PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

3 December 2015
Report No.: AB7811
(The report # is automatically generated by IDU and should not be changed)

Operation Name	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	December 3, 2015
Estimated Date of Appraisal	May 1, 2016 (tbc)
Estimated Date of Board Approval	July 29, 2016 (tbc)
Corporate Review Decision	TBD

I. Key development issues and rationale for Bank involvement

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 5 percent in 2014 and projected at 4.7 percent in 2015. While the national poverty rate was halved from 1999 to 2012, 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 (14.7 percent in 2014) and tax-to-GDP (10.9 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 slowdown in nominal growth and steep decline in commodity prices, there is a risk that revenue collection may not create the necessary fiscal space for spending on development priorities. *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**. 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. The slow pace of execution of investment programs (budget execution rates for capital expenditure averaged 86 percent between 2010 and 2014) hinders improving service delivery and efforts for boosting economic growth.

This proposed DPL series is an integral part of the Indonesia Country Partnership Framework (CPF) *Collecting More and Spending Better*[1] engagement, which aims to support the Government's fiscal reforms. The proposed DPL series aims to address key policy and institutional bottlenecks in support of the Government's fiscal reforms to improve the quality of spending, strengthen revenue administration and enhance tax policy, which would further the country's medium-term economic development and poverty reduction goals.

II. Proposed Objective(s)

This is the first in a proposed series of two development policy loans supporting the Government of the Republic of Indonesia's critical policy and institutional reforms in the fiscal sector. The three pillars of the operation have the following development objectives: Pillar A Improving Quality of Spending: *Improving composition of spending, budget execution and efficiency of spending*; Pillar B Strengthening Revenue Administration: *Increasing revenue administration efficiency and compliance and audit capability*; and Pillar C Enhancing Tax Policy: *Increasing revenue potential and economic efficiency of tax policy.*

III. Preliminary Description

The proposed DPL series supports the Government's overall objective to collect more and improve the quality of spending by supporting the institutional and policy reforms being undertaken in the fiscal sector by the Government that are expected to have the most impact on addressing the underlying challenges and contribute most significantly to achieving the overall objectives**.** The proposed DPL series is structured around the following three pillars, set of program development objectives (PDOs) and government program reform areas:

- **Pillar A: Improving Quality of Spending.** *PDO: Improving composition of spending, budget execution rates and efficiency of spending* by (i) improving central government budget allocation; (ii) strengthening budget monitoring and management through FMIS

[1] *Country Partnership Framework For The Republic Of Indonesia (Fy16 – Fy20),* World Bank, 2015

(SPAN); (iii) facilitating increased usage of PPPs; (iv) removing barriers to multi-year contracts for infrastructure; and (iv) conducting early procurement.

- **Pillar B: Strengthening Revenue Administration.** *PDO: Increasing administration efficiency and compliance and audit capability* by (i) strengthening VAT administration; (ii) increasing electronic tax filing; (ii) establishing a unique and permanent taxpayer ID system; (iii) improving DG Tax access to taxpayer asset and banking data for audits; and (iv) strengthening the IT system for tax administration.
- **Pillar C: Enhancing Tax Policy.** *PDO: Increasing revenue potential and economic efficiency of tax policy* by (i) revising main tax instruments (VAT, Excise, Income Tax, Final tax for micro and SMEs); and (ii) taking regulatory measures against base erosion.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

A number of the reform areas in this DPL could potentially have material poverty and inequality impacts. Higher budget allocations to infrastructure, social assistance and health are expected to have positive direct impact on reducing poverty and inequality. Some tax reforms may have slightly negative direct/first-round impact i.e. excluding the benefits from additional fiscal space for pro-poor spending from increased state revenues. The fiscal incidence analysis that has been conducted as part of the Indonesian Commitment to Equity (CEQ) pilot, which has provided a benchmark of the distributional impact of taxes and government spending for 2012, will be used to analyze these potential impacts further.

Environment Aspects

The environmental impacts of the fiscal reform actions supported by the DPL are likely to be positive overall, with further assessment planned on the impact of prior actions and triggers supporting increasing infrastructure spending and the establishment of an excise tax on motor vehicles.

V. Tentative financing

Source:	($m.)
Borrower	0
International Bank for Reconstruction and Development	500
Borrower/Recipient	
IBRD	
Others (specify)	
Total	

VI. 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

VII. 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