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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

ON A PROPOSED LOAN

IN THE AMOUNT OF US$400 MILLION

TO THE

REPUBLIC OF INDONESIA

FOR A

FIRST INDONESIA FISCAL REFORM

DEVELOPMENT POLICY LOAN

May 5 2016

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East Asia and the Pacific

REPUBLIC OF INDONESIA-GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 1, 2016)

Currency Unit	Rupiah (IDR)
US$ 1.00 =	IDR 13,200

ABBREVIATIONS AND ACRONYMS

APBN	Approved State Budget	LGST	Luxury Goods Sales Tax
Bappenas	Badan Perencanaan Pembangunan Nasional (National Development Planning Agency)	LKPP	*Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah* (National Public Procurement Agency)
BEPS	Base Erosion and Profit Shifting	MoF	Ministry of Finance
BI	Bank Indonesia	MoPWH	Ministry of Public Works and Housing
BKF	Fiscal Policy Agency, Ministry of Finance	OECD	Organization for Economic Co-operation and Development
BLSM	*Bantuan Langsung Sementara Masyarakat* (temporary unconditional cash transfer)	OJK	Otoritas Jasa Keuangan (Financial Services Authority)
BP	Basis point (bp)	PDF	Project Development Facility
BPK	*Badan Pemeriksa Keuangan* (State Audit Agency)	Per Dirjen	DG Regulation
BPN	*Badan Pertanahan Nasional* (National Land Agency)	PerPres	Presidential Regulation
BPS	*Badan Pusat Statistik* (Central Bureau of Statistics)	PEFA	Public Expenditure and Financial Accountability
CIT	Corporate Income Tax	PFM-MDTF	Public Financial Management Multi-Donor Trust Fund
CMEA	Coordinating Ministry of Economic Affairs	PIT	Personal Income Tax
CPF	Country Partnership Framework	PMK	Ministry of Finance Regulation
DAK	Earmarked specific transfers to regions	pp	Percentage point (pp)
DG	Directorate General	PPP	Public-private partnerships
DPL	Development Policy Loan	PSIA	Poverty and Social Impact Analysis
EOP	End of period (eop)	REER	Real effective exchange rate
FDI	Foreign Direct Investment	RPJMN	*Rencana Pembangunan Jangka Menengah Nasional* (National Medium Term Development Plan)
FMIS	Financial Management Information System	SARA	Semi-autonomous revenue administration
FY	Fiscal Year	SCD	Systematic Country Diagnostics
GDP	Gross Domestic Product	SOE	State-Owned Enterprise
GFMRAP	Government Financial Management and Revenue Administration Project	SPAN	*Sistem Perbendaharaan dan Anggaran Negara* (State budget and treasury system)
GoI	Government of Indonesia	SUSENAS	*Survei Sosial dan Ekonomi Nasional (*National Socio-economic Survey)
IBRD	International Bank for Reconstruction and Development	TA	Technical Assistance
ICR	Implementation Completion and Results	US$	United States Dollar
IDR	Indonesian Rupiah	VAT	Value Added Tax
IEG	Independent Evaluation Group	VSL	Variable Spread Loan
IMF	International Monetary Fund	WB	World Bank
INPRES	Presidential Instruction	WBG	World Bank Group
KPPIP	National Committee for Acceleration of Priority Infrastructure Development	YOY	Year-on-year

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THE REPUBLIC OF INDONESIA

FIRST INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN

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SUMMARY OF PROPOSED LOAN AND PROGRAM
REPUBLIC OF INDONESIA
FIRST INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN

Borrower	The Republic of Indonesia
Implementation Agency	Ministry of Finance
Financing Data	IBRD Variable Spread Loan; Amount: USD 400 million.
Operation Type	Programmatic (1st of 2), single-tranche
Pillars of the Operation And Program Development Objectives	This programmatic DPL series comprises of three pillars and PDOs: • **Pillar A: Improving Quality of Spending.** PDO: Improving composition of spending, budget execution and efficiency of spending • **Pillar B: Strengthening Revenue Administration**. PDO: Increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes • **Pillar C: Enhancing Tax Policy.** PDO: Increasing revenue potential and economic efficiency of tax policy
Result Indicators	A1: Sustained increase in the share of central government budget allocated to infrastructure, social assistance and health
	A2: Reduction in the time taken for central government monthly budget realization data to be publicly available
	A3: Increase in the number of PPPs supported by the Project Development Facility
	A4: Increase in the proportion of Ministry of Public Works and Housing budget delivered through multi-year contracts
	A5: Increase in the proportion of the value of contractual package being procured by the Ministry of Public Works and Housing in the first semester
	B1: Increase in the share of monthly VAT, annual individual income tax and corporate income tax returns filed electronically
	B2: Reduction in the number of taxpayers with multiple/duplicate IDs that can be used to file returns
	B3: Reduction in the average time taken to receive land asset and credit card data requested by DG Taxes for audit use
	C1: The VAT regime is revised to reduce the share of final consumption exempt from standard VAT
	C2: Replacement of the vehicle LGST with a vehicle excise tax
	C3: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base
	C4: Increase in the number of new taxpayers joining the MSME regime and reduction in the number of standard income taxpayers moving to the regime
Overall Risk Rating	Substantial
Operation ID	P156655

IBRD PROGRAM DOCUMENT FOR A PROPOSED
FIRST INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN (DPL)
TO THE REPUBLIC OF INDONESIA

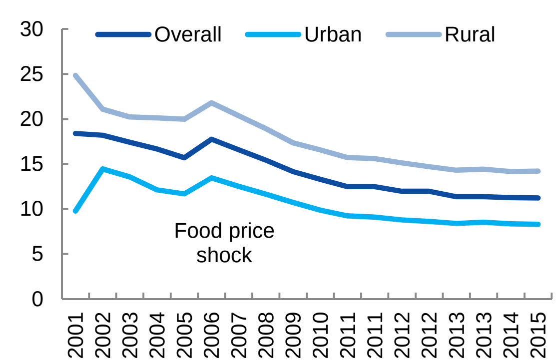
1. INTRODUCTION AND COUNTRY CONTEXT (INC. POVERTY DEVELOPMENTS)

1. **This document presents a Development Policy Loan to support the Government of Indonesia to improve quality of spending, strengthen revenue administration and enhance tax policy** 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 with three development objectives: A) Improving composition of spending, budget execution and efficiency of spending; B) Increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes; and C) Increasing revenue potential and economic efficiency of tax policy.

2. **Over the past decade, Indonesia has seen strong growth and job creation, supporting poverty reduction, but the end of the commodity boom has exposed structural weaknesses.** Following the recovery from the Asian financial crisis, annual growth averaged 5.6 percent over 2001-12. 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. The slowdown in growth and weakening of commodity prices has increased fiscal pressures significantly in 2015 and 2016.

3. **Indonesia's progress on poverty reduction contrasts sharply with its performance in sharing prosperity.** From 1999 to 2015, the national poverty rate halved to 11.2 percent (Figure 1), largely through sustained growth and job creation. Recently, however, the rate of poverty reduction has begun to stagnate, with a near zero decline in 2015. Lifting the "hard core" poor permanently out of poverty will require greater focus and new programs. The number of vulnerable in 2014 (i.e., those between the poverty line and 1.5 times the line) remains high, at 27 percent of the population, mainly due to a lack of productive employment And vulnerability to shocks[1]. Together, the poor and vulnerable are 38 percent of the population. Inequality, as measured by the Gini coefficient, increased from 30 points in 2000 to 41 points by 2014, by far the fastest widening seen in East Asia, and with the true level of inequality likely to be higher as household survey data do not sufficiently capture rich households[2]. Rising inequality has been driven largely by an increasing skilled wage premium and an unequal distribution of capital ownership and capital income.

Figure 1: National poverty rate (percent)



Source: Statistics Indonesia, BPS

4. **As set out in the Systematic Country Diagnostics (SCD), eliminating poverty**

[1] World Bank staff calculation using the National Socioeconomic Survey (Susenas) for 2014.
[2] World Bank staff calculation.

and increasing shared prosperity in Indonesia requires delivery on three challenges: (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 recognized in the SCD as critical in addressing these challenges.

5. **However, the Government faces significant challenges in *Collecting More.*** Even before the recent sharp declines in commodity prices, Indonesia had 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[3]), among its regional and emerging market peers. 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 to persistently low compliance rates (50-60 percent)[4] across a wide range of taxes[5], taxpayers segments and sectors. The gap is also partly due to sub-optimal tax policy design that narrows the tax base (many exemptions, high thresholds), makes administration difficult and distorts behavior (complex tax structures, multiple rates). Due to the slowdown in nominal growth, imports and steep decline in commodity prices, the revenue-to-GDP declined to 13.1 percent in 2015. Under a "no reform" scenario with continued moderation of commodity prices, the ratio could decline further to 12 percent in the medium-term, severely constraining the fiscal space for development priorities. *Collecting More* in the medium-term requires intensified, coherent and sustained reform efforts in revenue policy and administration.

6. ***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 more important than ever to improve the execution of investment programs (budget execution rates for capital expenditure averaged 86 percent between 2010 and 2014). Poor execution hinders improving public service delivery and efforts for boosting economic growth. Improving efficiency and effectiveness of spending at the subnational level, where over half of the national budget (net of subsidies and interest payments) is spent, is also critical.

7. **This DPL series forms an integral part of the Indonesia Country Partnership Framework (CPF)[6] *Collecting More and Spending Better* engagement, which aims to support the Government's fiscal reforms**.

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[3] Fenochietto, R. and Pessino, C., 2013, "Understanding Countries' Tax Effort", IMF Working Paper WP/13/244.
[4] Filing and payment rates estimated at 50-60 percent of registered taxpayers, also low rates of accurate reporting (DG Taxes discussions, 2015)
[5] VAT compliance rate estimated at 57% in 2013 (Sugana and Hidayat, 2014); Coal royalties compliance rate estimated at 57% in 2012 (World Bank, 2014)
[6] *Country Partnership Framework For The Republic Of Indonesia (Fy16 – Fy20)*, World Bank, 2015

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **Indonesia's economy has slowed since 2012 as a result of the commodities downturn and policy response, with recent headwinds coming from renewed financial market volatility.** Real GDP growth declined to 4.8 percent in 2015, down from 5.0 percent in 2014 and from its 6.4 percent peak in 2010. The main cause of the growth moderation has been slower investment growth. Weaker job creation and significant Rupiah depreciation have also weighed on household consumption growth. In line with weak domestic demand, import volumes contracted significantly this year after growing by around 2 percent in 2013-2014. Exports have also declined in year-on-year terms since Q4 2014. The public sector supported GDP growth in H2 2015 as expenditure disbursement, including on infrastructure development, accelerated. In 2015, capital expenditure by the government increased by 42 percent yoy in nominal terms.
9. **Weaker global commodity prices and demand have put exports under pressure.** Export revenues contracted in each of the last four years, with the decline reaching 14.4 percent yoy in 2015. Sharp falls in commodity prices have driven much of the decline in commodity export revenues, which account for approximately 60 percent of total exports.[7] Commodity export volumes have declined by about a quarter over the same period. The commodities downturn has reduced potential GDP growth - now estimated at below 5.5 percent - and exposed structural challenges, including the low quantity and quality of public investment, the quality of the investment climate and skills shortages.
10. **The current account balance weakened as global commodity prices declined, but the deficit remains moderate relative to GDP**. After recording generally small surpluses over the 2000s, the current account swung into deficit in the final quarter of 2011, reaching -3.0 percent of GDP in 2014. The deficit opened up mainly due to a sharp contraction in the goods trade surplus since 2012, resulting from weaker net commodity exports and a large oil and emerging gas deficit. Import compression on the back of more moderate domestic demand growth helped the goods trade surplus rise in 2014 and a further contraction in imports, especially due to lower oil prices, brought down the deficit to 2.1 percent of GDP in 2015. There are large structural deficits in the services trade and income sub-accounts.
11. **Despite the narrowing current account deficit, external financing vulnerabilities remain, including significant private external debt rollover requirements**. FDI, which has declined substantially in levels, covered about 50 percent of the current account deficit in 2014 and 2015. Consequently, financing of the current account deficit has continued to rely on potentially volatile portfolio investment. This surged in 2014 to a record high, driven mainly by strong net foreign purchases of domestic government bonds. However, net equity outflows have been recorded in Q2-Q4 2015. Gross external financing needs have also increased due to rising private (non-financial) sector external debt: US$125 billion or 14.5 percent of GDP in November 2015, up from US$82 billion in December 2011. Short-term total private sector external debt stood at US$54 billion in November 2015, more than twice its level at end-2009, but still well-covered by reserves.

[7] The net weighted price index for Indonesia's six major export commodities (coal, natural gas, crude oil, palm oil, rubber and copper) was about 60 percent lower at end-2015 than its February 2011 peak.

12. **The overall financial system position remains solid but corporate and SOE sectors are showing signs of strain.** Banks are well-capitalized, with capital at 21.3 percent of risk-weighted assets in November 2015. However, as growth has slowed and funding costs have risen, nonperforming loans have increased from 1.8 percent of total loans at the end of 2013 to 2.7 percent in November 2015. The recent rise in NPLs has been driven by non-financial corporate debt (including SOEs), which stood at 33 percent of GDP in September 2015.

Table 1: Key Macroeconomic Indicators

	2012	2013	2014	2015	2016f	2017f	2018f
Real Economy	*Annual percentage change, unless otherwise indicated*						
Real GDP	6.0	5.6	5.0	4.8	5.1	5.3	5.5
Per Capita GDI (USD Atlas Method)	3,599	3,759	3,654	3,515	3,514	3,662	3,998
Contributions to GDP growth (ppt):							
Consumption	3.5	3.6	3.0	3.1	3.2	3.4	3.3
Investment	2.9	1.6	1.5	1.6	1.7	1.7	1.9
Net exports	-1.5	0.6	-0.3	0.9	-0.9	0.2	0.0
Imports (real growth)	8.0	1.9	2.2	-5.8	0.2	2.8	6.2
Exports (real growth)	1.6	4.2	1.0	-2.0	-3.9	3.6	5.9
Unemployment rate (ILO definition)	6.3	6.1	5.9	5.8	..	..	..
GDP deflator (avg.)	3.8	5.0	5.4	4.2	4.6	4.9	4.5
CPI (avg.)	4.0	6.4	6.4	6.4	4.0	4.6	4.8
Fiscal accounts*	*Percentage of GDP*						
Expenditure	17.2	17.3	16.9	15.6	15.1	15.3	16.4
Revenue	15.4	15.1	14.7	13.1	12.2	12.5	13.6
General Government Balance	-1.8	-2.2	-2.2	-2.5	-2.8	-2.8	-2.8
General Government Debt	23.0	24.9	24.7	26.9	28.3	28.3	28.8
Selected Monetary Accounts	*Annual percentage change*						
Base Money (M2)	18.5	13.8	11.5	12.8	..	..	..
Credit to non-government (eop)	22.4	22.1	14.2	..	..	..	..
Interest (key policy interest rate), eop	5.8	7.5	7.8	7.5	..	..	..
Balance of Payments	*Percentage of GDP, unless otherwise indicated*						
Current Account Balance	-2.7	-3.2	-3.1	-2.1	-2.3	-2.5	-2.7
Imports	23.2	23.2	22.7	19.2	19.9	19.7	21.1
Exports	23.0	22.5	22.3	19.8	20.0	19.6	20.6
Direct Investment (net, US$ billion)	13.7	12.2	14.8	9.3	13.1	13.4	14.6
Gross Reserves (US$ million, eop)	112.8	99.4	111.9	105.9	106.0	114.0	126.0
Months' import cover (goods)	7.6	6.8	8.0	7.7	7.0	6.9	6.4
As % of short-term external debt	206.4	176.6	188.8	185.5	178.8	175	182.4
External Debt	27.5	29.2	33.1	35.6	36.3	35.9	34.4
Term of Trade (index 2008=100)	94	81	92.4	96.6	..	..	..
Exchange Rate (average) IDR/US$	9,387	10,461	11,865	13458	..	..	..
Memo items							
GDP nominal in (in billion US$)	918	910	889	858	918	1,012	1,116

Note: Using revised and 2010-rebased GDP. *Fiscal accounts for 2016-2018 are World Bank staff projections and includes the estimated impact of the fiscal reforms set out in this DPL (Table 2). A downside risk scenario where the fiscal reforms are not implemented or impact is not realized is presented in Table 3.
Source: BPS; Ministry of Finance; BI; World Bank staff projections for 2016-2018

13. **Monetary policy has anchored inflation expectations and prioritized reducing external imbalances**. Bank Indonesia (BI) held its policy rate at 7.5 percent between February and December 2015 in response to sticky inflation and elevated exchange rate pressures, despite weakening domestic demand. Headline inflation, averaged 6.4 percent in 2015, above the target of 4 +/-1 percent on account of the November 2014 fuel price increase[8] and persistently high food prices. Consistent with tighter monetary policy, domestic credit growth declined from over 23 percent yoy in September 2013 to 10.3 percent in December 2015. Mainly owing to base effects, inflation declined to 3.4 percent yoy in December. Weaker price pressures, coupled with a relatively stable currency in recent months, allowed BI to cut its key interest rates by 25 bps twice, at its January and February 2016 policy meetings.

14. **Flexible exchange rate management since mid-2013 has contributed to macroeconomic stability, but continued depreciation pressures require vigilance.** The Rupiah has fallen by around 25 percent against the US Dollar since July 2013. After an initially sharp adjustment in Q3 2013, the depreciation has been generally orderly as BI foreign exchange interventions have limited volatility. The flexible exchange rate has helped to cushion the trade shock which began in 2011 and strengthened currency market liquidity (which, however, remains very shallow). However, owing to persistently high domestic inflation in 2014 and 2015, the Rupiah has depreciated only by about 4 percent in real terms over the same period, with export competitiveness remaining a major challenge. The gradual currency adjustment appears to have been manageable for the corporate sector to date. BI has also taken steps to encourage more hedging and penalize high levels of external leverage. Nevertheless, there are risks that some businesses (e.g., in mining or manufacturing) may face external debt repayment difficulties.

15. **Fiscal management has been generally prudent and there has been a significant energy subsidy reform.** The general government deficit is capped by law since 2003 at 3 percent of GDP and this has been adhered to. The threshold for each level of government is determined each year in a MoF regulation; the 2015 and 2016 maximum threshold for the sub-national government has been set at 0.3 percent and for the central government at 2.7 percent of GDP. The fiscal stance has been mildly expansionary, with the primary balance moving to a deficit of around 1.0 percent of GDP in 2013 and 2014 to 1.2 percent in 2015. This was driven initially by expenditure pressures, notably on energy subsidies, mainly for fuels, which swelled to an average of 3.4 percent of GDP over 2012-2014 (30 percent of central government expenditures). In a major policy shift, effective January 1, 2015, the Government introduced a new regulated fuel pricing system with semi-automatic monthly price adjustments based on economic costs, removal of the explicit subsidy for gasoline, and introduction of a fixed per liter subsidy for diesel. This reduced fuel subsidy costs from 2.3 percent of GDP in 2014 to 0.5 percent of GDP in 2015 and provided space for higher spending on infrastructure and social programs. Although, the implementation of the new fuel pricing system has been uneven so far, the 2016 budget sustained the 2015 reforms. With

[8] Subsidized gasoline and diesel prices were raised by an average of 33 percent in June 2013 and 34 percent in November 2014, each increasing the consumer price index by 3-3.5 percent.

energy commodity prices expected to remain moderate through the medium-term, the risk of policy reversal is considered low. Electricity subsidies have declined from 1.0 percent of GDP in 2014 to 0.5 percent of GDP in 2015 due to increase in tariffs for selected large businesses.

16. **Although the energy subsidy reform reduced the impact of oil price on spending, state revenues remain sensitive to the global commodity price cycle.** In 2008, oil and gas income taxes and oil, gas and mining royalties (called non-tax revenues) equaled 5.6 percent of GDP and represented one-third of total revenues. Between 2009 and 2014, these natural resource-based revenues averaged 3.4 percent of GDP and one quarter of total revenues. The high energy commodity prices between 2011 and 2013 failed to boost revenues as it was offset by a structural decline in domestic oil and gas production, which continues until today. The sharp decline in commodity prices reduced resource revenues to 1.3 percent of GDP or 10 percent of total revenues in 2015.

17. **Weak revenue performance has emerged as a major fiscal challenge amid a challenging macroeconomic environment.** Since 2012, the revenue-to-GDP ratio has been declining, falling from 15.4 percent in 2012 to 14.7 percent in 2014. Underpinning this was the decline in natural resource-based revenues coupled with no increase (as a share of GDP) in total other revenues. The revised 2015 Budget set an ambitious revenue collection target of IDR 1,762 tln or 15.1 percent of GDP. However, due to the slowdown in nominal growth, imports and steep decline in commodity prices in 2015, only IDR 1,504 tln was realized – a shortfall of IDR 258 tln or 2 percent of GDP, relative to the revenue target, and a nominal decline of 3 percent yoy in total revenue collection. The revenue-to-GDP ratio fell to 13.1 percent. The decline in oil and gas income taxes (by 43 percent yoy) and natural resource non-tax revenues (by 58 percent yoy) far outweighed the improvement in non-oil and gas income taxes, which increased by 21 percent yoy, as a result of initiatives such as the asset reevaluation program[9].

18. **Despite the revenue shortfall in 2015, government expenditure was maintained in nominal terms with a significant shift in allocation of spending from subsidies to capital**. Total expenditure realized in 2015 was slightly higher than in 2014 (in nominal terms) at IDR 1,796 tln, but falling as a share of GDP from 16.9 percent in 2014 to 15.6 percent in 2015. The overall disbursement rate was 90.5 percent of the revised Budget target. Capital spending was prioritized over other expenditures, increasing by 42 percent yoy to IDR 209 tln, supported by strong political commitment to infrastructure development and improved budget execution in the second half of the year. To preserve capital spending given the revenue shortfall, the Government raised the fiscal deficit from 1.9 percent of GDP (budget target) to 2.5 percent of GDP, lowered energy subsidy spending and non-tax revenue (from natural resources) sharing to sub-national governments[10], and carried out measures to control other expenditures.

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[9] The fixed asset revaluation facility, which allows individuals and companies to apply for revaluation of their fixed assets, where the increase in fixed assets resulting from the revaluation is subject to a reduced rate of "final income tax" ranging from 3 to 6 percent. Between October 15, 2015 (i.e. issuance of the regulation PMK-191/2015) and December 31, 2015, total tax collection from asset revaluation was IDR 20.1 trillion.

[10] Through the issuance of Ministry of Finance regulation (PMK 249/2015 – December 29 and PMK 259/2015 on December 31). No information is currently available on whether some part of the reduction in payments will be treated as postponed i.e. arrears with an obligation to pay in the future.

Table 2: Key Fiscal Indicators: 2012-15 Actual, 2016 GoI State Budget, 2016-20 WB Baseline Projections

Percentage of GDP	**2012**	**2013**	**2014**	**2015**	**2016f**		**2017f**	**2018f**	**2019f**	**2020f**
	Actual				**GoI**	**WB Baseline Projections**				
Overall balance	**-1.8**	**-2.2**	**-2.2**	**-2.5**	**-2.2**	**-2.8**	**-2.8**	**-2.8**	**-2.8**	**-2.8**
Primary balance	-0.6	-1.0	-0.9	-1.2	-0.7	-1.3	-1.5	-1.4	-1.5	-1.5
Revenues: 1+2	**15.4**	**15.1**	**14.7**	**13.1**	**14.3**	**12.2**	**12.5**	**13.6**	**13.8**	**13.9**
1. Tax Revenues	**11.4**	**11.3**	**10.9**	**10.8**	**12.2**	**10.6**	**10.9**	**12.0**	**12.3**	**12.3**
Domestic tax	10.8	10.8	10.5	10.5	11.8	10.3	10.6	11.7	12.0	12.0
Income tax	**5.4**	**5.3**	**5.2**	**5.2**	**6.0**	**5.3**	**5.6**	**5.9**	**6.2**	**6.3**
Non-oil and gas	4.4	4.4	4.4	4.8	5.6	5.1	5.4	5.7	6.0	6.2
Oil and gas	1.0	0.9	0.8	0.4	0.3	0.2	0.2	0.2	0.1	0.1
VAT (inc. LSGT)	**3.9**	**4.0**	**3.9**	**3.7**	**4.5**	**3.7**	**3.7**	**4.2**	**4.2**	**4.0**
Excises	**1.1**	**1.1**	**1.1**	**1.3**	**1.2**	**1.1**	**1.1**	**1.4**	**1.4**	**1.4**
International trade tax	0.6	0.5	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
2. Non-tax revenues	**4.0**	**3.7**	**3.8**	**2.2**	**2.2**	**1.6**	**1.6**	**1.6**	**1.6**	**1.5**
Oil, gas & mining	2.6	2.4	2.3	0.9	1.0	0.4	0.4	0.4	0.4	0.4
Expenditures: 1+2+3	**17.2**	**17.3**	**16.9**	**15.6**	**16.5**	**15.1**	**15.3**	**16.4**	**16.6**	**16.7**
1. Central govt. spending	**11.6**	**11.9**	**11.4**	**10.2**	**10.4**	**9.4**	**9.2**	**9.2**	**9.2**	**9.2**
Personnel	2.3	2.3	2.3	2.4	2.7	2.5	2.5	2.5	2.5	2.5
Goods and services	1.6	1.8	1.7	2.0	2.6	2.2	2.2	2.2	2.2	2.2
Capital*	**1.6**	**1.9**	**1.4**	**1.8**	**1.6**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**
Interest payments	1.2	1.2	1.3	1.4	1.5	1.5	1.3	1.4	1.3	1.3
Subsidies, of which:	4.0	3.7	3.7	1.6	1.4	1.2	1.2	1.2	1.2	1.2
Energy	**3.6**	**3.3**	**3.2**	**1.0**	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Fuels	2.5	2.2	2.3	0.5	0.5	0.4	0.4	0.3	0.3	0.3
Electricity	1.1	1.0	1.0	0.5	0.3	0.3	0.3	0.4	0.4	0.4
Non energy	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Social expenditures	0.9	1.0	0.9	0.8	0.4	0.4	0.4	0.4	0.5	0.4
Other expenditures	0.0	0.0	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
2. Transfers to regions	**5.6**	**5.4**	**5.4**	**5.4**	**6.1**	**5.7**	**5.7**	**6.1**	**6.2**	**6.1**
3. *Additional Spending (likely to increase capital expenditures)*						***0.0***	***0.3***	***1.0***	***1.3***	***1.4***
Selected sector spending										
As share of actual govt. spending										
Infrastructure	12.1	11.7	10.6							
Health	3.9	3.9	4.7							
Social assistance	2.9	2.7	2.6							

As share of budgeted central govt. spending							
Infrastructure	13.6	12.5	10.8	19.0	19.5	19.5	19.5
Health	3.7	3.8	4.5	5.0	7.2	7.2	7.2
Social assistance	2.9	2.7	2.5	3.2	3.6	3.6	3.6
Net Financing	2.0	2.5	2.5	2.8	2.1		
Domestic (net)	2.3	2.6	2.6	2.7	2.1		
of which bonds (net)	1.9	2.4	2.6	3.1	2.6		
Foreign (net)	-0.3	-0.1	-0.1	0.1	0.0		
Disbursement	0.4	0.6	0.5	0.7	0.6		
Amortization	-0.6	-0.6	-0.6	-0.6	-0.5		

Source: 2012-2015 Actual and 2016 State Budget from Ministry of Finance, 2016-2020 World Bank projections
Notes:
Revenue: (i) Baseline revenue projection includes the medium-term (positive) impact of tax administration and policy reforms in the DPL operation on the collection of non-oil and gas income tax, VAT and excise taxes. (ii) Projections exclude the short-term impact of the proposed tax amnesty program (upside), the impact of tax incentives (downside). They also exclude the impact of comprehensive IT reforms and SARA, which are outside of the DPL and there is still policy uncertainty on the direction and timing of implementation.
Expenditure: (i) Total expenditure is equal to baseline revenue plus fiscal deficit of 2.8 percent of GDP as it assumes government will increase total spending up to the fiscal rule. (ii) Additional spending is the difference between continuation of 2016 expenditure levels relative to GDP (except for interest payments, energy subsidies (based on oil price and policy) and transfers (based on revenue collection) and total expenditure. (iii) Energy subsidy assumes ongoing implementation of energy subsidy reforms started in January 2015. (iv) Additional spending is expected to be used for priority sectors such as infrastructure, therefore capital spending is likely to higher than what is shown. (iv) Infrastructure and health sector spending refers to the definition outlined in the 2016 Budget Financial Note. Infrastructure spending is not equivalent to *capital spending*; it includes expenditures of the Ministry of Public Works and Housing, Ministry of Transport, Ministry of Energy and Mineral Resources, and Ministry of Agriculture; transfers to sub-national governments through DAK and the Village Fund for infrastructure programs; and capital injections into state-owned enterprises. Health spending includes expenditures by the Ministry of Health and the Medicine Control Agency, and transfers to local governments through DAK for health programs. (v) Social assistance sector spending excludes the health insurance subsidy for the poor, which is included in health spending, and the temporary compensation for fuel price increases. In the budget social assistance sector spending is shown under the *social expenditure* and *goods and services* line items. In 2016, a large number of social assistance sector spending was reclassified from *social expenditure* to *goods and services* spending.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

19. **In the baseline scenario, GDP growth is expected to pick up to 5.1 percent and 5.3 percent in 2016 and 2017, respectively**. Indonesia is transitioning to a new level of trend growth, roughly 1–1.5 percentage points lower than during the commodities boom. Domestic demand growth is projected at 5.1 percent in 2016, supported by higher public spending but hampered by still subdued private sector investment. This scenario is predicated on the government prioritizing infrastructure spending and reforms to improve the business environment.[11] Export volumes are expected to decline for a second year as global trade

[11] The Government started a significant effort of regulatory reform with eleven (so far) economic policy packages announced between September 9 2015 and end February, 2016. The recently announced reforms go beyond regulatory simplification and fiscal stimuli, and include structural reforms. The Government's intent is fourfold: to increase investments, revitalize domestic industry, facilitate trade and improve logistics, and ease the procurement of raw materials, particularly in such sectors as agriculture, marine affairs and fisheries, and mining products. However, the effectiveness of the packages will depend on the government's implementation capacity.

remains weak, but imports will likely pick up on the back of more infrastructure spending. Consequently, net exports are expected to reduce output growth in 2016.

20. **Risks to the growth outlook are to the downside.** External risks stem from volatile global financial conditions and the possibility of a further weakening in commodity and external demand, including as a consequence of China's economic rebalancing and slowdown. Despite the significant decline in exports to China – which in 2015 were at two-thirds of their 2011 level – the country remains one of Indonesia's largest trading partners with a 10-percent share in total exports (three quarters of which commodities). Domestic risks include slower and more modest reform implementation, lower public investment due to a higher than expected revenue shortfall, and that relatively tight credit and profit margins continue to weigh on private spending.

21. **The projected significant decline in inflation has opened some room for monetary easing, but BI will have to balance this against the risk of continued nominal currency depreciation pressures**. The current account deficit is expected to increase to 2.3 percent in 2016, with the down-shift in global oil prices reducing net oil imports, although partly offset by lower natural gas revenues. The expectation of only modest global trade growth with no upswing in commodity prices weighs on the outlook for exports, while the ambitious public spending program would also add to import demand. Consequently, BI, with its focus on limiting external pressures, is likely to move cautiously in loosening monetary policy.

22. **The approved 2016 Budget has an ambitious revenue target and public spending program.** Improvements in the allocation of the budget has been sustained with lower energy subsidies and higher allocation to infrastructure, health and social assistance (Table 2). However, realization will depend on revenue collection, how the government responds to the expected revenue shortfall, and the implementation of transfers to subnational governments for health and infrastructure programs[12]. The total revenue target of IDR 1,822 tln is highly ambitious given the further weakening of commodity prices since October 2015 when the budget was approved. The Ministry of Finance is expecting a large contribution (MoF numbers cited range from IDR 50 tln to IDR 150 tln[13]) from the tax amnesty program, the bill for which has been submitted to Parliament, to help reach the target.

23. **The World Bank 2016 fiscal baseline (Table 2) projects a significant revenue shortfall.** Revenue is projected to reach IDR 1,547 tln, which represents a nominal increase of 2.8 percent yoy, but a difference of IDR 275 tln with the 2016 Budget target[14] and a decline in the revenue-to-GDP ratio to 12.2 percent. The baseline forecast accounts for the sharp fall in international oil and gas prices, lower oil production, and continuing moderate rates of growth in nominal GDP, import and private consumption expected in 2016. The baseline

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[12] In contrast to 2015, the increase in public infrastructure investment will be channeled through transfers to local governments ear-marked (DAK) for capital spending and capital injections into state-owned enterprises rather than central government spending.

[13] Credit Suisse analyst report (Feb 2016) estimated a range of IDR 40-60 tln (0.3 to 0.5% GDP), citing that a previous amnesty (the sunset clause enacted in 2008), which was weaker in design, generated 0.2% GDP. The upper range assumes that 30-50% of USD 200 billion undeclared assets held overseas and USD 100 billion held domestically will avail of the tax amnesty.

[14] In addition to differences in macroeconomic assumptions and the treatment of the tax amnesty, the World Bank revenue forecast is lower than the 2016 Budget, because the latter was prepared in July 2015 when the full extent of the 2015 revenue shortfall was not known.

includes about IDR 40 tln from intensified tax enforcement efforts and tax administration reforms implemented in 2014-2015, including the roll-out of electronic VAT invoicing, expansion of electronic tax filing, establishment of a unique taxpayer ID system, and improvement in access to land asset data for audit purposes. However, there is a risk that these measures result in a smaller than expected increase in tax revenues. An upside risk to the baseline is the impact of the tax amnesty program, which is not included in the projection.

24. **The Government is expected to adjust expenditure and expand the fiscal deficit to 2.8 percent of GDP if revenue collection is below target**. Given the commitment to increasing infrastructure spending and the concrete measures that have already been taken, such as early procurement by line ministries for capital projects, it is expected that the Government will, as it did in 2015, preserve capital spending by adjusting non-priority expenditures, namely material and other (contingency) spending, and allow the fiscal deficit to expand from the target of 2.2 to 2.8 percent of GDP. The ability to preserve priority program spending will be reduced by higher than expected revenue shortfall.

25. **As in the past, fiscal financing risks in 2016 are being mitigated through frontloading securities issuance.** A larger than targeted fiscal deficit may be associated with higher financing risks and costs. Although global financial markets have recently favored Indonesia, with local currency sovereign yields down by about 80 basis points in the year to March 9 for the 10-year bond, financial conditions remain volatile. However, the government has proactively taken measures to manage such risks, frontloading its market financing strategy. As of March 7, the government has secured IDR 190 trillion from securities issuance out of estimated gross financing needs of IDR 711 trillion (based on fiscal deficit of 2.8 percent of GDP) in 2016.

26. **In the medium-term, revenue reforms – both administration and policy - are essential to create the fiscal space for spending on development priorities.** The World Bank baseline revenue projection (Table 2) includes the expected positive impact of tax administration and policy reforms contained in the DPL operation on the collection of non-oil and gas income tax, VAT and excise taxes over the medium-term. The improvements in VAT administration, income tax e-filing, unique taxpayer ID and access to third-party data for audit is expected to improve VAT and non-oil and gas income tax compliance rates moderately from 53% in 2015 to 60% by 2020, leading to an additional 1.1 percent of GDP in tax by 2020[15]. The reforms of VAT and LGST policy (reductions in exemptions and replacement of vehicle LGST with a vehicle excise tax) and income tax policy (anti-tax base erosion measures) are expected to increase the tax base for VAT, excise and non-oil and gas income tax, leading to an additional 1.3 percent of GDP in tax by 2020[16]. While these estimates do not assume during this period that there will be a comprehensive modernization of the IT and data management or establishment of a fully functioning semi-autonomous

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[15] Sensitivity analyses: 1 percentage point increase in VAT compliance rate increases VAT collection to GDP by 0.06 percentage points; 1 percentage point increase in non-oil-and-gas income tax compliance rate increases income tax collection to GDP by 0.1 percentage points.

[16] VAT: the lower bound estimate of additional revenues is 0.3 percent of GDP, the upper bound is 0.9 percent of GDP. The baseline of 0.5 percent of GDP assumes 50 percent of currently exempt value-addition becoming subject to standard VAT rate. Excise: the lower bound estimate of additional revenues is 0.2 percent of GDP, the upper bound is 0.4 percent of GDP. The baseline of 0.3 percent of GDP assumes retail price increases and a small decline in consumption volume.

revenue authority, they do assume that DG Taxes continues to implement various initiatives that provide incremental improvements in administrative capacity and complements the revenue reforms contained in the DPL operation (see Annex 4).

27. **Revenue reforms in this DPL operation can help bring revenue and expenditure levels closer to 2014 levels by 2019-2020.** As total expenditure as a share of GDP has fallen significantly since 2013, we expect the government to increase spending up to the fiscal rule i.e. total government expenditure is equal to total revenue plus 2.8 percent of GDP. This means total expenditure as share of GDP can rise to 16.6 and 16.7 percent of GDP by 2019 and 2020 – creating an additional 1.3-1.4 percent of fiscal space for spending (on top of the automatic increase in transfers to regions from higher revenue) compared to a scenario with no revenue improvement (Table 3). The additional fiscal space is expected to be used for priority sectors, in particular infrastructure.

28. **Without sustained revenue reforms, revenues are expected to continue to weaken, constraining government expenditure in order to adhere to the fiscal rule.** There are a number of downside risks to the above baseline medium-term scenario: incomplete implementation of planned revenue reforms; absence of complementary DG Taxes initiatives to improve administrative capacity; and/or a negative impact of other policies/measures on revenue collection. In this "no revenue reform" scenario the ratio of revenue-to-GDP falls to and stays below 12 percent of GDP in the medium-term, underpinned by continued weakness of commodity prices. Government expenditure (except transfers which will fall in line with revenue[17]) then remain stagnant at WB projected 2016 levels through the medium-term with no additional fiscal space created for priority spending.

[17] A large component of transfers to regions is the DAU (balancing fund), which is based on expected revenues so if lower revenues are expected, the DAU also decreases. As the DAU goes into the general budget of the subnational government, it is unclear which sectors will be affected, although the majority of DAU has been spent on administration.

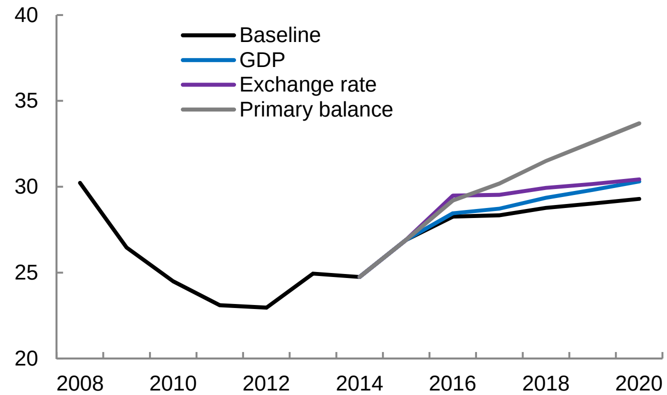
Table 3: Key Fiscal Indicators with 2016-20 WB Baseline and 'No revenue reform' Projections

Percentage of GDP	2012	2013	2014	2015	2016f		2017f	2018f	2019f	2020f
	Actual				GoI	WB Baseline Projection WB 'No revenue reform' Projection				
Overall balance	**-1.8**	**-2.2**	**-2.2**	**-2.5**	**-2.2**	**-2.8**	**-2.8**	**-2.8**	**-2.8**	**-2.8**
Revenues and Grants	**15.4**	**15.1**	**14.7**	**13.1**	**14.3**	**12.2**	**12.5**	**13.6**	**13.8**	**13.9**
						11.9	***11.7***	***11.6***	***11.5***	***11.5***
Tax Revenues	**11.4**	**11.3**	**10.9**	**10.8**	**12.2**	**10.6**	**10.9**	**12.0**	**12.3**	**12.3**
						10.3	***10.1***	***10.1***	***10.0***	***9.9***
Income tax	**5.4**	**5.3**	**5.2**	**5.2**	**6.0**	**5.3**	**5.6**	**5.9**	**6.2**	**6.3**
						5.0	***5.0***	***5.1***	***5.1***	***5.2***
Non-oil and gas	4.4	4.4	4.4	4.8	5.6	5.1	5.4	5.7	6.0	6.2
						4.8	*4.9*	*4.9*	*5.0*	*5.0*
Oil and gas	1.0	0.9	0.8	0.4	0.3	0.2	0.2	0.2	0.1	0.1
VAT (inc. LSGT)	**3.9**	**4.0**	**3.9**	**3.7**	**4.5**	**3.7**	**3.7**	**4.2**	**4.2**	**4.0**
						3.6	***3.4***	***3.3***	***3.2***	***3.1***
Excises	**1.1**	**1.1**	**1.1**	**1.3**	**1.2**	**1.1**	**1.1**	**1.4**	**1.4**	**1.4**
						1.1	***1.1***	***1.1***	***1.1***	***1.1***
Non-tax revenues	**4.0**	**3.7**	**3.8**	**2.2**	**2.2**	**1.6**	**1.6**	**1.6**	**1.6**	**1.5**
Oil, gas & mining	2.6	2.4	2.3	0.9	1.0	0.4	0.4	0.4	0.4	0.4
Expenditures: 1+2+3	**17.2**	**17.3**	**16.9**	**15.6**	**16.5**	**15.1**	**15.3**	**16.4**	**16.6**	**16.7**
						14.7	***14.5***	***14.4***	***14.3***	***14.3***
1. Central govt. spending	**11.6**	**11.9**	**11.4**	**10.2**	**10.4**	**9.4**	**9.2**	**9.2**	**9.2**	**9.2**
						9.0	***8.9***	***8.9***	***8.9***	***8.9***
Personnel	2.3	2.3	2.3	2.4	2.7	2.5	2.5	2.5	2.5	2.5
						2.4	*2.4*	*2.4*	*2.4*	*2.4*
Goods and services	1.6	1.8	1.7	2.0	2.6	2.2	2.2	2.2	2.2	2.2
						1.9	*1.9*	*1.9*	*1.9*	*1.9*
Capital*	**1.6**	**1.9**	**1.4**	**1.8**	**1.6**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**
Subsidies, of which:	4.0	3.7	3.7	1.6	1.4	1.2	1.2	1.2	1.2	1.2
Energy	3.6	3.3	3.2	1.0	0.8	0.7	0.7	0.7	0.7	0.7
Non energy	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Social expenditures	0.9	1.0	0.9	0.8	0.4	0.4	0.4	0.4	0.5	0.4
2. Transfers to regions	**5.6**	**5.4**	**5.4**	**5.4**	**6.1**	**5.7**	**5.7**	**6.1**	**6.2**	**6.1**
						5.7	***5.6***	***5.5***	***5.4***	***5.3***
3. *Additional Spending (likely to increase capital expenditures)						***0.0***	***0.3***	***1.0***	***1.3***	***1.4***
						0.0	***0.0***	***0.0***	***0.0***	***0.0***

Source: 2012-2015 Actual and 2016 State Budget from Ministry of Finance, 2016-2020 World Bank projections
Notes on the "No revenue reform scenario": (i) "No revenue reform' scenario projection excludes the medium-term (positive) impact of tax administration and policy reforms in the DPL operation on the collection of non-oil and gas income tax, VAT and excise taxes. (ii) Total expenditure is equal to 'No revenue reform' revenue plus fiscal deficit of 2.8 percent of GDP as it assumes government will increase total spending up to the fiscal rule. (iii) Allocation of the reduced budget (compared to the baseline scenario) assumes adjustments to be made in personnel, goods and services spending in order to preserve capital spending as per the Government's policy priorities.

29. **Government debt sustainability is strong.** Following a decade-long steep and sustained decline on the back of small fiscal deficits and solid GDP growth, government debt-to-GDP fell to 23 percent in 2012. The debt-to-GDP ratio remains moderate under a range of economic scenarios. Under the baseline fiscal deficit of 2.8 percent of GDP during 2016-2020, the debt-to-GDP is projected to rise to 28.3 percent in 2016 and then gradually to 29.3 percent by 2020. In scenarios with a one-time, permanent one standard deviation shocks to either real GDP growth or the exchange rate in 2015, government debt stays at 30 percent of GDP in the medium term. Only when a similar shock (equivalent to 0.7 percentage points of GDP) is applied to the primary balance does the debt-to-GDP ratio increase to 34 percent by 2020. In addition to a moderate debt level, the risk profile of the government debt stock is solid, although non-resident holdings of domestic bonds are relatively high at 38 percent. The average time to maturity is relatively long, at 9.3 years. 14 percent of the debt is variable rate. Currency exposure is significant, with 44 percent of total debt denominated in foreign currency.[18] In order to mitigate this risk, Indonesia's debt management strategy continues to focus on domestic bond issuance and financing from multilateral and bilateral partners. Finally, fiscal risks arising from expanding balance sheets of key state-owned enterprises need to be monitored closely.

Figure 2: In the baseline trajectory government debt-to-GDP remains below 30 percent
(government debt-to-GDP, percent, under baseline and -1 standard deviation shocks to key variables)



Source: Ministry of Finance; World Bank projections

30. **The macroeconomic policy framework is considered adequate for the proposed operation.** Indonesia's economy has weathered a significant deterioration in external demand and its terms of trade and, in mid-2013 and mid-2015, in financial market conditions. This resilience in part reflects a comparatively large domestic demand base and strong structural growth forces, including demographics and rapid urbanization, but also a policy framework that has proved itself responsive to the risk of macroeconomic imbalances. The Government has also made sizeable progress in strengthening crisis preparedness and management protocols.

[18] All debt profile figures are preliminary as of December 31, 2015 (Source: Ministry of Finance).

3. THE GOVERNMENT'S PROGRAM

31. **Since taking office, the Jokowi administration has set out a series of ambitious development goals, particularly relating to infrastructure development and social programs**. The President's electoral platform – the "Nawa Cita" – has been reflected in the National Medium-term Development Plan (RPJMN) for 2015-2019, which sets out national development goals and the main directions of policy for the period. The government's growth strategy is based on a big infrastructure push and accelerating structural reforms, with a series of reform packages announced since mid-September 2015. The infrastructure push requires significant public and private sector financing, making improving domestic revenue mobilization critical. To reach these goals, the RPJMN for 2015-2019 emphasizes the need to: (i) strengthen state revenue administration capacity and improve tax policy to increase the state revenue from tax and non-tax sources; and (ii) strengthen planning and budgeting institutions to improve budget execution, the composition of spending, and the effectiveness (impact) of public expenditure.
32. **The 2015 and the 2016 state budgets contain significant improvements in the composition of spending.** The estimated fiscal savings of nearly IDR 200 trillion from the energy subsidy reforms undertaken in 2015 provided space for higher spending on infrastructure and social assistance programs. The government showed its policy intent in the 2016 budget to maintain low energy subsidies and sustain the increase in pro-poor and pro-growth spending on infrastructure, health and social assistance.
33. **To address long-standing budget execution and efficiency of spending challenges, in particular for infrastructure projects, the government has taken a number of measures**, including: revision of the land acquisition regulation to accelerate the process; increase usage of early procurement for the 2016 Budget capital projects; issuance/revision of regulations to ease constraints on public-private partnerships and usage of multi-year contracts. In addition, the government is continuing to strengthen the control environment and the regulatory framework for public procurement to improve the efficiency of spending i.e. how well resources are used as intended and translated into outputs[19]. At the subnational level, the government initiated in 2015 reforms (still ongoing) to improve the quality of specific earmarked transfers (DAK) to the regions and of the village funds (direct transfers to villages).
34. **Strengthening tax administration, through increasing the capacity of the Directorate General of Taxation (DG Taxes), is seen as key to raising revenue.** DG Taxes adopted in early 2014 the long-term *Institutional Transformation Blueprint*, as the next phase in an ongoing reform process that started in the early 2000s[20]. In practice it has had difficulties operationalizing the recommendations and prioritizing those that most directly contribute to

[19] GoI has adopted COSO as its control framework. The internal audit function has been streamlined and an association of public sector internal auditors established. Revised procurement regulations have been issued that have begun the process of standardized bidding documents, use of e-procurement and putting in place dedicated procurement service units in procuring agencies.

[20] During the period between 2001 and 2008, DG Taxes initiated a set of tax administration reforms, including "extensification" program (i.e. registering of additional taxpayers); improving audit and collection of late tax payments processes and creation of large, medium and small taxpayers' offices, and reforms in HR management. These reforms were estimated to mobilize additional revenues of 1 percent of GDP over four years (Brandolo, J. et al. (2008). "Tax Administration Reform and Fiscal Adjustment: The Case of Indonesia (2001-07)").

revenue performance. Notwithstanding, DG Taxes has implemented various initiatives that all provide incremental improvements in administrative capacity. These include: promotion of electronic tax filing (VAT returns, individual and corporate income tax), implementing a unique taxpayer ID system, improving access to third-party taxpayer data for auditing, and developing the initial methodology for a compliance risk management (CRM) model. There is an ongoing process to modernize their heavily outdated ICT and data management systems – one of the most significant hindrances to improving tax administration. DG Taxes is looking at financing modalities, including through a PPP, to make the significant ICT investments required. The government is considering turning DG Taxes into a semi-autonomous revenue authority (SARA) by 2017-8 to provide greater autonomy on human resources, organization, and budget management. The decision is currently under discussion in Parliament as part of the revision of the general tax administration (KUP) Law.

35. **The government has also set out an ambitious tax policy reform agenda, starting in 2016**[21] with revisions of the VAT and Income Tax Laws scheduled to be tabled to the Parliament. In addition, the government plans to revise the final tax regime established by government regulation in 2013 for micro, small and medium enterprises. This agenda provides a significant opportunity to increase the tax potential by broadening the tax base, and to ease administrative complexity, reduce economic distortions and incentives for strategic behavior by taxpayers by simplifying tax structures. While collecting more is a priority for the Government, there is also more emphasis on using tax policy as an instrument to boost consumption and investment[22], namely through expanding tax incentives that could potentially mean foregoing revenue, at least in the short-term.

36. **In addition to these medium-term revenue reforms, the pressure to meet ambitious revenue targets in 2015 and 2016** has led to a number of initiatives designed to raise revenues in the short-term, including the asset reevaluation program in 2015 and the planned tax amnesty program for 2016. The tax amnesty program aims to bring undeclared assets into the tax net and is being presented as a one-time opportunity for taxpayers to 'come clean' before global disclosure is in effect (through the planned implementation of the Automatic Exchange of Information). The program will be established through the Tax Amnesty Law, which is currently in discussion in the Parliament. The details of the program are still being debated but it is thought that there will be a limited window (to the end of 2016) for taxpayers to pay a defined percentage (lower if declared earlier and if assets are repatriated) of the undeclared assets in exchange for forgiveness of tax liability in previous periods.

[21] There were a few measures undertaken in 2015 to raise taxes but no substantial changes in tax policy (MoF issued regulation PMK 90/2015 and PMK 107/2015 expanding the type of goods and withholding agents and lowering the threshold for the withholding tax (Art 22 of the income tax law); MoF raised in July import duties on around 1000 consumer goods).

[22] Key 2015 measures include: 1) Increasing the non-taxable personal income tax threshold to IDR 36 million (from IDR 24.3 million previously) through PMK 122/2015; 2) Revision of government regulation on investment-linked tax allowances (PP18/2015) in April 2015 expanding the scope to 144 business sectors and streamlining the process for applying and securing these tax allowances; 3) The Ministry of Finance issued in August 2015 PMK 159/2015, which expanded the existing tax holiday facility, enabling discretion of the Minister to offer investors in sectors defined as "pioneering" holidays of up to 20 years.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

37. **The proposed DPL series supports the Government's overall objectives to collect more and improve the quality of spending** by supporting institutional and policy reforms being undertaken by the Government. In doing so the operation has been selective on which government initiatives and reforms to support through the DPL – namely those that are expected to contribute significantly to the overall objectives through the medium-term. Some reforms such as strengthening the tax administration IT systems are critical but are being supported by other Bank instruments. See Annex 4 for a summary overview of the Government's fiscal reform agenda and the different instruments of support from the Indonesia Country Partnership Framework (CPF) *Collecting More and Spending Better* engagement.

38. **The Fiscal Reform DPL series is structured around the following three pillars, set of objectives 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 (SPAN); (iii) facilitating investment by private sector in essential infrastructure; (iv) removing barriers to multi-year contracts for government procurement; and (v) conducting early procurement.
    - **Pillar B: Strengthening Revenue Administration.** *PDO: Increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes* by (i) strengthening VAT administration; (ii) increasing electronic tax filing; (iii) establishing a unique and permanent taxpayer ID system; and (iv) improving DG Taxes access to taxpayer asset and financial data for audits.
    - **Pillar C: Enhancing Tax Policy.** *PDO: Increasing revenue potential and economic efficiency of tax policy* by (i) improving VAT, LGST and Excise tax regimes; and (ii) improving Income Tax regimes.

39. **The operation builds on fiscal reforms supported by previous DPLs in Indonesia in the last 10 years**[23]. These reforms were mostly public financial management reforms in budget preparation, treasury management, accounting and internal auditing, with some tax administration. Similar to the new Energy DPL series, by taking a focused sectoral approach, the operation aims to obtain stronger government ownership and a more comprehensive coverage of the fiscal sector. The Fiscal Reform DPL series has a deeper focus on infrastructure spending and tax administration than in previous DPLs and includes new areas, in particular budget allocation and tax policy.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

40. **The policy matrix** (Annex 1) **has been developed through intensive dialogue between the Government, in particular the Ministry of Finance, and the World Bank, and is underpinned by substantial advisory and analytical work** (past, ongoing and planned) by

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

the Bank and development partners engaged on fiscal issues (in particular: Australia AIPEG, GPF, and IMF). Additional technical assistance has been initiated to support the government to design and implement the triggers for the second operation.

41. **All eleven prior actions have been completed by the end of 2015**. They are summarized in Table 4 below with the analytical underpinnings. In early December 2015, when the Concept Review for the DPL took place, there were three outstanding actions. The government successfully completed the remaining by the end of December 2015. In many of the reform areas, the prior action is followed by an indicative trigger to expand and/or sustain the reform in the planned second operation. We expect all the indicative triggers to be completed by end of March 2017 and the result indicators reflect the expected timing of the two operations. However, given the long-standing structural challenges, especially in revenue administration, there will still be many unfinished reforms, which could be supported through further operations.

Table 4: Prior actions, current status and analytical underpinnings

Government reform area	Proposed prior actions	Completion Status	Analytical underpinnings
Pillar A— Improving Quality of Spending ***PDO A: Improving composition of spending, budget execution and efficiency of spending***			
Improving central government budget allocation	Prior action #1. The Borrower has increased the share of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-fuel subsidy reform years (2012-2014), as evidenced through the 2016 Budget Law, the Financial Note for 2016 State Budget and the Presidential Regulation 137/2015.	Completed (November 2015)	• WB PERs (2008-2015) (roads, WSS), health and social assistance) • WB infrastructure and growth ESWs • WB medium-term fiscal framework model
Strengthening budget monitoring and management through FMIS (SPAN)	Prior action #2. The DG Treasury has completed the roll-out of the financial management information system (SPAN) to all regional treasury offices, as evidenced through the issuance of the Certificate of Operational Acceptance to the service provider.	Completed (June 2015)	• GFMRAP supervision • IDN (2014) PEFA report • FMIS Study of selected PEMNA members (Indonesia): • WB analytical work on Cash Management
Facilitating investment by private sector in essential infrastructure	Prior action #3. The Borrower has enabled its ministries and agencies to engage in Availability Payment Contracts for infrastructure projects with the private sector, as evidenced through the Presidential Regulation 38/2015, Minister of Finance Regulation 190/2015, Head of Bappenas Regulation 4/2015 and Head of LKPP Regulation 19/2015.	Completed (October 2015)	• WB TA work to support Indonesia's PPP design and implementation • WB (2012) Road PER • WB policy notes on public investment management • AIPEG analytical work on infrastructure contracting • WB (2012) report on constraints to
Removing barriers to multi-year contracts for	Prior action #4. The Minister of Finance has reduced major barriers for ministries and agencies to issue multi-year contracts for government procurement by: (a) not requiring the land acquisition process,	Completed (December 2015)	

government procurement	which remains necessary, to be completed prior to submission of multi-year contracts to the Minister of Finance; (b) eliminating the requirement for an external audit for no-cost contract extensions; and (c) increasing the flexibility of annual budget reallocation for multi-year contracts, as evidenced through the Minister of Finance Regulation 238/2015.		infrastructure budget execution
Conducting early procurement	Prior action #5. The Borrower has enabled the increased usage of early procurement for capital projects listed in the 2016 State Budget, as evidenced through the Presidential Instruction 1/2015, Minister of Public Works and Housing Instruction 3/2015 and Minister of Finance Circular Letter S-577/2015.	Completed (July 2015)	• WB (2013) report on bottlenecks in the procurement of infrastructure project in Indonesia
Pillar B---Strengthening Revenue Administration ***PDO B: Increasing administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes***			
Strengthening VAT administration	Prior action #6. The DG Taxes has launched in July 2015 an electronic VAT invoice online application that ensures systematic submission of detailed information on taxable goods and services by taxpayers, as evidenced through the DG Taxes Decree 136/2014.	Completed (July 2015)	• WB Tax Administration technical assistance missions to support component VI of the PFM MDTF • IMF (2014) Tax Policy and Administration TA report
Increasing electronic filing of tax returns	Prior action #7. The DG Taxes has reduced the burden of the Validation Process for individual e-filing by allowing tax officers to validate on the premises of employers with twenty or more employees, as evidenced through the DG Taxes Regulation 41/2015.	Completed (December 2015)	
Establishing a unique and permanent taxpayer ID system	Prior action #8. The DG Taxes has abolished the statement of regional information in the taxpayer identification number so that taxpayers will not receive new tax IDs when they move to a different region as a major step in establishing a unique and permanent taxpayer identification system, as evidenced through the DG Taxes Circular Letter SE 44/2015.	Completed (June 2015)	
Improving DG Taxes access to taxpayer asset and financial data for audits	Prior action #9. The DG Taxes and BPN have implemented an electronic data exchange to enable DG Taxes to access taxpayers' land asset data held by BPN for compliance purposes in a systematic manner.	Completed (August 2015)	
Pillar C---Enhancing Tax Policy ***PDO C: Increasing revenue potential and economic efficiency of tax policy***			

Improving VAT, Luxury Goods Sales Tax and Excise tax policy	Prior action #10. The Minister of Finance has submitted to the Ministry of Law and Human Rights the white paper (naskah akademik) for the revision of the VAT and LGST Law no. 42 of 2009 that recommends (a) broadening the VAT base by rationalizing exemptions and limiting the Ministry of Finance's discretion in granting exemptions; (b) replacing vehicle LGST with a vehicle excise tax; and (c) incorporating remaining LGST goods into the VAT regime.	Completed (December 2015)	• IMF (2014) Tax Policy and Administration TA report • WB (2014-5) policy notes on vehicle LGST, tax allowance & tobacco excise • WB (2015) VAT Policy Study • Sugana and Hidayat (2014): *Analysis of 2013 VAT Revenue Potential and Gaps in Indonesia* Ongoing/to be done • WB (2015-6) study on the final tax regime for MSMEs • WB (2016) Income Tax study • WB (2016) review of anti-BEPS regulations
Improving income tax policy	Prior action #11. The Minister of Finance has established a maximum debt-to-equity ratio of 4:1 for calculating the allowable deduction from interest paid on debt to address thin capitalization, as evidenced through the Minister of Finance Regulation 169/2015.	Completed (September 2015)	

42. **There is ongoing policy dialogue and technical assistance on important reform areas that could be potentially added in the second operation.** The expenditure pillar would be further strengthened with reforms aimed out improving the quality of subnational expenditure, in particular the DAK transfers from central government to subnational governments for infrastructure projects. The Ministry of Finance is planning to issue regulations in 2016 on the budget allocation, implementation and monitoring of DAK. The revenue administration pillar could be bolstered through the inclusion of non-tax revenue administration reforms supported by Ministry of Finance and Ministry of Energy and Mineral Resources as past analytical work has shown that the revenue loss from low compliance in non-tax revenues from natural resource sector is also high[24]. To strengthen the trigger on improving access to taxpayer land asset and credit card data for audit purposes, the Ministry of Finance is seeking to improve the timeliness of access to banking (deposit) data for audit purposes[25]. On tax policy, there is ongoing technical assistance on tobacco excise tax reform to support revenue and public health objectives. Indonesia's tobacco excise taxes are low and the multiple tiers increases the risk of tax avoidance. However, the political economy of reforms are difficult as the industry is a major source of employment[26] and is powerful. The government's commitment to expand public investment coupled with the risks of revenue performance not picking up will put pressure on maintaining the target fiscal deficit.

[24] Mining non-tax revenue compliance rates estimated at 53% (Mining NTR administration study, WB 2014).
[25] The Ministry of Finance has already issued PMK 125/2015 on procedures for information exchange. It needs implementing guidelines from OJK to improve access to bank customer data for audit purposes.
[26] Estimated over 1 million tobacco and clove farmers and cigarette factory workers (Sakernas labor force survey, 2013).

Strengthening fiscal risk and debt management may become more critical in the future and future operations may consider adding a new pillar in this area.

PILLAR A— IMPROVING QUALITY OF SPENDING

Improving central government budget allocation

43. **Rationale:** Indonesia has persistently underspent on infrastructure, health and social assistance sectors. Total government (central and subnational) infrastructure spending has hovered around 2 percent of GDP[27] leading to a huge infrastructure deficit that can be seen in the chronic congestion on the country's roads, ports and airports, power shortages, and low access to water and sanitation. In 2012, total government expenditure on health only reached 1 percent of GDP – the fifth-lowest health spending-to-GDP ratio out of 188 countries[28]. Spending on social assistance programs, which are the most pro-poor and inequality-reducing type of spending[29], has also been persistently low (0.55[30] percent of GDP in 2014 compared to 1-2 percent of GDP among Indonesia's peers). This has meant that social assistance programs could only provide partial and non-guaranteed protection to the vulnerable and poor from shocks and risks faced.
44. **Prior action #1 and indicative trigger #1:** For fiscal year 2015, the Government implemented major fuel subsidy reforms and reallocated the savings to infrastructure and social programs in the revised 2015 Budget. The government has showed its policy intent in the 2016 Budget Law approved by Parliament in October 2015 (Prior action #1) to continue to maintain low energy subsidies and use the additional fiscal space created to raise spending – in absolute terms as well as a share of central government spending[31] - on infrastructure, health and social assistance, in particular targeted programs such as conditional cash transfers (PKH). Given the significant needs in these priority sectors, it is important to sustain these improvements in the composition of the budget through to the 2017 Budget Law (Indicative Trigger #1) and in the following years' annual budgets; this would be consistent with the Government's national medium term development plan (RPJMN) 2015-2019 [32].
45. **Expected results:** The average share of the central government budget allocated during 2012-14 for social assistance, health and infrastructure was 2.7 percent, 4.0 percent and 12.3 percent, respectively. The share of the 2016 budgeted central government spending for social assistance, health and infrastructure are 3.6 percent, 7.2 percent and 19.5 percent

[27] Total investment by the central government, sub-national governments, state-owned enterprises and the private sector has remained at only 3 to 4 percent of GDP over the past decade, below the rates of above 7 percent of GDP before the 1997 Asian financial crisis and the 10 percent and 7.5 percent spent by China and India, respectively.
[28] While performance in health is not all about money, it is likely to be a major factor behind Indonesia's poor health indicators in many areas. Despite significant progress in infant and child mortality, 37 percent of children are stunted and Indonesia has one of the highest maternal mortality rates in the Asia region (190 per 100,000 live births in 2013).
[29] World Bank. (2015). "Inequality in Indonesia: Why it is rising, why it matters, and what can be done".
[30] 0.3 percent excluding health insurance for the poor and temporary compensation for fuel price rises.
[31] Spending that the central government directs (central line ministry spending, specific grant transfers, investments) i.e. excluding block transfers to regions.
[32] World Bank analysis for the RPJMN 2015-2019 period estimated that total govt. spending needs to increase from 1% to 2.4% of GDP in Health, from 0.6% to 1.2% in social assistance, and from 2% to 4-5% in infrastructure to support economic growth, poverty reduction and health sector targets in the RPJMN.

respectively, and these are taken as the target for the 2017 budget[33]. The relative budget allocation in the approved budgets are generally maintained in realized/actual spending even if the nominal values are different. Therefore, we expect to see a significant increase in the share of central government *actual* spending on infrastructure, social assistance and health sectors in the years 2016 and 2017 compared to 2012-2014 years (see Table 2).

Strengthening budget monitoring and management through FMIS (SPAN)

46. **Rationale:** SPAN[34] is the core budget and treasury system at the heart of the Bank-financed Government Financial Management and Revenue Administration Project (GFMRAP) that was initiated over a decade ago. Similar to Financial Management Information Systems (FMIS) in other countries, SPAN was conceived as a means of streamlining the government payment process, to provide transparency and comprehensiveness in expenditure reporting, to provide timely information to budget holders on their spending, and to reduce the opportunities for informal payments and/or misappropriation of funds**.** As it has been implemented in Indonesia, SPAN has automated previously manual business processes throughout the cycle from budgeting to reporting. It will provide centralized databases of all government financial transactions, which, through real-time reporting and accounting, will help the government manage budget allocation, expenditure commitments, and spending limits. SPAN is also expected to improve cash flow forecasts and planning.

47. **Prior action #2:** The development of SPAN started in 2009 after a protracted procurement process. It then took the MoF more than four years to develop the system due, in part, to the need to integrate previously standalone systems for budgeting, budget execution, accounting, and reporting and another year to complete the pilot. In 2015 DG Treasury achieved a major milestone (Prior Action #2) by completing the SPAN roll-out started in 2014 to all treasury offices across the country and issued the Certificate of Operational Acceptance to the service provider[35]. Going forward, DG Treasury will need to maintain the system and ensure that there are no breaks in its availability. A SPAN system audit is being undertaken in 2016, supported by the Bank, to identify system risks to be addressed. DG Treasury has also commenced discussions with the National Procurement Agency (LKPP) on putting in place a data exchange between the SPAN system and the LKPP procurement data (procurement plan, bidding process, and contract data) system. The data exchange, which is unlikely to be implemented before end 2017, would enable MoF and LKPP to better assess the factors that contribute to better value-for-money in public procurement.

48. **Expected results:** A fully functional SPAN system will greatly improve the accuracy and timeliness of central government financial statements, contributing to increased internal and external accountability. The time it takes for monthly budget realization data to be *publicly* available will fall from 2 months in 2014 to an average of 15 days after the end of the month from mid-2016.

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[33] This assumes current policy on fuel subsidy reforms continue. Low oil prices, which we expect to continue through the medium-term, reduces the pressure of policy reversal.

[34] Acronym for Sistem Perbendaharaan dan Anggaran Negara meaning State Budget and Treasury System

[35] The letter to the service provider stating that all contractual terms had been fulfilled and the system ownership of SPAN had been transferred to DG Treasury.

Facilitating investment by private sector in essential infrastructure

49. **Rationale:** The estimated total financing (from public and private sector) to meet the infrastructure targets set out in the RPJMN is IDR 4,796 trillion (USD 352 billion or 6.8 percent of GDP) over five years: 2015-2019. The Government recognizes the critical role of the private sector in providing financing and valuable technical expertise and has targeted 35 percent of the financing needs to be met through public private partnership (PPP) schemes[36]. However, PPP usage has been hindered by weak intergovernmental coordination, inadequate institutional capacity and resources to facilitate PPP projects, lack of clarity for line agencies on how to engage with private sector for PPPs, and lack of suitable contract types for engaging with the private sector on multi-year infrastructure projects.

50. **Prior action #3:** To accelerate the delivery of priority infrastructure projects and private sector involvement, the government has taken a number of significant steps. In 2015, the PerPres 38/2015 'Co-operation between Government and business entities in Infrastructure Provision' was issued to allow line agencies to engage in a wider range of contract types with the private sector, including Availability Payment Contracts (where concessionary payments are made for the availability of services provided by the private sector to the government), which are often used in large infrastructure projects. This was followed by three implementing regulations from Bappenas, Ministry of Finance and LKPP[37].

51. **Indicative trigger #2:** In 2014, the National Committee for Acceleration of Priority Infrastructure Development (KPPIP) was established, chaired by the Coordinating Economic Minister. The KPPIP's function is to establish the priority (infrastructure project) list and coordinate relevant ministries to ensure delivery of the projects. Projects on this list will be eligible for support from the government Project Development Facility (PDF). The KPPIP issued the first priority list in January 2016 with 30 projects, each with investment value of more than IDR 500 million, and the majority are designated to be carried out through PPPs or by SOEs. The Ministry of Finance (Indicative Trigger #2) will establish a PDF to support line ministries to do PPPs on the priority list by financing Final Business Case and transaction advisory services. A Ministry of Finance regulation (PMK 265/2015) has already been issued for the establishment of the PDF. The PPP projects to be supported over the next year is being confirmed and operational guidelines are being put in place.

52. **Expected results:** The prior action and trigger together should in the long-term contribute to increasing private sector investment in essential infrastructure, including through PPPs. In the medium-term, we expect an increase in the quantity and quality of PPP projects being issued. During the period of this operation, we expect to see preparation of at least three PPP projects being supported by the Ministry of Finance PDF.

Removing barriers to multi-year contracts for government procurement

53. **Rationale:** Multi-year contracts (MYCs) are generally more efficient than a series of single year contracts for large, multi-year infrastructure (and non-infrastructure, for example, IT

[36] BAPPENAS 2015 PPP Book

[37] Bappenas regulation on guideline for PPP cooperation (Permen 4/2015). LKPP regulation on procurement for PPP (Perka LKPP no 19/2015). Ministry of Finance regulation on availability payment by central government and subnational government (PMK 190/2015)

services) projects. It enables higher economies of scale for contractors thereby lowering average total project costs, increases quality of the project through better design and implementation, and increases efficiency from fewer procurement processes. However, line ministries have been found it hard to issue MYCs because of onerous requirements, including having to complete land acquisition prior to the submission of MYCs to the Ministry of Finance, a requirement for an external audit to be completed for contract extensions (the audit itself could take a long time) and the inflexibility of moving budgets between years (for example, the unspent budget in the first year from a three-year contract cannot be automatically carried forward to the second or third year).

54. **Prior action #4:** The Ministry of Finance issued a regulation (PMK 238/2015) in 2015 to reduce major barriers for ministries and agencies to issue multi-year contracts for government procurement by: (a) not requiring the land acquisition process, which remains necessary, to be completed prior to submission of multi-year contracts to the Minister of Finance; (b) eliminating the requirement for an external audit for no-cost contract extensions; and (c) increasing the flexibility of annual budget reallocation for multi-year contracts**.**
55. **Expected results:** The removal of major barriers through PMK 238/2015 should lead to increased utilization of MYCs by line ministries in government procurement, including for infrastructure projects, starting in 2016. We expect the proportion of Ministry of Public Works and Housing (who execute the majority of central government infrastructure budget) total budget delivered through MYCs to increase from 7 percent in 2014 to 17 percent in 2016 and 2017.

Conducting early procurement

56. **Rationale:** Currently budget execution is extremely back-loaded, particularly for capital expenditure. This makes executing the full budget difficult and is likely to reduce the quality of spending as line ministries are incentivized to prioritize spending based on ease of execution rather than development impact. One of the reasons for the back-loading is that line ministries typically begun the procurement process in January/February of the fiscal year and then only complete it in the middle of the year. By starting the procurement process earlier based on the proposed Budget, line ministries should be in a position to sign contracts shortly after the Budget is approved and budget warrants (DIPAs[38]) are issued in December.
57. **Prior action #5 and indicative trigger #3:** A Presidential Instruction: (INPRES 1/2015) on "Accelerating Public Procurement Process", an implementing Ministry of Public Works and Housing instruction (PUPR 3/2015) on "Accelerating the Implementation of the Budget for Fiscal Year 2015 and Early 2016 auction", and a Ministry of Finance circular letter (S-577/2015) on "Budget for Project Preparation for Fiscal Year 2016 and 2017" have been issued to increase usage of early procurement for capital projects in the 2016 State Budget (Prior Action #5). Unlike previous regulations on early procurement, these new regulations had bite; for example, the instruction from the Minister of Public Works and Housing to the implementing unit (Satker) was accompanied by budget funds to do the early procurement work. By October 2015 the Directorate General of Highway had started early procurement for 41 percent of the total 2016 budget (IDR 19 trillion)[39]. To sustain this improvement in

[38] Daftar Isian Pelaksanaan Anggaran
[39] http://www.pu.go.id/berita/10676/Lelang-Dini-Tahap-III,-Ditjen-Bina-Marga-Tenderkan-Rp-5,91-Triliun

the procurement process, (Indicative) Trigger #3 is for the Ministry of Public Works and Housing to issue a regulation in 2016 to use early procurement on an ongoing basis for APBN capital projects.

58. **Expected results:** Earlier procurement should reduce the heavy back loading of capital spending and reduce risks to implementing projects in the budget year. We expect to see an increase in the proportion of the value of contractual package for the budget year being procured by the Ministry of Public Works and Housing in the first semester from 70 percent in 2014 to 90 percent in 2016 and 2017.

PILLAR B - STRENGTHENING REVENUE ADMINISTRATION

Strengthening VAT administration for compliance management

59. **Rationale:** The VAT compliance rate has been estimated at between 53% (IMF, 2014) and 57% (Sugana and Hidayat, 2014). With an average VAT-to-GDP collection of 4.0 percent (2013-2014), this means approximately 3 to 3.5 percent of GDP was lost per year because of non-compliance. Reasons for the low compliance rate include: 1) The lack of details provided by taxpayers on taxable goods and services in the manual VAT invoice forms has encouraged fraud and made it difficult for tax officers to evaluate the accuracy of returns; 2) Acceptance of many manual VAT returns has strained the capacity of DG Taxes and limits their ability to monitor tax compliance risk; and 3) Lack of a risk-based approach to auditing VAT refunds takes scarce audit resources away from higher-risk, higher return audits.

60. **Prior action #6 and indicative trigger #4:** In July 1 2015, DG Taxes launched an online application through which taxpayers create electronic VAT invoices (Prior Action #6). The e-VAT invoice and application aligns Indonesia with good international practice by requiring detailed information on the taxable goods and services to be provided on every transaction and captures that information in the online application so it is easily accessible to tax officers[40]. DG Taxes has issued a regulation to enforce mandatory use by July 2016 of the e-VAT invoice[41]. DG Taxes intends to continue strengthening VAT administration processes to support VAT compliance management and audit (Indicative Trigger #4) by: (a) enforcing universal use of the e-VAT invoice by July 2016 by disallowing VAT payers to obtain VAT invoice numbers on manual forms; (b) enforcing electronic filing of VAT returns (e-SPT) by all taxpayers by July 2016[42] This is feasible because VAT payers using the e-VAT invoice

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[40] The key improvements of the electronic invoice system over the manual VAT invoice process are: 1) The electronic invoice does not require original signature and has a QR code for verification; 2) In the manual process, taxpayers have discretion to submit detailed information about the goods or service. In contrast, the electronic invoice requires taxpayers to provide detailed information about the taxable goods or services for every transaction; 3) In the manual process, detailed information were submitted as attachments to the main form. In the electronic system, the information is captured in the application and displayed in the main form itself; 4) Taxpayers using electronic invoice can easily create monthly VAT return by using the e-VAT invoice application; and 5) Taxpayers using electronic invoice can easily request invoice number through the website.

[41] The guidance to use manual tax invoice and its standard format is stated in PER-24/PJ/2012, which is valid until July 2016 where all taxable entrepreneurs (PKP) are mandated to use the electronic VAT invoice.

[42] VAT payers in Java and Bali already have to file electronically VAT returns in 2015, by July 2016 this requirement is extended to the rest of Indonesia.

application can easily create the electronic monthly VAT return[43]; and (c) ensuring that VAT return data is available within 72 hours after filing for use in DG Tax's compliance risk management (CRM) analytical model to enable a more strategic, risk-based approach to auditing VAT refunds[44].

61. **Expected results:** Most countries in OECD with mandatory e-filing of VAT returns have achieved a near universal (99 percent) e-filing level so it is expected that Indonesia will be able to achieve e-filing level of 90 percent of VAT returns by end 2016, in addition to near universal use of the e-VAT invoice. This will strengthen DG Tax's VAT compliance management and audit capability. DG Taxes still needs to implement a robust audit selection criteria and strengthen follow-up on audit results to improve VAT compliance significantly.

Increase electronic filing of tax returns

62. **Rationale:** Electronic filing of tax returns can greatly increase tax administration's efficiency in processing returns (compared to manual returns) as well as reducing the costs of paying taxes (in terms of time) for taxpayers. This is especially relevant to Indonesia as the government is promoting massively increasing registration (*extensification*) and universal filing so the number of returns the administration will have to process is likely to increase significantly. However, most cost savings are realized only once the majority of returns are filed electronically[45]. In addition, e-filing can contribute to better governance by reducing the face-to-face interaction between taxpayers and the tax authorities and the risk of collusion.

63. **Prior action #7 and indicative trigger #5:** DG Taxes issued a regulation (Per Dirjen 41/2015) to encourage individual taxpayers to file electronically their annual tax return for 2015 (in March 2016) by reducing the burden of the validation process for individual e-filing by allowing tax officers to validate on the premises of employers with twenty or more employees in which case the individual taxpayers do not have to go to the DG Taxes offices to be validated as e-filers **(**Prior Action #7)[46]. Previously, individual taxpayers had to go in person to the tax office to register for e-filing, with most coming a couple of weeks before the due date, thereby clogging up the IT system. As DG Taxes cannot legally enforce e-filing for individuals as mandatory, this simplification is important to increase e-filing rates among individuals. (Indicative) Trigger #5 builds on the prior action with DG Taxes issuing further regulations in 2016 to increase e-filing rates of other taxes and other taxpayers: (a) corporate income tax returns by all companies who are VAT payers (currently e-filing of corporate

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[43] Moreover, the creating the monthly VAT return is overall easier as the backup documentation required will have already been uploaded in the e-VAT invoice process.

[44] However, there remains other issues, for example, the personal liability faced by auditors, established in regulation, in the case of errors create a very risk averse approach to VAT refund audits.

[45] As e-filing rates approach 100 percent, submission processing costs can be reduced by an average of 45 percent. McKinsey tax performance benchmark analysis finding quoted in *Tax myths: Dispelling myths about transformation in rapidly growing economies* (McKinsey, 2015)

[46] DG Taxes will provide e-FIN (registration number for e-filing) automatically to all registering taxpayers. This information can be delivered by letter, e-mail, or other method of communication. The validation process for e-filing will be simplified. A tax officer can now go to the premises of employers with 20 or more people (instead of the taxpayers going to the tax office) willing to be registered to use e-filing to check the taxpayer TIN and e-fin and register them as e-filers (the validation process).

income tax returns is mostly done by large and medium corporate taxpayers); and (b) withholding tax returns by withholding agents.

64. **Expected results:** DG Taxes aims to substantially increase the number of individual income tax returns filed electronically from 2.6 million for 2014 tax year (out of 9.8 million returns) to 5.5 million for the 2016 tax year. If achieved, the impact on data quality, administrative cost and taxpayer compliance costs (by reducing the return processing time from few months[47] to only days) would be significant. Similar benefits will accrue from increasing corporate income tax e-filing from 13,000 for 2014 tax year (out of 616,000 returns) to 400,000 (the number of VAT payers) for the 2016 tax year.

Establishing a unique and permanent Taxpayer ID system

65. **Rationale:** Indonesia faced a significant tax administration challenge with a large number of taxpayers holding multiple tax IDs (estimated 500,000 duplicate IDs i.e. IDs that belonged to the same taxpayer in 2014), because the taxpayer ID contained a regional identifier so taxpayers could get new IDs every time they moved within Indonesia. The use of multiple IDs to file returns for the same taxpayer made compliance and audit tasks challenging. DG Taxes began a data cleansing process in 2014 by identifying existing duplicate IDs in the taxpayer database and invalidating them so that the duplicate IDs cannot be used to file tax returns.

66. **Prior action #8:** DG Taxes has taken a further major step in 2015 to establish a unique and permanent taxpayer identification system by abolishing the regional part of the taxpayer identification number so that taxpayers will not receive new tax IDs (i.e. creating new duplicate IDs) when they move to a different region. Currently, there are less than 3,000 duplicate taxpayer IDs**.** DG Taxes is now undertaking a process to match taxpayer and national IDs (Indicative trigger #6) which will help address the remaining issue as the national ID is a unique ID and will only be matched to one taxpayer ID.

67. **Expected results:** The prior action should maintain the risk of duplicate taxpayer IDs being used to file returns to less than three thousand duplicate IDs between 2016 and 2018, thereby eliminating a significant source of compliance risk. This result facilitates further action by the Government to enforce the use of the taxpayer ID in a broader range of financial transactions and makes easier the process to match taxpayer IDs with national IDs (see Indicative Trigger #6).

Improving DG Taxes access to taxpayer asset and financial data for audits

68. **Rationale:** Timely access to relevant third-party data by the tax authority for tax administration purposes is standard international practice. In particular financial data and fixed asset data (especially in Indonesia where a large proportion of the wealth of high-net worth individuals are held in fixed assets) is critical for effective audits. Under the Banking Secrecy Law, DG Taxes is allowed access to banking (deposit) data for taxpayers for audit purposes; the Minister of Finance has to make a formal request for each taxpayer. However,

[47] In the past, significant resources were allocated to process returns from drop boxes, which are deployed across the nation. This includes sorting, mailing to the processing center, scanning, data entry, etc. All these steps will be eliminated when the taxpayers file electronically.

in practice, there is a considerable delay between the submission of the request and receipt of data from the bank (average 1 year), which hinders considerably the auditing process. The previous procedure of requesting data on registered land asset data for taxpayers involved the tax offices submitting a formal letter to the local Land Agency (BPN) office. The result could take 5 or more days to be received and as the requests are only submitted to the local BPN offices, BPN will only provide land registration data within the local area. This means that in cases of taxpayers who may have other assets registered in different city or province, information about those assets will not be provided to the tax offices.

69. **Prior action #9 and indicative trigger #6:** In 2015, DG Taxes and BPN signed a MOU and implemented an electronic data exchange to enable DG Taxes to access taxpayers' land asset data held by BPN for tax analyses, compliance management and audit purposes (Prior Action #9). DG Taxes account representatives, auditors, tax officers can now request and receive land asset data (nation-wide, not just local) held by BPN of taxpayers through the DG Taxes Application Portal in a systematic and timely (standard 1 day turnaround by BPN) manner. The limitation is that DG Taxes has to know the national ID of the taxpayer as only national IDs are collected by BPN when land assets are registered. Building on this reform, under (Indicative) Trigger #6, DG Taxes completes matching of national and taxpayer IDs (for those filing tax returns) to enable it to access land asset data for all individual tax filers. On the financial side, under (Indicative) Trigger #6, OJK is planning to issue a circular to systematically share credit card information (which is not covered under the Banking Secrecy Law) with DG Taxes.

70. **Expected results:** If the trigger is achieved, it should be feasible to reduce the average time it takes to receive third-party data requested by DG Taxes for audit use from 5 days (limited to local BPN data) to 1 day (nation-wide BPN data) for land assets and from no access to annual access for credit card information by 2017. Gaining assured access to relevant third-party data will strengthen DG Tax's audit capability. DG taxes will still need to improve its audit methodology and governance to reap the full benefits of timely access to third-party data, but it is an important first step.

PILLAR C---ENHANCING TAX POLICY

Improve VAT, Luxury Goods Sales Tax and Excise Tax Policy

71. **Rationale:** VAT represents more than one third of tax revenue in Indonesia. However, the VAT-to-GDP ratio (3.7 percent in 2015) has been falling since 2013 and is markedly low compared to other countries. Given the expected continued moderation in commodity prices affecting resource-related revenues and the expansion of tax incentives, which may impact income taxes, it will be even more important to strengthen the VAT system to protect overall revenue collection. This will require strengthening VAT compliance (Prior action #6 and Indicative Trigger #4) as well as improving VAT policy[48]. Overall, while the current

[48] *Review of Indonesia Value Added Tax and Luxury Goods Sales Tax System & Assessment of Policy Reform Options* Study for Ministry of Finance, World Bank and MoF Team Asistensi, Nov 2015. Simulations using Indonesia data show there is potential to increase VAT collection by around 0.5 percent of GDP through increasing

Indonesian VAT system is well designed in terms of having a single standard rate (10 percent) on domestic value addition and imports, and allowing zero rate only on exports, the VAT base is reduced by numerous exemptions (which also complicates administration and is distortionary) and by having one of the highest VAT registration thresholds in the world since January 2014 (when it increased from IDR 600 million to IDR 4.8 billion of gross-turnover). Indonesia also imposes an additional luxury goods sales tax (LGST) on deemed "luxury" goods, which is administered separately from VAT.

72. **The LGST generates very little revenues** (0.14 percent of GDP in 2014 with 90 percent coming from vehicles) **while imposing additional administration costs.** The vehicle LGST has a limited tax base as it does not apply to many common types of vehicles, including trucks and smaller engine motorcycles. The vehicle LGST is also not consistent with environmental considerations; for example, pick-ups/trucks are zero rated although they cause more environmental damage than most cars. Excise taxes can be an effective instruments to raise additional revenues while addressing negative externalities and equity concerns. They are typically imposed on fuels and electricity, vehicles and tyres, and so-called "sin goods and activities" such as tobacco, alcohol, soft drinks, fast food, coffee and gambling. Indonesia currently collects 1.1 percent of GDP in excise tax with the majority coming from tobacco excise. There are currently no excises on vehicle or fuel.

73. **Prior action #10:** The Government will submit a revision of the VAT and LGST Law No.42 of 2009 to the Parliament during 2016. At the end of 2015 the Minister of Finance submitted to the Ministry of Law and Human Rights the white paper (*naskah akademik*) for the revision of the VAT and LGST Law (Prior Action #10). The VAT white paper[49] sets out the policy reforms proposed by the Ministry of Finance in the revision of the Law, including: (a) broadening the VAT base by rationalizing exemptions - limiting it to common exemptions, such as final consumption of basic education, health services, social services, basic food and public transport - and limiting the Ministry of Finance's discretion in granting exemptions outside of the VAT Law; (b) replacing the vehicle LGST with a vehicle excise tax, which is permitted under the existing Excise Tax Law 39/2007[50], in order to broaden the tax base; and (c) removing the LGST by incorporating remaining LGST goods into the VAT regime[51] to improve administrative efficiency.

74. **Indicative trigger #7:** After inter-ministerial consultations on the VAT white paper, the Government will submit to Parliament for deliberation the draft revision of the VAT and LGST Law No.42 of 2009 containing the proposed reforms from the VAT white paper before the end of 2016 (Indicative Trigger #8). Most likely, the revised Law will not be approved by Parliament until 2017, which means the new VAT regime will be in place in 2018. If the approved Law removes the vehicle LGST, a replacement vehicle excise tax could be

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the VAT rate (from 10 percent to 11 percent), lowering the VAT registration threshold, improving compliance and expanding the VAT base by reducing exemptions.

[49] The Bank provided technical assistance to the Ministry of Finance during the process of developing the white paper, through weekly policy discussions, workshops and analytical work, culminating in the *Review of Indonesia Value Added Tax and Luxury Goods Sales Tax System & Assessment of Policy Reform Options* Study.

[50] Goods that qualify to be subject to excise tax are: 1. Goods, whose consumption and sales must be controlled; 2. Goods which impose negative externality on the society and environment; and 3. Good which should be taxed at a higher rate for equity reasons.

[51] In 2015 Ministry of Finance (PMK 106/ 2015) already reduced the list of items subject to the LGST to include only apartments and houses, aircrafts and helicopters, firearms, and yachts.

proposed by the Ministry of Finance in 2017 as part of the 2018 State Budget. The vehicle excise tax would cover a broader set of vehicles, with rates based on carbon emission and vehicle size (e.g., higher tariffs on trucks than on cars and motorcycles, to account for their larger negative impact on traffic congestion and road damage) as well as equity considerations (i.e. lower tariff for motorcycles with less than 250 cc engine capacity as they are more likely to be purchased by lower income households).

75. **Expected results:** The reforms proposed by the VAT white paper, if carried through to the revised VAT Law approved by Parliament, would significantly improve VAT and Excise tax performance starting from 2018. The rationalization of exemptions will broaden the VAT base (increase the share of final consumption subject to standard VAT) as well as improve the neutrality of VAT and reduce the distortions caused by cascading effect of exemptions. Replacing the vehicle LGST with a vehicle excise tax will broaden its tax base[52] and better address negative environmental externalities. Removing other LGST reduces administration costs with immaterial impact on tax collection.

Improve Income Tax Policy, including the Final Micro & SME Tax

76. **Rationale:** Non-oil and gas income tax collection has been steady at 4.4 percent of GDP between 2012 and 2014[53], comprising corporate income tax (2.1 percent), final tax (0.8 percent[54]), withholding taxes (0.6 percent) and personal income tax (1 percent). The complex tax structure with multiple income tax rates adds administrative complexity and reduces the tax base[55]. The final tax regime for micro, small and medium enterprises (MSMEs) introduced in the middle of 2013 (through the government regulation PP46) has reduced the tax base for the standard income tax because of the extremely high threshold of IDR 4.8 billion[56] (equivalent to average USD 404,550 in 2014) and the very low tax rate: 1 percent of gross turnover (compared to standard corporate income tax rate of 25 percent), which creates major disincentives to migrate to the standard income tax regime. The final MSME tax aimed to bring in new (previously not registered as taxpayers) into the income tax system; however, revenue that has been collected from new taxpayers has been below expectations and less than the revenue foregone from taxpayers who previously paid standard income tax and then moved to the final MSME tax regime[57].

77. **Similar to many other countries, Indonesia's income tax collection is likely to be affected by base erosion and profit-shifting (BEPS) activities**[58] due to an inadequate regulatory framework to address the different sources (domestic and international) of base erosion,

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[52] World Bank simulation results suggest that broadening the tax base could double the collection of taxes on sales of new vehicles

[53] Rising to 4.8 percent of GDP in 2015, most likely due to measures aiming to raise revenues in the short-term such as the asset reevaluation program.

[54] All final taxes are recorded under the Article 4(2) and include the final tax on MSMESs, final tax on different fees (e.g. construction work), final tax on income from lottery, on land rental, etc.

[55] For example, the IMF (2014) recommends applying the single (25%) CIT rate to all those in the standard CIT regime and extending the coverage of the top PIT rate (30%) by reducing the threshold for the top PIT rate to include the third bracket

[56] The same as the VAT threshold

[57] DG Taxes presentation at World bank MSME tax workshop, October 2015

[58] Estimating the magnitude of base erosion is generally very difficult as BEPS activities are not reported by companies. No empirical analysis of the extent of BEPS activities has been made so far in Indonesia.

including thin capitalization and transfer mispricing. The current income tax system provides favorable tax treatment for debt financing as compared to equity financing because corporations can deduct interest expenses in determining their net income while no deduction is allowed for dividend payments. This disparity creates incentives for thin capitalization – when corporations adopt a capital structure with higher debt levels as well as disguise equity contributions as debt (particularly equity from related parties) to lower their tax obligation. A Ministry of Finance survey of listed companies (non-financial sector) found 12 percent of companies had debt-to-equity ratio of 3:1 or more.

78. **Prior action #11:** The Minister of Finance issued a regulation (PMK 169/2015) in September 2015 to address the risk of thin capitalization by establishing a maximum debt-to-equity ratio of 4:1 for calculating the allowable deduction from interest paid on long- and short-term debt for corporations. Although, according to international good practice, a 4:1 ratio is fairly generous with 3:1[59] or 2:1 more commonly advised, this regulation is a significant step in the right direction as there had been no regulatory measure in place previously. PMK 169 also supports the development of the capital markets and provide more assurance to companies concerned about being inspected/audited for thin capitalization.

79. **Indicative trigger #8:** The Government will submit to Parliament for deliberation the draft revision of the Income Tax Law No.36 of 2008 in 2016 (Indicative Trigger #8). The Ministry of Finance, who is leading the drafting of the revised Law, is proposing[60] reforms to broaden and increase the tax base such as the introduction of an inheritance tax and an alternative minimum tax and implementation of further anti-BEPS reforms, including provisions to tackle transfer mispricing. To inform the anti-BEPS reform agenda, the Ministry of Finance is conducting an inventory of current laws and regulations[61]. The Bank is providing ongoing technical assistance to the Ministry of Finance on income tax policy issues, including on BEPS (for example on how to strengthen PMK 169[62]) to support the finalization of the draft Law.

80. **Indicative trigger #9:** In parallel, the Government intends to issue a revision of the Government regulation (PP 46/2013) for the final MSME tax by early 2017, with the aim of bringing in more new (previously unregistered) taxpayers and lowering the number of taxpayers in the standard income tax system migrating to the final tax regime. Reforms, considered good international practice, being considered by the Ministry of Finance

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[59] ASEAN region is generally 3:1

[60] Currently proposed, not yet finalized as the reforms are still being internally deliberated between the different DGs within the Ministry of Finance.

[61] As part of the agreement from the ASEAN Forum on Taxation in Yogyakarta, Sept 29-30, 2015. Discussions at the ASEAN forum highlighted a number of potential areas, including: 1) Improvement of policies and regulations to prevent artificial avoidance permanent establishment status (which effectively define what entities are subject to tax); 2) Strengthen implementation of Controlled Foreign Corporation (CFC) rules that limit the deferral of tax due to the country of residence by booking income earned offshore to an offshore entity. Indonesia already has – DG Taxes Reg/PER-59/PJ/2010 - but unclear if being implemented; 3) Policies and regulations related to addressing transfer mispricing, in particular of intangibles; 4) Improving tax filing documentation requirements from related-parties transactions. This is particularly important for extractives sectors; 5) Exchange of information tools and processes to limit base erosion from international sources through more transparency; 6) Institutionalize tax expenditure statements in the Budget documents.

[62] Options include: 1) adding an arm's length cap on interest deductions from intra-company debt; 2) having a clearer definition of what is considered debt and what is equity (especially with hybrid instruments which have components of each; and 3) lowering the debt-to-equity ratio to 3:1.

include: introduction of a sunset clause so that there is a fixed timeframe for final taxpayers to migrate to the standard CIT regime; limiting eligibility to non-corporates; and introduction of anti-abuse provisions. The World Bank has started a program of technical assistance to the Ministry of Finance to support this process, including conducting surveys with MSMEs taxpayers who are targeted by this final tax**.**

81. **Expected results:** The impact of the prior action and triggers is expected to be significant in increasing the tax base and tax potential of income tax in Indonesia by introducing additional types of income taxes (inheritance tax, alternative minimum tax), attracting new taxpayers to the final MSME tax regime, reducing tax base erosion by increasing the number of anti-BEPS measures, and reducing the number of standard income taxpayers migrating to the final tax regime. The introduction of the inheritance tax, which will focus on high-net worth individuals, will also support equity goals.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

82. **The DPL is central to achieving the objectives under the CPF *Collecting More and Spending Better* engagement.** Fiscal policy, in its revenue mobilization and quality of spending functions, were identified in the Indonesia SCD as key to poverty reduction and shared prosperity and the CPF reflects this with the *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 revenue administration and tax policy pillars of the DPL also supports the WBG Domestic Revenue Mobilization (DRM) agenda.

83. **The DPL provides an anchor and coordination mechanism for the broader CPF engagement with the government**. The DPL by itself will not be sufficient to achieve the overall objectives of collecting more and spending better; the DPL instrument provides an effective entry point for the Bank to engage in substantive dialogue and use other instruments across the spectrum of fiscal issues. The DPL process has helped re-engage with DG Taxes on tax administration reforms, which could be supported by an investment lending project on the modernization of DG Tax's IT systems. The Bank's knowledge services (analytical work and technical assistance) are being extensively used in each of the reform areas of the DPL to build the evidence base for reforms, e.g., the potential revenue impact, and to provide inputs into the design and implementation of reforms. The DPL has led to an increase in client demand for new knowledge services, in particular in the important area of tax policy.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

84. **The Government's fiscal reforms and objectives have been discussed with key external stakeholders.** This includes the extensive discussions held during the development of the National Medium-term Development Plan (RPJMN) for 2015-2019. Individual policy measures supported in this operation have also been separately consulted upon, in particular tax policy reforms/regulations are discussed with industry (associations and individual companies).

85. **The Bank team is collaborating closely with other development partners supporting the *Government's Collecting More and Spending Better* agenda**: 1) Australia Indonesia Partnership for Economic Governance (AIPEG) have embedded advisors in DG Taxes and DG Budget. The Bank team coordinates with AIPEG, for example, jointly delivering a workshop on the international experience with semi-autonomous revenue agencies. AIPEG are also funding two senior Indonesian public policy and tax experts at the request of the Head of BKF to support the Ministry of Finance to prepare the DPL working closely with the Bank team; 2) The Australia GPF (Governance Partnership Facility) program places Australian Treasury advisors in the Fiscal Policy Agency (BKF), including in the Centre for State Revenue Policy. The Bank has a well-established capacity building/technical assistance capacity building program at BKF (SEMEFPA) and coordinates closely with GPF to minimize duplication and ensure complementarity; 3) The IMF conducted a joint tax administration and policy technical assistance mission in September 2014 and produced a comprehensive TA report identifying key reforms in each of these areas. The Bank's advisory support and the DPL design have been informed by and are consistent with recommendations in that report. In general, the working relationship between the IMF and the World Bank in Indonesia is very strong, with joint working programs in a number of areas (budget reforms, taxation issues, asset-liability management, crisis preparedness, financial sector, statistics and macroeconomics) and close coordination through frequent meetings between resident offices and with headquarters missions, including the Article IV consultation[63]; 4) The US Treasury is embarking on providing TA to DG Taxes, focused on developing key performance indicators, and the Bank has provided inputs into the scoping of the TA; and 5) Several development partners finance the Indonesia PFM-MDTF, which is used to provide more extensive and specialized TA and training to DG Taxes.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

Prior to the energy subsidy reforms of 2015, fiscal policy contributed relatively little to reducing poverty and inequality in Indonesia.

86. **Fiscal policy can have a potentially large impact on poverty and inequality.** First, public expenditure can reduce poverty and inequality today. For example, investments in infrastructure can help create jobs, as well as reduce the cost of goods and services through more efficient logistics. At the same time, social assistance can boost the incomes for the poor and vulnerable, while social insurance can help them cope with shocks to that income. Spending can also reduce poverty and inequality tomorrow; investments in health and education today, particularly those which benefit poorer children and more remote areas, can increase the income they will earn later in life. Second, adequate domestic resource mobilization is essential for financing this spending. Third, the design of the tax system itself

[63] Details of the World Bank-IMF collaboration in Indonesia, including the *Indonesia Joint Managerial Action Plan, 2015−16*, is contained in the informational annex to the Staff Report For The 2015 Article IV Consultation (http://www.imf.org/external/pubs/cat/longres.aspx?sk=43787.0)

can also affect poverty and inequality. Who pays how much of which taxes directly affects how much disposable income they have and their consequent standard of living.

87. **However, recent fiscal policy in Indonesia has done relatively little to reduce poverty and inequality.** Recent work[64] indicates that the total impact of Indonesian taxes and government spending from 2012-14 has been to reduce poverty by 1.1-1.4 percentage points and the Gini coefficient by 2.6-3.3 points (see Table 5).[65] These reductions are relatively small by international standards. This is due partly to the low impact of potentially progressive policies: personal income tax collection is low with poor compliance; social assistance spending is low; health spending is low and much of it is not on the primary care which most benefits poorer households; education spending is high and has some impact on inequality, but not to the degree seen in other countries. It is also partly due to high spending on energy subsidies which predominantly benefit richer households.

Table 5: Fiscal Policy Impact on Poverty and Inequality 2012-14

		Poverty (percentage points)	Inequality (points of Gini)
Baseline Fiscal Policy Impact	2012	-1.4	-2.6
	2013	-1.1	-3.2
	2014	-1.3	-3.3
	Average	-1.3	-3.0

Source: World Bank (2015), Susenas, APBN and World Bank calculations.
Note: Excludes BLSM in 2013 and 2014.

Several reform areas in this DPL can potentially have substantial positive poverty and inequality impacts.

88. **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 impact of the revenue raising measures in the DPL should not be divorced from the inequality and poverty reducing impact of the spending measures in the DPL. The burgeoning literature on fiscal incidence (e.g. Commitment to Equity project) emphasizes looking at the aggregate effect on poverty and inequality from the overall fiscal framework. Pro-poor spending needs to be funded. Revenue raising, which is paid for in part by the poor and then used to fund pro-poor

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[64] The 2012 result is from a fiscal incidence paper (World Bank and Ministry of Finance 2015), and the 2013 and 2014 results are from a coming update to that paper. The analysis is based on the Commitment to Equity framework (commitmentoequity.org), and applies standard fiscal incidence analysis to the majority of GoI taxes and spending.
[65] The poverty impact in 2013 and 2014 was actually to reduce it by 3.9 and 4.6 points respectively, if we include BLSM in the analysis. However, BLSM was a temporary direct cash transfer used to compensate the poor for increases in fuel prices. Without the cash transfer, poverty would have increased significantly. Since the fuel price increases are not captured in the incidence analysis, we have left the BLSM impact on poverty out of the 2012-14 baseline for the current analysis. Similarly, the Gini reduction in 2013 and 2014 was actually 4.1 and 4.3 points when BLSM is included, but we have used the non-BLSM Gini impacts for the baseline, since BLSM is not part of the 2016 APBN.

spending, then in net can be progressive. The medium-term fiscal scenario presented in Table 3, Section 2, shows that additional spending on the Government's development priorities – above 2016 levels – is only possible over the medium-term *if* revenue collection increases. Higher spending on infrastructure, social assistance and health are expected to have a positive impact on poverty and inequality reduction (see next section). The indirect impact of revenue measures in the DPL is likely to be as important, if not more, than the direct impacts.

89. **An increase in direct taxes, in particular personal income tax collection, would be progressive.** Revenue administration pillar reforms to increase compliance among individual taxpayers as well as the revision of the Income Tax law in the Tax Policy pillar are expected to lead to higher personal income tax collection. Moreover, the Government is aiming to introduce an inheritance tax as part of the revision of the Income Tax law. Although details of the design are not available at this stage to conduct a fiscal incidence analysis, an inheritance tax is typically progressive, targeting high-net worth individuals, and as such, would be likely to reduce inequality. However, its effectiveness would depend on minimizing non-compliance and avoidance behaviour[66].

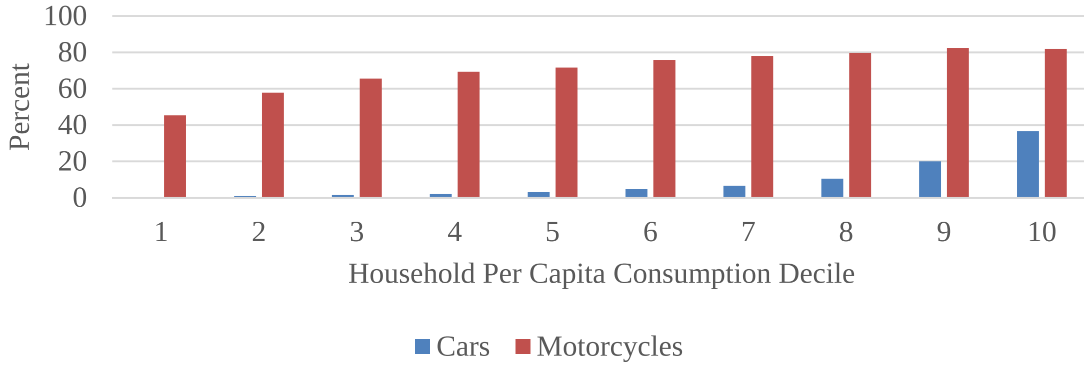
90. **The move from a narrow LGST to a broader excise tax on most vehicles is likely to have little *direct* impact on poverty and inequality.**[67] Less than 2 percent of the poorest half of Indonesians own cars, and ownership rates only reach or exceed 20 percent for the richest two deciles (Figure 3), so broadening the range of cars taxed is progressive. However, this progressivity could be offset by the increase in the range of motorcycles taxed, with ownership rates high, even amongst the poor. In particular, the smallest and least expensive motorcycles, which are currently exempt from LGST, are most likely to be owned by poorer households. The impact from the extension of an excise to buses on inequality and poverty is unclear, as this will depend in part on whether the higher cost is passed through to consumers; bus-based public transportation prices are currently regulated. In designing the specific excise tax rates, which will be specified in implementing Ministry of Finance regulations, equity considerations in addition to environmental will be taken into account, e.g., the excise tax imposed on the smallest and least expensive motorcycles is expected to be smaller in absolute and relative (to vehicle price) terms.

91. **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.** The removal of VAT exemption from a range of goods and services, particularly some foods, could lead up to a 0.19 percentage point increase in poverty. This estimate is driven largely by the new application of standard VAT to a range of food items which had previously been exempt and the assumption that this will lead to corresponding increase in food prices[68], as food consumption represents around two-thirds

[66] On compliance risks, DGT has now systematic access to national land registry data so they should know when estates are transferred between people. There are still risks of anti-avoidance behaviour, such as putting assets in family trusts to avoid estate taxes.
[67] This DPL component is excluded from the fiscal incidence analysis as the type of car and motorcycles owned, or how much they cost, is not included in the household survey data required for the analysis.
[68] Given that VAT exemption means the producer's inability to recover the VAT paid on their inputs, then, depending on the price elasticity of demand and producer's ability to shift part of the unrecovered cost to the final consumer, the VAT exemption may have already contributed to an increase in the consumer price. With the removal of the exemption, the producer becomes eligible to recover the input VAT, hence, the additional tax burden may

of total poor household expenditures. There is very little impact on inequality, with the Gini estimated to increase by 0.03 points. While the additional VAT paid by the poor represents more of their income, in absolute terms, much more will be paid by richer households. The revenue raised can be used on pro-poor spending. As discussed in Section 2, VAT reforms could raise additional 0.5 percent of GDP of VAT by 2019-2020, which is equivalent to total social assistance spending in 2014.

Figure 3: Car and Motorcycle Ownership by Household Per Capita Consumption Decile



Source: Susenas 2014 and World Bank analysis.

92. **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.** The impact of additional infrastructure spending cannot be estimated through a fiscal incidence analysis due to data and methodological difficulties, but it is expected to be positive on poverty reduction. 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. The size of the impact depends on the type of infrastructure and where it is located; the poorest and most marginalized may not benefit much from economic growth generated through large infrastructure projects.

93. **Increased social assistance spending is expected to have a significant impact on poverty and inequality reduction due to its targeted nature.** The additional social assistance spending in 2016 (Table 6) is expected to have a meaningful impact on poverty and inequality. In 2016, poverty is estimated to be reduced by an additional 0.25 percentage point, which is equivalent to 20 percent of the average total impact of fiscal policy from 2012-14. The Gini would be reduced by 0.12 points, or around 3 percent of the 2012-14 average total impact. While these are relatively modest reductions, if revenue collection improvements over the medium-term enables further increases in social assistance spending, the impact on poverty and inequality reduction is expected be higher in the future. Good program design and implementation will be important in ensuring the positive impact of additional spending is substantial. In that respect, Indonesia has taken steps to improve the targeting of social

not be significant. As a result, the consumer price might not increase by the full amount of VAT after the exemption removal.

assistance programs. The *Unified Database*, established in 2012, is now used to target all major social assistance programs. Evaluations have shown that it has improved targeting outcomes, and a recent update in 2015 is now ready to be used for any expansion in social assistance, and is expected to further improve targeting accuracy.

94. **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.** Health and education spending are in-kind services consumed by households, and so can benefit the poor directly (although there is no direct effect on the measured poverty rate, as government health spending does not affect the poverty line or the household consumption aggregate). The impact of additional health spending in 2016 (Table 6) on inequality will depend on exactly how it spent; there is currently little detail available on which specific health programs and services will benefit from the increased health spending. If the new spending is assumed to have the same incidence across households as spending in 2014, then the incremental impact on inequality would reduce inequality by just 0.07 points. However, if the allocations are more pro-poor, the impact could be higher. The Ministry of Health's medium-term plan is to use increased government budgetary allocation (starting in 2016) to strengthen primary health care. Priority districts include those that are remote and underserved and have high poverty rates. In addition, the Government also plans to expand the coverage of full national health insurance (JKN) premium subsidy recipients from 86 million to 107 million poor individuals by 2019, which will reduce out of pocket health spending by the poor. The World Bank is currently preparing a lending operation with the Ministry of Health, which aims to improve the quality of primary health care spending. In addition, the World Bank conducts analytical works on health financing to inform policy discussion and formulation to improve the system's performance, including providing the poor financial protection from shocks due to illnesses.

Table 6: Health and Social Assistance Spending, Projected 2016 against 2014 Baseline

	Social Assistance			Health
(IDR Billions)	BSM	PKH	Raskin	
2014 Baseline	6,600	5,200	18,165	59,499
2016 (Inflation Adjusted)	10,558	9,193	19,176	93,246
Nominal Increase from Baseline	3,958	3,993	1,011	33,747
% Change from Baseline	60%	77%	6%	57%*

Note: *Even though health line ministries budget + health social assistance budget + health DAK budget have increased by 57%, nevertheless these budget only comprise 42% of total General Government Health Expenditure, while the rest of 58% is contributed by local governments.. Thus total General Government Health expenditure is expected to rise by only 24% in 2016 compared to 2014 Baseline.

5.2 ENVIRONMENTAL ASPECTS

The environmental impacts of the fiscal reforms supported by the DPL are likely to be positive.

95. **The policy actions of the expenditure pillar will make it possible for Indonesia to meet more of its infrastructure needs, more efficiency and rapidly.** The actions to improve public infrastructure spending in the DPL do not target specific infrastructure sectors. The

government's infrastructure plans are wide-ranging, including water supply and sanitation, roads, rail and transportation, ports and power generation and distribution, and telecommunications.

96. **To the extent that the reforms accelerate and expand investments in infrastructure for solid waste management, wastewater collection and treatment, water supply, drainage and flood control, they will have direct environmental and public health benefits**. Less than one-half of the solid waste generated in Indonesia cities is collected and recycled or disposed of in landfills. Only 11 cities have sanitary sewer systems and wastewater treatment plants, and these serve less than 3 percent of Indonesia's urban population. In 2009, approximately 50 percent of the urban population did not have access to improved water supply. While the predicted risk of losses from flood damage measured in dollar terms has declined in Jakarta as a result of drainage system improvements since 2007, it still remains high, at USD 143 million per annum.

97. **To the extent that the reforms accelerate investments in transportation infrastructure, positive environmental impacts will result from more efficient fuel usage.** The demand for road transport is rising rapidly in Indonesia, and the vehicle fleet doubled in the five years that ended in 2012. The development of road infrastructure and public transport services has not kept pace with rising demand, resulting in massive congestion, especially in urban areas where studies in the United States have shown that CO_2 emissions for light-duty and sports utility vehicles traveling in congested traffic were 18 percent and 65 percent higher, respectively, than when moving over the same distance in free-flowing traffic. Port expansion and new port development can have positive impacts on local water quality and marine pollution by including construction and operation of ship waste receiving facilities.

98. **To the extent that the reforms accelerate investments in power generation from renewable energy sources and gas, and in infrastructure to improve electricity transmission and distribution efficiency, environmental impacts are likely to be positive.** Thermal coal fired generation will be displaced leading to lower emissions and pollution by reducing coal consumption in power sector and from mining. Inefficient diesel and coal plants also give rise to local sulfur dioxide and other emissions. Endemic grid power shortages consequent to lack of generation investment have especially damaging local pollution and health consequences. Geothermal and other renewable energy programs are strongly win-win for environmental management in Indonesia.

99. **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**. There are, nonetheless, institutional and capacity gaps, particularly regarding enforcement of the existing legal framework, among government agencies and government levels, which may hinder the adequate identification and management of environmental risks. The World Bank has been supporting Indonesia's environmental management capacity building since the 1980s. In addition, the Government of Indonesia has long-standing and well-regarded collaborations with the Governments of Germany, Denmark and Canada on programs to improve environmental impact assessments. The World Bank is also committed to providing guidance and resources to support the Government of Indonesia in improving the environmental and social outcomes of their energy portfolio through the broader CPF engagement, including the energy reform DPL, additional investments in renewables, low

carbon development and related infrastructure (pumped storage, hydropower, geothermal) and in electricity distribution, as well as analytical and advisory services.

100. **The establishment of an excise tax on motor vehicles should have significant positive environmental impacts.** The excise tax can be used to address environmental externalities. It will likely be applied to a wider range of vehicles, including trucks and pick-up trucks, which are currently exempt from the LGST. The excise tax is also likely to be graduated with higher tax on less-fuel-efficient vehicles that produce higher emissions of air pollutants and greenhouse gases. The tax would be lower on buses to encourage investment in public transport, and energy-efficient vehicles would be tax exempt. The remaining reforms in the tax policy pillar and revenue administration pillar are expected to be environmentally neutral.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

101. **The overall fiduciary risk to this operation arising from Indonesia's public financial management (PFM) system, the use of budget resources and its foreign exchange environment as controlled by the Central Bank is assessed to be moderate.**

102. **Steady progress has been made in recent years in the way Indonesia's public finances are managed and in increasing transparency and independent oversight.** A repeat assessment of the Public Expenditure and Financial Accountability (PEFA) was conducted in 2012, following a first assessment in 2007. The results showed that Indonesia has made positive steps in strengthening the quality of its PFM systems; fourteen of the twenty six indicators registered an improvement (while two declined). More recently the Integrated Financial Management Information System was rolled out in 2014 and operational guidelines to implement full accrual accounting have been agreed and are being used since the start of 2015. Since 2009 GOI financial statements have received a qualified audit opinion, as opposed to a disclaimer before, with 71.3 percent of ministries and agencies achieving unqualified audit opinions in 2014. The Government publishes the annual budget in a timely manner, through the MoF website. Further improvements are required in several areas and are supported by the Indonesia PFM-MDTF.

103. **The foreign exchange control environment is assessed to be generally satisfactory**. Bank Indonesia (BI) was last subject to the transitional procedures under the Fund's safeguards assessment policy in 2002. That assessment recommended remedial action to address a number of vulnerabilities in the audit arrangements of BI. The main recommendations have been implemented. Audited financial statements for BI for 2014 have been reviewed and the audit report issued by BPK (the Supreme Audit Institution) contained an unqualified opinion.

104. **The borrower is the Republic of Indonesia and this operation is a single-tranche IBRD loan of US$ 400 million**. The loan will be made available upon loan effectiveness, provided that the Bank is satisfied with the progress achieved by the Borrower in carrying out the Program and with the adequacy of the Borrower's macroeconomic policy framework. The Government has confirmed that Indonesia will borrow this amount as an IBRD Flexible Loan with Variable Spread in US dollar currency with an annuity repayment schedule linked to commitments.

105. **The loan disbursement will follow the standard Bank procedures for DPLs.** The loan amount will be disbursed into a foreign currency account of the borrower at Bank Indonesia

that forms part of Indonesia's official foreign exchange reserves. The equivalent rupiah amount will immediately be transferred to the General Operational Treasury account of the borrower that is used to finance budget expenditures, as the loan is intended to be used to support the general Government budget. This arrangement has been followed for the previous DPLs. The borrower, within 30 days, will provide to the Bank a written confirmation that this transfer has been completed, and provide to the Bank any other relevant information relating to these matters, including the exchange rate of the conversion from US dollars to rupiah, that the Bank may reasonably request. Disbursements of the loan will not be linked to any specific purchases and no procurement requirements have to be satisfied, except that the borrower is required to comply with the standard negative list of excluded items that may not be financed with Bank loan proceeds, as defined in Schedule 1 to the loan agreement. If any portion of the loan is used to finance ineligible expenditures as so defined in the loan agreement, the Bank has the right to require the Government to promptly, upon notice from IBRD, refund the amount equal to such payment to the Bank. Amounts refunded to the Bank will be cancelled from the loan.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

106. **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 counterparts are the Ministry of Finance, with engagement with DG Taxes, DG Treasury, DG Budget and Fiscal Policy Agency (BKF) on the relevant expenditure and revenue reform areas, and with BKF on the overall program. The Ministry of Public Works and Housing has been directly engaged on the expenditure pillar. Monitoring of progress on indicative triggers and result indicators will be done on a regular, quarterly basis and be coordinated by the BKF for the duration of the programmatic series. It is expected that the indicative triggers will be completed by Q2 of 2017 and the second operation will go to the Board in Q3/Q4 of 2017 with a closing date of mid-2018, which means the ICR completion by mid-2019. 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 to be done as part of ongoing analytical work and technical assistance on fiscal issues.

107. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

108. **The overall risk rating of this operation is substantial.** Major risks are the following: (a) political and governance challenges; (b) macroeconomic (fiscal) risks, in particular revenue shortfalls relative to targets in 2016 and 2017; (c) sector strategies, in particular on tax policy; and (d) weak institutional capacity for implementation, in particular 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[69] (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.

109. **Political and Governance:** While *collecting more* and *spending better* is a priority for the government, there is not a government-wide consensus on how to achieve these objectives and how to balance them with other objectives such as supporting increased private sector investment. This tension will affect most laws and government-level regulations, such as the reform of the final tax for MSMEs, and policy actions requiring inter-governmental cooperation, such as the access to banking data trigger with OJK. The Parliament is involved in several triggers which generates significant uncertainty and risks. The 2017 budget law and the revised VAT and Income Tax Laws approved by Parliament could be substantially different from the drafts submitted by the Government to Parliament. Strong commitment from the Ministry of Finance is needed to maintain the integrity of the laws and regulations through the inter-ministerial consultations and Parliament discussions, but the outcomes remain uncertain. On tax administration, Indonesia has had an enduring governance challenge with poor enforcement and low compliance, driven in part by special interests who benefit from weak tax administration and a slower pace of reform, which undermines the linkage between policy actions, results and PDOs. Implementing DG Taxes reforms that reduce face-to-face interactions between taxpayers and tax authorities and strengthen the integrity of taxpayers' data such as electronic filing, applications and data exchanges (many are supported by the Bank through the DPL and/or through ASA work) are important in mitigating some of these risks.

110. **Macroeconomic (fiscal) risks:** The Government is expected to face significant fiscal pressures in 2016 arising from a shortfall of revenues, mainly due to lower commodity prices. Similar to 2015, the government through pre-financing can mitigate financing risks. However, even if the financing risks are mitigated, substantial expenditure cuts in response to the revenue shortfalls in 2016 could have a negative impact on achieving the expenditure pillar results and PDO, in particular the improvement in the composition of spending and budget execution. These risks can be reduced through an early revision of the 2016 budget, i.e. to lower the revenue target and adjust the expenditure plans in an orderly way to preserve expenditure on development priorities. However, it is not currently known when the Government will revise the 2016 budget.

111. **Sector Strategies:** Broader government tax initiatives (outside of the DPL) may impact negatively on achieving the PDOs of the revenue administration and tax policy pillars. The pressure to meet revenue targets are leading to adoption of short-term measures which 1) detract focus from reforms that lead to sustained improvements but may only yield results in the medium-term, and 2) may also undermine revenue collection directly, for example, the

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[69] Including the impact on revenue collection, as shown in Section 2 in the baseline revenue scenario.

planned tax amnesty can undermine tax enforcement, morale and future tax potential if not designed and implemented well. The risks would be lower if the government can credibly present the tax amnesty as a one-time only opportunity by using the upcoming global disclosure (from the planned implementation of the Automatic Exchange of Information) as the 'stick'. Another source of risk is over-reliance on tax policy to boost investment[70], in particular if it leads to lowering of tax rates and increased usage of tax incentives, which could have a negative impact on neutrality and revenue (in particular income tax) collection without a commensurate increase in investment[71]. To partially address some of these risks, the World Bank is providing ongoing technical assistance to the Government on initiatives, which are not part of the DPL series, for example, providing technical inputs on the design of the tax amnesty program.

112. **Institutional capacity for implementation and sustainability**: The capacity for DG Taxes for implementing tax administration reforms in the DPL and complementary reforms outside of the DPL may be weakened by a number of issues. The ongoing parallel ASA support to DG Taxes on tax administration by the Bank will continue to be important to help mitigate some of these risks. First, significant investments to strengthen the underlying IT infrastructure for tax administration are essential to improving its core tax operations; for example, to utilize the data collected through increased electronic filing. However, the Ministry of Finance has not yet finalized how such investments would be financed or procured. The Bank has been providing technical advice on potential IT solutions and has recently been requested by the Minister of Finance to review the feasibility study being done for a PPP IT project. Second, although DG Taxes may be better positioned to improve tax administration if it were able to operate as a semi-autonomous revenue authority (SARA), there is a potential risk of diverting resources and focus away from tax administration reforms to the formidable task of establishing a new agency, especially if a short-timeframe is set for SARA to be operational once the general tax administration law (KUP) is passed allowing for its establishment. If it is agreed to establish SARA, the Bank can provide advisory services on the design and implementation to minimize the impact on tax administration.

Table 7: Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (H, S, M or L)
1	Political and governance	S
2	Macroeconomic	S
3	Sector strategies and policies	S
4	Technical design of project or program	L
5	Institutional capacity for implementation and sustainability	S
6	Fiduciary	M
7	Environment and social	M
8	Stakeholders	M
9	Other	n/a
	Overall	S

Source: World Bank staff.

[70] Instead of tackling broader investment climate issues. Global experience shows that tax incentives are ineffective when there is a generally weak investment climate.
[71] And could also lead to mutually harmful regional tax competition.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results
Prior Actions under DPL 1	**Indicative Triggers for DPL 2**	
Pillar A— Improving Quality of Spending ***Program Development Objective A: Improving composition of spending, budget execution and efficiency of spending***		
Prior action #1. The Borrower has increased the share of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-fuel subsidy reform years (2012-2014), as evidenced through the 2016 Budget Law, the Financial Note for 2016 State Budget and the Presidential Regulation 137/2015.	(Indicative) Trigger #1 The Government proposes a 2017 Budget, which increases the relative central government budget allocation for infrastructure, social assistance and health sectors compared to pre-fuel subsidy reform years.	Result Indicator A1: Sustained increase in the share of central government budget allocated to infrastructure, social assistance and health: • Baseline (average 2012-14): o Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase): 2.7 percent o Health (including health insurance for the poor (JKN): 4.0 percent o Infrastructure: 12.3 percent • Target (2016 and 2017): o Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase): equal or more than 3.6 percent o Health (including health insurance for the poor (JKN): equal or more than 7.2 percent o Infrastructure: equal or more than 19.5 percent
Prior action #2. The DG Treasury has completed the roll-out of the financial management information system (SPAN) to all regional treasury offices, as evidenced through the issuance of the Certificate of Operational Acceptance to the service provider.		Result Indicator A2: Reduction in the time taken for central government monthly budget realization data to be publicly available: • Baseline (2014): On average 2 months after the end of the month • Target (From mid-2016 to end-2018): On average 15 days after the end of the month
Prior action #3. The Borrower has enabled its ministries and agencies to engage in Availability Payment Contracts for infrastructure projects with the private sector, as evidenced through the Presidential Regulation 38/2015, Minister of Finance	(Indicative) Trigger #2 The Government takes further measures to facilitate investment by private sector in essential infrastructure: (a) KPPIP issues the first priority project list; and (b) the Ministry of Finance establishes and implements a Project Development Facility (PDF) to	Result Indicator A3: Increase in the number of PPP projects supported by the PDF: • Baseline (By end 2015): Zero • Target (By end 2017): 3

Regulation 190/2015, Head of Bappenas Regulation 4/2015 and Head of LKPP Regulation 19/2015.	support line ministries to do PPPs on the priority list by financing Final Business Case and transaction advisory services.	
Prior action #4. The Minister of Finance has reduced major barriers for ministries and agencies to issue multi-year contracts for government procurement by: (a) not requiring the land acquisition process, which remains necessary, to be completed prior to submission of multi-year contracts to the Minister of Finance; (b) eliminating the requirement for an external audit for no-cost contract extensions; and (c) increasing the flexibility of annual budget reallocation for multi-year contracts, as evidenced through the Minister of Finance Regulation 238/2015.		Result Indicator A4: Increase in the proportion of Ministry of Public Works and Housing budget (total) delivered through multi-year contracts. • Baseline (2014):7% • Target (2016 and 2017):17%
Prior action #5. The Borrower has enabled the increased usage of early procurement for capital projects listed in the 2016 State Budget, as evidenced through the Presidential Instruction 1/2015, Minister of Public Works and Housing Instruction 3/2015 and Minister of Finance Circular Letter S-577/2015.	(Indicative) Trigger #3 The Ministry of Public Works and Housing issues a regulation to use early procurement on an ongoing basis for APBN capital projects.	Result Indicator A5: Increase in the proportion of the value of contractual package for the budget year being procured by the Ministry of Public Works and Housing in the first semester. • Baseline (2014): 70% • Target (2016 and 2017): 90%
Pillar B---Strengthening Revenue Administration ***Program Development Objective B: Increasing tax administration efficiency, compliance management and audit capability and reducing the cost of paying taxes***		
Prior action #6. The DG Taxes has launched in July 2015 an electronic VAT invoice online application that ensures systematic submission of detailed information on taxable goods and services by taxpayer, as evidenced through the DG Taxes Decree 136/2014.	(Indicative) Trigger #4 DG Taxes takes measures to strengthen VAT administration further by: (a) enforcing universal use of the e-invoice by July 2016; (b) enforcing electronic filing of VAT returns by all VAT taxpayers by July 2016; and (c) ensuring that VAT return data is available within 72 hours after filing for auditing and analysis of	Result Indicator B1: Increase in the share of monthly VAT, annual individual income tax and corporate income tax returns filed electronically: Monthly VAT returns • Baseline: (2014): 0% • Target: (From end 2016 to end 2018): 90

	compliance risks.	Individual income tax (simple form) returns • Baseline (2014 tax year): 27% (2.6m filed electronically out of a total of 9.8m returns) • Target (2016 tax year filed in 2017): 48% (5.5m filed electronically out of an estimated total of 11.5m returns) Corporate income tax returns • Baseline (2014 tax year): 2% (13,000 filed electronically out of a total of 616,000 returns) • Target (2016 tax year filed in 2017): 57% (400,000 filed electronically out of an estimated total of 700,000 returns)
Prior action #7. The DG Taxes has reduced the burden of the Validation Process for individual e-filing by allowing tax officers to validate on the premises of employers with twenty or more employees, as evidenced through the DG Taxes Regulation 41/2015.	(Indicative) Trigger #5 DG Taxes issues further regulations to increase e-filing of: (a) corporate income tax returns by companies who are VAT taxpayers; and (b) withholding tax returns by withholding agents.	
Prior action #8. The DG Taxes has abolished the statement of regional information in the taxpayer identification number so that taxpayers will not receive new tax IDs when they move to a different region as a major step in establishing a unique and permanent taxpayer identification system, as evidenced through the DG Taxes Circular Letter SE 44/2015.		Result Indicator B2: Reduction in the number of taxpayers with multiple/duplicate IDs that can be used to file returns: • Baseline (2014): 500,000 duplicate IDs • Target (2015 tax year filed in 2016, 2016 tax year filed in 2017 and 2017 tax year filed in 2018): <3,000 duplicate IDs
Prior action #9. The DG Taxes and BPN have implemented an electronic data exchange to enable DG Taxes to access taxpayers' land asset data held by BPN for compliance purposes in a systematic manner.	(Indicative) Trigger #6 DG Taxes and government agencies take measures to increase DG Taxes access to asset registration data and financial data for audit purposes: (a) DG Taxes completes matching of national and taxpayer IDs (for those filing returns) to enable it to access land asset data for these individual taxpayers; and (b) OJK issues a circular to share credit card information with DG Taxes.	Result Indicator B3:Reduction in the average time taken to receive land asset and credit card data requested by DG Taxes for audit use: Land asset data • Baseline (2014): 5 days, limited to local land agency data • Target (From beginning 2017 to end 2018): 1 day, nation-wide land agency data Credit card information • Baseline (2015): No data • Target (2017 and 2018): Once a year

Pillar C---Enhancing Tax Policy ***Program Development Objective C: Increasing revenue potential and economic efficiency of tax policy***		

Prior action #10. The Minister of Finance has submitted to the Ministry of Law and Human Rights the white paper (*naskah akademik*) for the revision of the VAT and LGST Law no. 42 of 2009 that recommends (a) broadening the VAT base by rationalizing exemptions and limiting the Ministry of Finance's discretion in granting exemptions; (b) replacing vehicle LGST with a vehicle excise tax; and (c) incorporating remaining LGST goods into the VAT regime.	(Indicative) Trigger #7 The Government submits to the Parliament for deliberation the draft revision of the VAT Law No.42 of 2009 containing the proposed reforms from the Naskah Akademik VAT.	Result Indicator C1: The VAT regime is revised to reduce the share of final consumption exempt from standard VAT.
		• Baseline (2015):
		    o 16.3% in the current VAT regime
		• Target (2018)*:*
		    o 9.0% in the revised VAT regime
		
		Result Indicator C2: Replacement of the vehicle LGST with a vehicle excise tax
		• Baseline (2015):
		    o Vehicle LGST in place
		• Target (2018)*:*
		    o Vehicle excise tax established

Prior action #11. The Minister of Finance has established a maximum debt-to-equity ratio of 4:1 for calculating the allowable deduction from interest paid on debt to address thin capitalization, as evidenced through the Minister of Finance Regulation 169/2015.	(Indicative) Trigger #8 The Government submits to the Parliament for deliberation the draft revision of the Income Tax Law No.36 of 2008, which includes reforms to further address tax base erosion and broaden the tax base.	Result Indicator C3: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base.
		• Baseline (2015):
		    o Few anti-tax base erosion measures in place: only controlled foreign company (CFC) rule
		• Target (2018)*:*
		    o Increase in anti-tax base erosion measures in place: CFC, thin capitalization, and anti-transfer pricing measures
		    o Alternative minimum tax established
		    o Inheritance tax established

	(Indicative) Trigger #9 The Government issues a revision of Government regulation PP 46/2013 (on the final tax for micro and SMEs) that aims to bring in more new taxpayers and reduce the number of standard income taxpayers migrating to the final tax regime.	Result Indicator C4: Increase in the number of new (previously not registered as taxpayers) taxpayers joining the MSME final tax regime and reduction in the number of standard income taxpayers moving to the regime.
		• Baseline:
		    o (end Oct 2015) # of new taxpayers who paid final tax: 68,000
		    o (2014) # of previous standard income taxpayers who paid final tax: 74,000
		• Target*:*
		    o (end 2017) # of new taxpayers paying final tax: 100,000
		    o (2018) # of previous standard income taxpayers paying final tax: no additions to the final regime

ANNEX 2: LETTER OF DEVELOPMENT POLICY

MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA

LETTER OF DEVELOPMENT POLICY

MINISTRY OF FINANCE

Jakarta, 31 March 2016

No.: S-233./MK.08/2016

Mr. Jim Yong Kim
President
World Bank

Dear Mr. President

1. Since taking office in October 2014, the Government of Indonesia has placed a particular emphasis on fiscal reforms, recognizing its crucial link with the country's economic and broader development performance. The purpose of this Development Policy Letter is to provide an overview of the Government's medium term reform agenda with regard to improving the quality of spending, strengthening revenue administration and enhancing tax policy, and to provide an update on recent progress towards implementing the reforms.

2. On behalf of the Government of Indonesia, we would like to express our appreciation for the technical assistance provided by International Bank for Reconstruction/World Bank to fiscal reforms in Indonesia over the recent and longer term. We would also like to request the support of the International Bank for Reconstruction/World Bank in the form of the First Indonesia Fiscal Reform Development Policy Loan.

Indonesia's Economic and Fiscal Situation

3. Following the recovery from the Asian financial crisis, Indonesia saw strong economic growth, at an average of 5.6 percent over 2001-12. However, real GDP growth has decelerated gradually since peaking at 6.5% in 2011, down to 4.8 percent in 2015, caused by the commodities downturn, declining exports and weakening of investment growth. The slowdown in growth and decline in commodity-related revenues increased fiscal pressures significantly in 2015 and is expected to continue to do so in 2016. Indonesia has made significant progress on reducing poverty with the national poverty rate falling from 24 percent in 1999 to 11 percent in 2015. However, the pace of poverty reduction has slowed down and nearly a quarter of the population lie slightly above the poverty line and are vulnerable to shocks. Moreover, while poverty has fallen, inequality has been rising in Indonesia.

4. Effective fiscal policy will be critical for accelerating growth and tackling poverty and inequality. First, the composition of the budget should be more pro-growth and pro-poor than in the past. Prior to 2015, large energy subsidies (more than 3 percent of GDP in 2011-2014, accounting for 30% of total government spending) crowded out spending on infrastructure, health and social assistance, leading to large infrastructure gaps and

incomplete coverage of health and social programs for the poor and vulnerable. Second, public investment should be better executed with more efficiency in order to realize the big infrastructure push, which underpins the Government's growth strategy.

5. To create the fiscal space for increased spending on infrastructure, health and social assistance, while adhering to the fiscal rule, Indonesia's revenue performance has to improve. Indonesia has low revenue-to-GDP (15 percent average 2009-2014) and tax-to-GDP (11 percent average 2009-2014) ratios, due to low tax compliance rates and narrow tax bases. The steep decline in oil, gas and other commodity prices and the slowdown in economic growth has negatively impacted revenues. While we were able to increase non-oil-and-gas income taxes in 2015 to protect our tax revenues, non-tax revenues fell from approximately 4 to 2 percent of GDP in 2015. With predicted weak global commodity prices through the medium-term, the Government needs to strengthen tax administration and enhance tax policy to counteract the effects of lower resource revenues.

Government Response and the Medium-Term Fiscal Reform Agenda

6. Since taking office in October 2014, President Joko Widodo has embarked on a significant reform program. The President's electoral platform – the "Nawa Cita" – has been reflected in the National Medium-term Development Plan (RPJMN) for 2015-2019, which sets out national development goals and the main directions of policy for the period. The Government's growth strategy is based on a big infrastructure push and accelerating structural reforms, with a series of economic policy packages being rolled out since mid-September 2015. The program of fiscal reforms to support the national development goals of the RPJMN and the Government's growth strategy is outlined below.

Improving the quality of spending

7. *Pro-growth and pro-poor central government budgeting:* In January 2015, the Government undertook major fuel subsidy reforms by removing the subsidy for gasoline and introducing a fixed per litre subsidy for diesel. The estimated fiscal savings of nearly IDR 200 trillion in the 2015 state budget provided space for higher spending on infrastructure and social assistance programs. The Government further lowered the share of the budget allocated to energy subsidies in the 2016 state budget and used that fiscal space to increase spending on infrastructure, health and social assistance. The Government intends to continue this policy direction in the 2017 proposed budget.

8. *Facilitating private sector financing for public infrastructure:* The significant public infrastructure investment targets in the RPJMN will only be met with a significant increase in private sector financing. The Government is creating an enabling environment for private sector investment and public-private partnerships, including issuance of regulations in 2015 to allow line agencies to engage in a wider range of contract types with the private sector, including Availability Payment Contracts that are often used in large infrastructure projects. The National Committee for Acceleration of Priority Infrastructure Development (KPPIP), chaired by the Coordinating Economic Minister, has issued the first priority (infrastructure project) list with 30 projects, each with

investment value of more than IDR 500 million. Projects on this list will be eligible for support from government Project Development Facility (PDF). The Ministry of Finance will establish a PDF to support line ministries to do PPPs on the priority list by financing Final Business Case and transaction advisory services.

9. *Reducing barriers to multi-year contracts:* For large, multi-year infrastructure projects, multi-year contracts are likely to reduce total project costs and increase quality compared to a series of single-year contracts. The Ministry of Finance issued a regulation (PMK 238/2015) in 2015 aiming to help line ministries use multi-year contracts by removing onerous requirements and increasing the flexibility of annual budget reallocation within multi-year contracts.

10. *Usage of early procurement:* To improve the execution of public investment programs, the Government issued a number of regulations in 2015 to increase usage of early procurement for capital projects in the 2016 State Budget. By October 2015 the Directorate General of Highway at the Ministry of Public Works and Public Housing had started early procurement for over a third of their total 2016 budget. The Government intends to continue the usage of early procurement to reduce the back loading of capital spending and reduce risks to implementing projects in the budget year. In addition, the Government is working to strengthen public procurement more generally through implementation of e-procurement.

11. *Strengthening budget monitoring and management through SPAN:* In 2015 DG Treasury achieved a major milestone by completing the roll-out of SPAN (State budget and treasury system) to all treasury offices across Indonesia. SPAN automates previously manual business processes throughout the cycle (from budgeting to reporting) and improves the accuracy and timeliness of central government financial statements, helping the Government to manage expenditures and increasing internal and external accountability. Going forward, DG Treasury will seek to maximise the potential of SPAN, for example, linking the SPAN system and the LKPP procurement data system to provide MoF and LKPP with data that will help improve value-for-money in public procurement.

Strengthening tax administration processes and capability

12. Strengthening tax administration processes and capability is critical to improving our revenue performance. DG Tax adopted in early 2014 the long-term *Institutional Transformation Blueprint*, as the next phase in an ongoing reform process, and is implementing a number of initiatives to strengthen tax administration, including the following that are highlighted in the Fiscal Reform DPL: promotion of electronic tax filing, implementing a unique taxpayer ID system, and improving access to third-party taxpayer data for auditing. In addition, DG Tax is continuing the extensification (expansion of the registered taxpayer base) program, developing compliance risk management (CRM) models, and training auditors. There is a major need to invest and modernize DG Tax's ICT and data management systems. Guidelines ("reference architecture") have been developed and adopted to guide future investments in IT hardware and software and DG Tax is installing a basic data warehouse as a first step in building the capacity to process data.

13. *Strengthening VAT administration:* DG Tax is undertaking a number of measures to strengthen VAT compliance management and audit capability and reduce the cost of VAT administration for the Government and VAT-payers. DG Tax has launched an online application through which taxpayers create electronic VAT invoices and provide systematically detailed information on taxable goods and services. DG Tax will enforce the regulation on universal use of this e-VAT invoice as well as the electronic filing of monthly VAT returns (e-SPT) by all taxpayers by July 2016. Electronic filing of VAT returns will enable the data to be available quickly for use in compliance risk management (CRM) models to help move to a more strategic, risk-based approach to auditing VAT refunds.

14. *Increasing electronic filing of income taxes*: Increasing the share of individual and corporate income tax returns filed electronically should reduce significantly the costs of paying taxes for taxpayers and increase DG Tax's efficiency in processing returns. DG Tax has issued a regulation (Per Dirjen 41/2015) to make it easier for individual taxpayers to register as e-filers and intends to issue further regulations in 2016 to increase e-filing rates of corporate income tax returns and withholding tax returns by withholding agents.

15. *Establishing a unique and permanent taxpayer ID system:* Previously, a large number of Indonesian taxpayers held multiple tax IDs that could be used to file returns – a source of compliance risk. In 2015, DG Tax abolished the regional part of the taxpayer identification number so that taxpayers cannot receive new tax IDs when they move to a different region. Regarding taxpayers that have existing multiple IDs, DG Tax is in the process of identifying these duplicate IDs in the taxpayer database and invalidating them so that they can't be used to file tax returns. Establishing a unique taxpayer ID system will also make it easier to match taxpayer IDs with national IDs.

16. *Improving DG Tax access to taxpayer asset and financial data for audits.* Getting assured, timely access to relevant third-party data for audit purposes will strengthen DG Tax's audit capability. In 2015, DG Tax and the National Land Agency (BPN) implemented an electronic data exchange to enable DG Tax account representatives, auditors and tax officers to access individual taxpayers' land asset data held by BPN for tax analyses, compliance management and audit purposes in a systematic and timely manner. DG Tax is seeking to further improve the timeliness of access to financial data for audit purposes, including credit card information and banking (deposit) data.

Tax policy reforms to increase the tax base and economic efficiency of tax policy

17. The Government has also set out an ambitious tax policy reform agenda with revisions of the VAT and Income Tax Laws scheduled to be tabled to the Parliament in 2016 and a planned revision of the final tax regime for micro, small and medium enterprises. This provides significant opportunities to increase the tax potential by broadening the tax base, and reduce economic distortions and incentives for strategic behavior by taxpayers as a result of complex tax structures.

18. *Improving VAT, Luxury Goods Sales Tax and Excise Tax Policy:* The Ministry of Finance has submitted to the Ministry of Law and Human Rights the VAT white paper (*naskah*

akademik) setting out the proposed reforms in the revision of the VAT and LGST Law No.42 of 2009. The reforms include rationalizing exemptions - limiting them to final consumption of basic education, health services, social services, basic food and public transport – to broaden the VAT base and reduce distortions caused by the cascading effect of exemptions. It also proposes replacing the vehicle LGST with a vehicle excise tax in order to better address environmental externalities, and incorporating the remaining LGST goods into the VAT regime to improve tax administrative efficiency. The Government plans to submit to Parliament for deliberation the draft revision of the VAT and LGST Law before the end of 2016.

19. *Improving income tax policy, including the MSME final tax, and tackling sources of tax base erosion:* The Government also plans to submit to Parliament for deliberation the draft revision of the Income Tax Law No.36 of 2008 in 2016. The Ministry of Finance, who is leading the drafting of the revised Law, is seeking to broaden the tax base and is considering proposing the introduction of an alternative minimum tax and tax on inheritance transfers and gifts. The latter tax will also support equity goals. The draft revision of the law will also propose strengthening of measures to tackle sources (domestic and international) of tax base erosion, including transfer mispricing practices. This will build on the Ministry of Finance regulation (PMK 169/2015) issued to address the risk of thin capitalization by establishing a maximum debt-to-equity ratio for calculating the allowable deduction from interest paid on long- and short-term debt for corporations. In parallel, the Government intends to issue a revision of the government regulation (PP 46/2013) for the final tax on MSMEs by early 2017, with the aim of bringing in more new (previously unregistered) taxpayers and reducing the number of taxpayers in the standard income tax system migrating to the final tax regime.

Conclusions

20. In summary, the Government is firmly committed to the program of fiscal reforms set out above in order to improve the quality of spending, strengthen revenue administration and enhance tax policy, which in turn can help to reduce poverty and contribute to broad-based economic growth.

21. The Government greatly values the support provided by the International Bank for Reconstruction/World Bank over the years to help finance Indonesia's development priorities and the provision of technical assistance that is helping us to identify issues and develop a comprehensive and well-coordinated fiscal reform program. We look forward to your continued engagement and support in the coming years.

Minister of Finance
Republic of Indonesia

Bambang P. S. Brodjonegoro

Cc:

1. Coordinating Minister for Economic Affairs
2. Director General of Budget Financing and Risk Management, Ministry of Finance
3. Head of Fiscal Policy Agency, Ministry of Finance
4. Director General of Tax, Ministry of Finance
5. Director General of Budget, Ministry of Finance
6. Director General of Treasury, Ministry of Finance

ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/81

INDONESIA

March 2016

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR INDONESIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 24, 2016 consideration of the staff report that concluded the Article IV consultation with Indonesia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 24, 2016, following discussions that ended on December 18, 2015, with the officials of Indonesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 8, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Indonesia.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

Press Release No. 16/104 FOR IMMEDIATE RELEASE
March 15, 2016

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2015 Article IV Consultation with Indonesia

On February 24, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Indonesia.

Over the past few years, the significant strengthening of the policy framework in Indonesia has bolstered macroeconomic resilience. This was demonstrated by sound monetary management and a prudent fiscal stance, underpinned by historic fuel subsidy reforms in 2015. These actions reinforced macroeconomic stability and supported growth. In effect, Indonesia safely navigated a difficult external environment in 2015, characterized by the fall of commodity prices, shifts in global financial conditions, and slower growth of trading partners. Medium-term prospects are favorable, supported by an inclusive growth-enhancing policy agenda that also places emphasis on stability.

Overall, macroeconomic performance in 2015 has been positive. Economic growth is forecast to see a moderate acceleration to around 5 percent in 2016; investment activity would lead the recovery, in particular, public sector spending. However, weak commodity prices and slower demand from trading partners present headwinds to growth. Inflation has fallen sharply at end-2015, and is expected to remain within the inflation target band (3–5 percent) in 2016. The external current account deficit narrowed significantly in 2015 to around 2 percent of GDP on lower imports, and is projected to increase moderately in 2016 due to a pickup in domestic demand. The fiscal deficit in 2015 widened but remained below the 3 percent of GDP statutory limit for the general government.

Risks to the outlook are tilted to the downside, mainly from external factors including more volatile global financial conditions, a deeper-than-expected slowdown in emerging market

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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trading partners, and further declines in commodity prices, requiring continued vigilance by policymakers.

The authorities' fiscal policy strategy aims to create fiscal space through improved revenue mobilization and reform of general subsidies in order to increase spending on infrastructure and targeted social programs. Early successes include the large reduction in fuel subsidies and the expansion of conditional cash transfers and public investment. Nonetheless, important challenges remain with revenue mobilization from the effects of lower commodity prices and a related contraction of imports.

The relatively tight stance of monetary policy in 2015, combined with exchange rate and bond yield flexibility, helped the economy adjust to external pressures, which have eased in early 2016. The authorities appropriately allowed the exchange rate to reflect market forces, with judicious foreign currency interventions to ensure the orderly functioning of markets. Allowing government bond yields to be market determined has facilitated government financing despite volatility in external financial conditions.

Looking ahead, the main policy challenge for Indonesia is to chart a course to higher, more inclusive growth in the medium term, while navigating the more volatile global environment by preserving macro-financial stability and further strengthening the external position.

Strengthening the fiscal framework through an enhanced revenue strategy would help, with policy framed in a medium-term plan that provides guidance to government programs. Higher public investment should be combined with sound public financial management, governance reform of state-owned enterprises, and monitoring of potential fiscal risks. The gradual unwinding of the tight monetary policy stance is appropriate as long as inflation remains contained and financial markets continue to be calm. Expeditious approval of the draft Financial System Safety Net law is a top priority to strengthen the institutional framework for financial sector stability. The structural reform strategy is well-focused on improving competitiveness to accelerate economic growth and diversify the economy. A series of policy packages issued since August 2015 signal a renewed policy strategy to improve the business climate and reduce the cost of doing business, thus catalyzing higher private investment and raising potential growth prospects for Indonesia.

Executive Board Assessment[2]

Executive Directors commended the authorities' sound macroeconomic management and commitment to reform, which has allowed the Indonesian economy to weather the downturn in commodity prices and the challenging external environment. While the outlook is positive,

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

downside risks remain, and Directors encouraged the authorities to continue to implement prudent policies to safeguard resilience and to sustain structural reform efforts.

Directors considered the fiscal strategy to be appropriate. They welcomed the authorities' commitment to adjust the 2016 budget in light of a lower revenue outlook, and looked forward to continued adherence to the fiscal rule. Directors commended the decisive energy subsidy reforms in 2015, including plans to better target electricity subsidies, and the use of the resulting fiscal space to increase growth-critical social and capital spending. At the same time, the underperformance of revenues has underscored the need to improve revenue mobilization by enhancing tax policy and revenue administration, in the context of a medium-term fiscal framework, to finance the large infrastructure needs and other priorities. Directors also stressed the importance of sound public investment planning and management, and highlighted the role that carefully designed PPPs could play in helping to address infrastructure needs.

Directors noted that the tight monetary policy in 2015 has helped to anchor inflation. While the recent easing is appropriate, they agreed that it should be gradual and cautious to safeguard financial stability, keep inflation within the target band, and support external adjustment. Directors supported continued exchange rate flexibility and market-determined bond yields. They welcomed efforts to deepen money markets to improve liquidity management, strengthen monetary policy transmission, and help manage external financial volatility.

Directors took positive note that Indonesia's financial system is sound, but called for close monitoring of pockets of vulnerability. They called for expeditious enactment of the Financial System Safety Net law to clarify the frameworks for emergency liquidity assistance and bank resolution and align the mandates of financial sector agencies with the new structure. Directors encouraged effective implementation of the framework for monitoring risks in the corporate sector to address vulnerabilities stemming from foreign currency exposures and refinancing risks.

Directors welcomed the new direction of structural reforms and investment liberalization and called for continued efforts to bolster employment, diversify the economy, and raise growth potential. They emphasized the need to press ahead with reforms to revamp the business climate, streamline regulations, increase international trade and investment integration, deepen financial markets, and improve labor market flexibility.

Indonesia: Selected Economic Indicators

	2011	2012	2013	2014 Est.	2015 Proj.	2016 Proj.
Real GDP (percent change)	6.2	6.0	5.6	5.0	4.7	4.9
Domestic demand	6.0	7.3	5.1	4.7	4.0	5.1
Of which:						
Private consumption 1/	5.1	5.5	5.4	5.3	4.8	4.9
Government consumption	5.5	4.5	6.9	2.0	4.0	5.0
Gross fixed investment	8.9	9.1	5.3	4.1	4.4	5.7
Change in stocks 2/	-0.2	0.8	-0.3	0.2	-0.5	0.0
Net exports 2/	0.2	-1.5	0.6	-0.3	0.8	0.0
Saving and investment (in percent of GDP)						
Gross investment 3/	33.0	35.1	34.0	34.7	34.3	34.8
Gross national saving	33.2	32.4	30.9	31.6	32.3	32.3
Prices (12-month percent change)						
Consumer prices (end period)	3.8	3.7	8.1	8.4	3.4	4.5
Consumer prices (period average)	5.3	4.0	6.4	6.4	6.4	4.5
Public finances (in percent of GDP)						
Central government revenue	15.5	15.5	15.1	14.7	13.0	12.1
Central government expenditure	16.5	17.3	17.3	16.9	15.7	15.0
Of which: Energy subsidies	3.3	3.6	3.3	3.2	1.0	0.6
Central government balance	-1.1	-1.8	-2.2	-2.2	-2.8	-2.8
Primary balance	0.1	-0.6	-1.0	-0.9	-1.4	-1.3
Central government debt	23.1	23.0	24.9	24.7	27.5	28.4
Money and credit (12-month percent change; end of period)						
Rupiah M2	17.4	14.4	9.4	13.5	13.5	14.0
Base money	18.3	14.9	16.7	11.6	6.4	11.0
Private Sector Credit	25.4	22.3	20.0	11.8	11.4	12.6
One-month interbank rate (period average)	6.2	4.4	5.8	7.5	7.2	...
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)						
Current account balance	1.7	-24.4	-29.1	-27.5	-16.8	-22.8
In percent of GDP	0.2	-2.7	-3.2	-3.1	-2.0	-2.5
Trade balance	33.8	8.7	5.8	7.0	14.9	10.8
Of which: Oil and gas (net)	-0.7	-5.2	-9.7	-11.8	-7.7	-7.6
Inward direct investment	19.2	19.1	18.8	23.0	18.8	20.4
Overall balance	11.9	0.2	-7.3	15.2	-4.3	2.5
Non-oil and gas exports, volume growth	12.6	4.5	2.5	3.3	-1.5	3.5
Non-oil and gas imports, volume growth	12.2	16.5	-1.2	-0.8	-8.3	9.6
Terms of trade, percent change (excluding oil)	5.3	-0.7	-2.2	-1.8	-8.3	-0.2
Gross reserves						
In billions of U.S. dollars (end period)	110.1	112.8	99.4	111.9	105.9	108.4
In months of prospective imports of goods and services	6.2	6.4	5.9	8.0	7.3	6.8
As a percent of short-term debt 4/	236	206	177	192	177	175
Total external debt 5/						
In billions of U.S. dollars	225.4	252.4	266.1	293.7	314.0	330.7
In percent of GDP	25.2	27.5	29.2	33.1	36.6	36.6
Exchange rate						
Rupiah per U.S. dollar (period average)	8,774	9,375	10,414	11,862	13,389	...
Rupiah per U.S. dollar (end of period)	9,075	9,638	12,171	12,435	13,788	...
Memorandum items:						
Jakarta Stock Exchange (12-month percentage change, composite index)	3.2	12.9	-1.0	22.3	-12.1	...
Oil production (thousands of barrels per day)	907	860	830	794	800	830
Nominal GDP (in trillions of rupiah)	7,832	8,616	9,525	10,543	11,516	12,629

Sources: Data provided by the Indonesian authorities; and IMF staff estimates and projections.

1/ Includes NPISH consumption.
2/ Contribution to GDP growth (percentage points).
3/ Includes changes in stocks.
4/ Short-term debt on a remaining maturity basis.
5/ Public and private external debt.

ANNEX 4: SUMMARY OVERVIEW OF GOVERNMENT PROGRAM AND BANK SUPPORT

Program/Reform *GoI commitment/underway* *Currently not yet (fully) implemented*	**World Bank Support**			
	Fiscal DPL	**Investment Lending**	**ASA and Policy Dialogue**	**Details of Bank Support**
Expenditure and PFM				
Reduce energy subsidies and increase allocation to infrastructure, health and social assistance	X Energy and Fiscal DPLs		X	• Sectoral PERs and TA to the RPJMN 2015-2019 process (PFM MDTF) • Ongoing analytical support and TA on fuel subsidy reform
Performance-based budgeting and Medium-term expenditure framework			X (minor)	• Some TA provided but stopped as limited GoI progress on the reforms (PFM MDTF)
Facilitate private sector investment for infrastructure inc. PPPs	X		X	• Ongoing TA on PPPs
Strengthen budget management and reporting: State Treasury and Budget Management System (FMIS/SPAN) rollout	X		X	• Extensive TA to reach SPAN completion and ongoing TA to support sustainability, including assessment of SPAN system risks (PFM MDTF)
Improve budget execution of capital/infrastructure spending	X		X	• Analytical studies e.g., DIPA tracking and advisory services on Public Investment Management (PFM MDTF)
Strengthen public procurement (e-procurement, open contracting)			X	• Ongoing TA to the national procurement agency (LKPP) (PFM MDTF)
Strengthen accountability institutions, inc. internal audit agency (BPKP), and internal controls			X	• Ongoing TA to BPKP (PFM MDTF)
Subnational transfers/ spending: improving design, implementation and monitoring	In discussion		X	• Ongoing TA, including on subnational fiscal data systems and design of intergovernmental transfers (PFM-MDTF)
Revenue Administration				
Extensification program (registration)				• Not actively supporting as unlikely to substantially raise revenues as not targeted
Strengthen filing: VAT invoice, electronic VAT & income tax filing, taxpayer ID system	X		X (minor)	• TA on revision of VAT invoice (PFM MDTF)
Strengthen tax analysis and development of compliance risk management (CRM) model (pilot so far)			X	• Ongoing TA and capacity building to BKF and DG Taxes on revenue forecasting and micro-simulations (PFM MDTF) • TA on CRM development (PFM MDTF)
Strengthen tax audit: -Increase access to and capacity to use third-party data -Strengthen auditor capacity for large taxpayers -Strengthening forensic investigator capacity	X		X	• Advisory support on management of existing third-party data (PFM MDTF) • Training on Multi National Enterprises and Cross-Border Transactions and seminar on management of large taxpayers for DG Taxes auditors (PFM MDTF) • Training for DG Taxes forensic investigators (PFM MDTF)

ICT and data management investment and modernization (Note 1)		X Potential and will be broader tax administration	X	• Providing advice to DG Taxes on acquiring a customizable commercial off-the-shelf IT system, and peer review of existing IT reform activities (PFM MDTF) • TA to develop IT hardware & software architecture guidelines adopted by DG Taxes to guide ICT investments, and installment of a basic data warehouse ((PFM MDTF)
Establish semi-autonomous revenue authority (SARA)			X (minor so far)	• Shared international experience in workshop. If SARA is established, TA to be provided on the design and implementation
Strengthen non-tax revenue administration (ESDM)			X	• Analytical study on mining NTR administration. Ongoing TA through the Natural Resource for Development program and MDTF
Tax Policy				
Revision of VAT& LGST Law	X		X	• Analytical study on current VAT and LGST system and ongoing TA, supported by global tax team
Revision of Income Tax law	X		X	• Ongoing TA on income tax policy issues, supported by global tax team
Revision of simplified final tax for micro and SMEs	X		X	• Ongoing TA on simplified tax regime, supported by global tax team. Includes SME taxpayer survey.
Anti-base erosion and profit-shifting (BEPS) regulations	X		X	• Ongoing TA through ASEAN tax program
Tobacco excise tax reform			X	• Analytical work to build the evidence base for reforms, including a tobacco industry employment study.
Expand use of tax incentives: investment-linked allowances and tax holidays			X	• Assessment of investment-linked allowances regulation (PP18).Analysis of effectiveness of tax incentives not completed due to lack of data.
Tax Amnesty Law/Program (Initial program in 2015. 2016 program tabled to Parliament)			X (minor so far)	• Shared international experience with voluntary disclosure and amnesty programs. Provided technical input on early draft of the law to reduce risks

Notes: 1) *ICT and data management modernization:*
The lack of an efficient integrated IT system remains a major obstacle for achieving visible improvements in compliance management, taxpayer services, and high tax performance. The ICT hardware and software needed to support the main business process functions are severely out-of-date, and DG Taxes relies on many manual processes or ad hoc temporary solutions. ICT modernization has been constrained by the limited flexibility of DG Taxes to procure goods and services that require multi-year contracting, forced rotation of skilled IT staff out of IT, and failure to adequately budget for IT related licensing renewals and for technical, operational, and functional obsolescence over the long term. The need to strengthen the IT system will increase as reforms aim to register more taxpayers, increase the rate of electronic filing, to analyze taxpayer compliance patterns across economic segments or to undertake sophisticated “data analytics” with high volumes of third party data in order to develop a more risk-based compliance management system. Until recently, DG Taxes ICT directorates had been implementing a piece-meal approach to addressing weaknesses in the ICT hardware and software. Supported by PFM MDTF, IT hardware and software architecture guidelines “reference architecture” have been developed to guide future ICT investments and DG Taxes is installing a basic data warehouse, which is the first step in acquiring the hardware capacity to process big data and to develop an effective compliance risk management engine. The data warehouse contract was awarded in 2015 with implementation due to take place in the first half of 2016. DG Taxes is looking at financing options, including through a PPP, on how to make the significant ICT investments required.