID Prepared	March 31, 2016
Estimated Date of Appraisal	March 22, 2016
Estimated Date of Board Approval	May 12, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Over the past decade Indonesia has seen strong growth and job creation, supporting poverty reduction, but the end of the commodity boom has exposed deep structural weaknesses. Annual growth averaged 5.6 percent for the period 2001-12 but, as the external tailwinds of commodity prices and demand and global financing conditions have turned to headwinds, growth has slowed, down to 4.8 percent in 2015 and projected at 5.1 percent in 2016. While the national poverty rate was halved from 1999 to 2015, vulnerability remains high and inequality has risen.

Reducing poverty and increasing shared prosperity in Indonesia requires delivery on three challenges. These include (a) sustaining economic growth that generates quality jobs, by addressing a broad range of structural weaknesses including infrastructure bottlenecks; (b) improving the quality of spending and access to key services; and (c) enhancing the quality of natural resource governance and management. Effective fiscal policy, in its revenue mobilization and quality of spending functions, is critical in addressing these challenges.

However, the Government faces significant challenges in *Collecting More.* Relative to its regional and emerging market peers, Indonesia has one of the lowest revenue-to-GDP (13.1 percent in 2015) and tax-to-GDP (10.8 percent) ratios as well as one of the biggest gaps between actual and potential revenue (it is estimated Indonesia is collecting less than 50% of its potential tax revenues). Over the past decade, low levels of revenue combined with a fiscal deficit legally capped at 3 percent of GDP has led to a suboptimal level of public spending (16.9 percent of GDP in 2014 compared to more than 28 percent for middle-income countries in Asia). The revenue gap is due partly to persistently low compliance rates across a wide range of taxes, taxpayers segments and sectors; it is also partly due to sub-optimal tax policy design that narrows the tax base, makes administration difficult and distorts behavior. Due to the steep decline in commodity prices, there is a risk that revenue collection may not create the necessary fiscal space for spending on development priorities through the medium-term. *Collecting More* requires intensified, coherent and sustained efforts in both revenue policy and administration.

***Spending better* in terms of improving both the composition and delivery/execution of public spending is also important**. Indonesia has persistently underspent on infrastructure, health and social assistance. Before the major fuel subsidy reform in January 2015, large energy subsidies crowded out other spending: in 2014, spending on energy subsidies accounted for more than one-fifth of the central government's budget and more than three times the allocation for infrastructure and health. With additional fiscal space for spending on infrastructure, it is important to improve the execution of investment programs. Poor execution hinders improving public service delivery and efforts for boosting economic growth.

II. Operation Objectives

The proposed DPL supports the Government of the Republic of Indonesia's objective to collect more and improve the quality of spending to further the country's medium-term economic development and poverty reduction goals. The proposed operation, in the amount of US$ 400 million, is the first in a planned programmatic series of two single-tranche operations supporting critical policy and institutional reforms that have three key development objectives:

- **Pillar A: Improving composition of spending, budget execution rates and efficiency of spending** through prior actions to improve central government budget allocation, strengthen budget monitoring and management through FMIS, facilitate investment by private sector in essential infrastructure, remove barriers to multi-year contracts for government procurement, and conduct early procurement. These actions are expected to contribute to the following results: increase in the share of budget allocated to infrastructure, health and social assistance; reduction in the time for budget realization data to be publicly available; increase in the number of PPPs supported by the Ministry of Finance's Project Development Facility; and an increase in the use of multi-year contracts and early procurement by Ministry of Public Works and Housing.
- **Pillar B: Increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes** through prior actions to strengthen VAT invoicing and filing, increase electronic tax filing, establish a unique and permanent taxpayer ID system, and improve DG Tax access to taxpayer asset and financial data for audits. These actions are expected to contribute to the following results: increase in the share of VAT and income tax returns filed electronically; reduction in the number of duplicate IDs that can be used to file tax returns; and reduction in the time taken for DG Tax to access land asset and financial data for audit purposes.
- **Pillar C: Increasing revenue potential and economic efficiency of tax policy** through prior actions to revise the VAT, LGST, Excise and Income Tax regimes. These actions are expected to contribute to the following results: increase in the share of final consumption

subject to standard VAT; replacement of the vehicle LGST with a vehicle excise tax; broadening of the income tax base and stronger anti-tax base erosion measures; and improvement in the simplified tax regime for micro, small and medium (MSME) enterprises.

III. Rationale for Bank Involvement

The DPL is central to achieving the objectives under the CPF *Collecting More and Spending Better* engagement. The PDOs of the DPL are consistent with and contribute to the development outcomes of the engagement: *Improve revenue collection through an increase in the compliance rate for individual and corporate taxpayers); and Improve efficiency and effectiveness of spending through a rise in the central government spending on health, capital expenditure (proxy for infrastructure), and social assistance and a rise in central budget execution rates of capital spending.* The DPL provides an anchor and coordination mechanism for the broader CPF engagement with the government and use of other instruments, including the Bank's knowledge services (analytical work and technical assistance). The revenue administration and tax policy pillars of the DPL also supports the WBG Domestic Revenue Mobilization (DRM) agenda.

The operation builds on fiscal reforms supported by previous DPLs in Indonesia in the last 10 years[1]. These reforms were mostly public financial management reforms in budget preparation, treasury management, accounting and internal auditing, with some tax administration. The Fiscal Reform DPL series takes a deeper focus on infrastructure spending and tax administration than in previous DPLs and includes new areas, in particular budget allocation and tax policy.

IV. Tentative financing

Source:		($m.)
Borrower		0.00
International Bank for Reconstruction and Development		400.00
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	400.00

V. Tranches *(if applicable)*

One tranche operation.

VI. Institutional and Implementation Arrangements

The operation, including the development of the program development objectives and result indicators, has been prepared through intensive policy dialogue with the Government. The main counterpart is the Ministry of Finance, with engagement with DG Tax,

[1] DPL series 1 to 8 (2004 to 2011), INSTANSI 1 and 2 (2012-2013)

DG Treasury, DG Budget and Fiscal Policy Agency (BKF) on the relevant expenditure and revenue reform areas, and with BKF on the overall program coordination. The Ministry of Public Works and Housing will be responsible for implementation of some reforms in the expenditure pillar. Some result indicators will be publicly available such as the Budget Law, some are part of internal monitoring within the Ministry of Finance or the Ministry of Public Works and Housing, and some may need specific ex-post evaluation, which could be conducted as part of ongoing analytical work and technical assistance on fiscal issues done by the Bank.

VII. Risks and Risk Mitigation

The overall risk rating of this operation is substantial. Major risks are the following: (a) political economy and governance challenges that affect the outcome of tax legislation process and the quality of tax enforcement; (b) sector strategies, in particular short-term measures to raise revenue and over-reliance on tax incentives to boost investment; (c) macroeconomic risks, in particular revenue shortfalls relative to targets in 2016 and 2017; and (d) weak institutional and implementation capacity in tax administration. These risks, if materialized, could negatively impact the Government's willingness and ability to implement the indicative triggers and the achievement of the intended positive results (even if the prior actions and triggers are completed). Furthermore, these risks could affect the achievement of the PDOs as the reforms contained in the DPL are important but not sufficient conditions for achieving the PDOs. A mitigating factor against these risks will be strong Ministry of Finance commitment and focus, e.g., during the inter-ministerial consultations and Parliament discussions, and ongoing technical assistance provided to the Ministry of Finance on tax administration and policy issues by the World Bank and other development partners. As noted above, these risks must be set against the significant benefits of improved fiscal performance in Indonesia given the challenges the sector poses for improved growth and shared prosperity.

VIII. Poverty and Social Impacts and Environment Aspects

Several reform areas in this DPL can potentially have substantial positive poverty and inequality impacts. Increasing total revenue collection through stronger revenue administration and enhanced tax policy is necessary to finance significantly higher spending on infrastructure, social assistance and health. The indirect impact of revenue measures in the DPL is likely to be as important, if not more, than the direct impacts. An increase in personal income tax collection would be progressive. The move from a narrow LGST to a broader excise tax on most vehicles is likely to have little direct impact on poverty and inequality. The removal of VAT exemptions from a range of goods and services could lead to a modest increase in poverty; however, this can be offset if higher VAT collection finances additional pro-poor spending. Increased spending on infrastructure, social assistance and health through improvements in budget allocation and execution (expenditure pillar) enabled by revenue improvements, would be expected to have positive direct impacts on reducing poverty and inequality. To the extent the new infrastructure investments reduce transportation costs and connect markets, they are likely to benefit the poor through lower prices for goods and services, particularly for food, and potentially create new jobs. Increased social assistance spending is expected to have a significant impact on poverty and inequality reduction due to its targeted nature. Additional health spending increases in-kind services for households, and, if complemented by improvements in the quality of spending, could have a significant impact on inequality.

The environmental impacts of the fiscal reform actions supported by the DPL are likely to be positive overall. The policy actions of the expenditure pillar will make it possible for Indonesia to meet more of its infrastructure needs, more efficiency and rapidly. To the extent that the reforms accelerate and expand investments in solid waste management, wastewater collection and treatment, water supply, drainage and flood control, transportation infrastructure, power generation from renewable energy sources and gas, and in infrastructure to improve electricity transmission and distribution efficiency, there will likely be environmental and public health benefits. Indonesia has a comprehensive legal and institutional framework for environmental impact assessment and licensing of infrastructure development, including aspects related to management of direct, induced and cumulative impacts. Moreover, the establishment of an excise tax on a broader range of motor vehicles should have significant positive environmental impacts.

IX. Contact point

World Bank
Contact: Yue Man Lee
Title: Senior Economist
Tel: 5781+3153 / 62-21-5299-3153
Fax:
Email: ylee8@worldbank.org
Location: Jakarta, Indonesia (IBRD)

Borrower
Contact: Ayu Sukorini
Title: Director of Loan and Grant, Ministry of Finance
Tel: 62-21-345-9616
Email: ayu_sukorini@dmo.or.id

X. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop