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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF US$300 MILLION TO

THE REPUBLIC OF INDONESIA

FOR THE

SECOND INDONESIA FISCAL REFORM

DEVELOPMENT POLICY LOAN

October 3, 2017

Macroeconomics & Fiscal Management and Governance Global Practice
East Asia and the Pacific

REPUBLIC OF INDONESIA-GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of August 31)

Currency Unit	Rupiah (IDR)
US$ 1.00 =	IDR 13,326

ABBREVIATIONS AND ACRONYMS

ASA	Advisory Services and Analytics
APA	Advanced Pricing Agreement
BI	Bank Indonesia
BKF	Fiscal Policy Agency, MoF
BLSM	*Bantuan Langsung Sementara Masyarakat* (temporary unconditional cash transfer)
BP	Basis point (bp)
BPK	*Badan Pemeriksa Keuangan* (State Audit Agency)
BPS	*Badan Pusat Statistik* (Central Bureau of Statistics)
CIT	Corporate Income Tax
CPF	Country Partnership Framework
CPS	Country Partnership Strategy
DAK	Earmarked specific transfers to regions
DPL	Development Policy Loan
EOP	End of period (eop)
FDI	Foreign Direct Investment
FMIS	Financial Management Information System
FY	Fiscal Year
GDP	Gross Domestic Product
GFMRAP	Government Financial Management and Revenue Administration Project
GOI	Government of Indonesia
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion and Results
IDR	Indonesian Rupiah
IEG	Independent Evaluation Group
IMF	International Monetary Fund
INPRES	Presidential Instruction
KPPIP	National Committee for Acceleration of the Infrastructure Priority Development
LKPP	*Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah* (National Public Procurement Agency)
LGST	Luxury Goods Sales Tax
MAP	Mutual Agreement Process
MoF	Ministry of Finance
Naskah Akademik	White Paper
OECD	Organization for Economic Co-operation and Development
PDF	Project Development Facility
Per Dirjen	DG Regulation
PerPres	Presidential Regulation
PEFA	Public Expenditure and Financial Accountability
PFM-MDTF	Public Financial Management MDTF
PIT	Personal Income Tax
PLN	*Perusahaan Listrik Negara* (State Electricity Company)
PMK	Ministry of Finance Regulation
PP	Percentage point (pp)
PPP	Public-private partnerships
PSIA	Poverty and Social Impact Analysis
REER	Real effective exchange rate
RPJMN	*Rencana Pembangunan Jangka Menengah Nasional* (National Medium Term Development Plan)
SCD	Systematic Country Diagnostics
SOE	State-Owned Enterprise
SPAN	*Sistem Perbendaharaan dan Anggaran Negara* (Integrated Financial Management System)
Susenas	*Survei Sosial dan Ekonomi Nasional (*National Socio-economic Survey)
TA	Technical Assistance
US$	United States Dollar
VAT	Value Added Tax
VSL	Variable Spread Loan
WB	World Bank
WBG	World Bank Group
YOY	Year-on-year

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THE REPUBLIC OF INDONESIA

SECOND 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 Loan Terms: IBRD Flexible Loan with fixed spread; Front End Fee: 0.25%; Amount: USD $300 million
Operation Type	Programmatic, single-tranche. 2nd of original series of three operations
Pillars of the Operation and Program Development Objectives	This programmatic DPL series comprises of three pillars with the following 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 and compliance and audit capability **Pillar C: Enhancing Tax Policy.** PDO: Increasing revenue potential and economic efficiency of tax policy
Results Indicators	A1: Sustained increase in the share of central government actual spending on infrastructure, social assistance and health after fuel subsidy reforms
	A2: Reduction in the time taken for central government monthly budget realization data to be publicly available
	A3: Availability of enabling regulatory framework for Availability Payment Contracts for infrastructure projects with the private sector
	A4: Increase in the proportion of Ministry of Public Works and Housing budget (total) delivered through multi-year contracts
	A5: Reduced deviation between indicative line ministry expenditure ceiling in a new budget and the forward estimate in the earlier planned budget
	A6: 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
	A7: Increase in the proportion of districts meeting the requirement to spend 25% of DAU and revenue sharing allocations on infrastructure
	A8: Increased proportion of contracted value of DAK by July of each year
	B1: Increase in the share of monthly VAT returns filed electronically
	B2: VAT refunds audited based on objective risk criteria
	B3: Increase in the share of annual individual income tax and corporate income tax returns filed electronically
	B4: Reduction in the number of taxpayers with multiple/duplicate IDs that can be used to file returns
	B5: Reduction in the average time taken to receive land asset and access financial information requested by DGT for audit use
	C1: Increase in the number of new (previously not registered) taxpayers joining the MSME final tax regime and reduction in the number of standard income taxpayers moving to the regime
	C2 The VAT regime is revised to reduce the share of final consumption exempt from standard VAT
	C3: Replacement of the vehicle LGST with a vehicle excise tax
	C4: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base (indicator 1)
	C5: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base (indicator 2)
	C6: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base (Indicator 3)
	C7: Increase in number of new APA and MAPs concluded under new rules.
	C8: Access to information on passive income improved
	C9: Number of treaties negotiated based on model treaty
Overall Risk Rating	Substantial
Operation ID	P161475

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

1. INTRODUCTION AND COUNTRY CONTEXT, INCLUDING POVERTY DEVELOPMENTS

1. **The proposed DPL aims to support the Government of the Republic of Indonesia's priorities for improving quality of spending, strengthening revenue administration and enhancing tax policy to further the country's medium-term economic development and poverty reduction goals**. The proposed operation, in the amount of US$300 million, is the second in a programmatic series of now three single-tranche operations supporting critical policy and institutional reforms with three development objectives: A) Improving composition of spending, budget execution rates and efficiency of spending; B) Increasing tax administration efficiency and compliance and audit capability; and C) Increasing revenue potential and economic efficiency of tax policy. A third single tranche operation is proposed, with the same development objectives. The proposed third operation responds to a direct request from the government to support the acceleration of fiscal reform efforts in 2017. Government's commitment to maintaining reform momentum before the election cycle beginning in 2019, is evidenced in recent appointments of a revenue reform team and special advisers to the Minister of Finance, as well as a significant increase in demand for technical assistance which the World Bank is responding to with development partners.

2. **Indonesia's economic fundamentals have improved significantly.** After 5 years of adjusting to lower commodity prices, economic growth strengthened in 2016 on the back of higher private consumption growth. In 2016, consumer price inflation also fell to a record low, while the unemployment rate and the current account deficit declined to a 5-year low. The fiscal deficit remains conservative, with enhanced fiscal credibility earning the country's sovereign bonds an upgrade from Standard and Poor's (S&P) to an investment grade. The economic outlook remains positive, supported by a projected pick-up in the global economy and lower domestic borrowing costs, carrying both investment and exports.

3. **Poverty and inequality dropped recently, thanks to resilient economic growth and lower inflation**. The official poverty rate edged down 0.2 percentage points a year to March 2017 to 10.6 percent. However, this decline is still lower than the rates of poverty reduction achieved between 2006 and 2010, which averaged 1.1 percentage points annually. The Gini coefficient for March 2017 was 39.3, falling by 0.4 points from 39.7 in March 2016. This continues the trend that began in September 2015, when the Gini started to fall after a relatively flat period between 2011 and 2015. While government is under increasing pressure to tackle inequality, fiscal policy in Indonesia has been shown to have little impact, reducing poverty by 1.1-1.4 percentage points and the Gini coefficient by 2.6-3.3 points over the period 2012-14[1] due to tax exemptions and thresholds, and poor targeting of social assistance and service delivery.

4. **Effective fiscal policy, in its revenue mobilization and quality of spending functions, is recognized as a priority in the Indonesia Systematic Country Diagnostic (SCD)**. **However, the Government faces significant challenges in *Collecting More.*** Relative to its regional and emerging market peers, Indonesia has one of the lowest revenue-to-GDP ratios (12.5 percent in 2016 from 13.1 percent in 2015) and tax-to-GDP ratios (10.4 percent in 2016 from 10.7

[1] World Bank Public Expenditure Review and Commitment to Equity analysis.

percent in 2015) 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[2]). The revenue gap is due to persistently low compliance rates[3] across a wide range of taxes[4], taxpayers segments and sectors. It 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). Thanks in part to revenue administration reforms and a pick-up in commodity prices, the declining revenue to GDP ratio may stabilize in 2017. Under a "no major reform" scenario with continued moderation of commodity prices, the ratio may stay at that lower level through the medium-term. This would severely constrain the fiscal space for spending on development priorities. 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 (16.8 percent of GDP in 2016 compared to more than 28 percent for middle-income countries in Asia).

5. ***Spending better*** **in terms of improving both the composition and execution of public spending is also important**. First, despite energy subsidy reforms begun in 2015, subsidies still constitute over 9.3 percent of spending or 1.4 percent of GDP in 2016. Eliminating energy subsidies and better targeting other subsidies would free up fiscal space for more productive spending such as infrastructure. Second, half of the national budget (net of subsidies and interest payments) is spent at the subnational level, and dominated (60 percent) by personnel spending. Removing the perverse incentive in the DAU (*Dana Alokasi Umum*) intergovernmental transfer formula to spend on personnel would create further fiscal space. Finally, improving the planning and accountability of spending through the medium-term expenditure framework and conducting early procurement to spend more evenly within the fiscal year will also enhance the quality of spending.

6. **This DPL series forms an integral part of the Indonesia Country Partnership Framework (CPF)** ***Collecting More and Spending Better***[5] **engagement, which aims to support the Government's fiscal reforms**. The proposed DPL series aims to address key policy and institutional bottlenecks in support of the Government's fiscal reforms to improve the quality of spending, strengthen revenue administration and enhance tax policy.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

7. **Indonesia's economic fundamentals have improved significantly, but continue to gradually adjust to lower global commodity prices.** Indonesia's real GDP growth was 5.0 percent yoy in Q2 2017, unchanged from Q1 as stronger investment was offset by contracting government consumption and slower net export growth. Growth rates have been hovering around 5 percent since Q1 2014, significantly lower than those recorded at the beginning of the decade, as the economy continues to adjust to lower global commodity prices. In Q2 2017, private consumption growth remained steady at 5.0 percent supported by a stable Rupiah and muted

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[2] Fenochietto, R. and Pessino, C., 2013, "Understanding Countries' Tax Effort", IMF Working Paper WP/13/244.

[3] Filing and payment rates estimated at 50-60 percent of registered taxpayers, accentuated by low rates of accurate reporting.

[4] VAT compliance rate estimated at 57% in 2013 (Sugana and Hidayat, 2014); Coal royalties compliance rate estimated at 57% in 2012 (World Bank, 2014).

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

inflation. Investment growth also strengthened at 5.4 percent on the back of lower borrowing costs and continued reforms to improve the business environment. Government consumption saw a notable contraction, partly reflecting base effects of a surge in Q2 last year. After surging in Q1, export and import growth both slowed significantly, in part reflecting weakening commodity prices in Q2, despite a more supportive global economy.

8. **Monetary policy continues to be accommodative and the financial sector remains stable.** Inflation in the first seven months of the year rose to 4.0 percent from the record low of 3.5 percent in 2016, driven by electricity tariff hikes in the first half of the year. Inflation is expected to average 4.0 percent this year, remaining within Bank Indonesia's inflation target band of 3 to 5 percent. Consistently, monetary policy has remained accommodative with the central bank keeping the policy rate on hold for the ninth consecutive month, after last year's series of six policy rate cuts that eased a total of 150 basis points. With inflation temporarily elevated, real interest rates have fallen further compared to H2 2016. The Jakarta Composite Index (JCI) has surged by more than 11 percent thus far this year, and sovereign bonds yields across all tenors have fallen. Non-performing loans (NPLs) are plateauing at around 3 percent and the capital adequacy ratio remains well above the Basel III threshold.

9. **After falling to a five-year low in 2016, the current account deficit remains narrow in Q2 2017.** Weakening commodity prices also led to the widening of the current account deficit to a still narrow 2.0 percent of GDP in Q2. Contributing to the larger deficit was a seasonal rise in the primary income deficit and a doubling of the services trade deficit as transport and travel imports jumped during Idul Fitri. The goods trade surplus also declined on lower non-oil and gas export earnings, with softer crude palm oil and rubber prices.

10. **Gross financing needs have declined.** Gross external financing needs have declined in recent years to 7.4 percent of GDP in 2016 down from 9.5 percent in 2014. Gross external short-term debt stood at US$42.1 billion in Q4 2016, down from 46.0 billion in Q4 2014.

Table 1: Key Macroeconomic Indicators

	2012	2013	2014	2015	2016	2017f	2018f	2019f
Real Economy	*Annual percentage change, unless otherwise indicated*							
Real GDP	6.0	5.6	5.0	4.9	5.0	5.1	5.3	5.3
Per Capita GDI (USD Atlas Method)	3,599	3,759	3,654	3,515	3,514	..	..	..
Contributions to GDP growth (ppt):								
Consumption	3.1	3.0	2.9	2.7	2.8	2.7	2.9	2.9
Investment	2.9	1.6	1.4	1.6	1.5	1.6	1.6	1.7
Net exports	-1.5	0.6	-0.2	1.0	0.1	0.4	0.3	0.3
Imports (real growth)	8.0	1.9	2.1	-6.4	-2.3	3.2	3.8	4.0
Exports (real growth)	1.6	4.2	1.1	-2.1	-1.7	5.0	4.8	4.8
Unemployment rate (ILO definition)	6.3	6.1	5.9	6.2	..	..	..	..
GDP deflator (avg.)	3.8	5.0	5.4	4.0	2.5	3.9	3.2	3.0
CPI (avg.)	4.3	6.4	6.4	6.4	3.5	4.0	3.5	3.5
Fiscal accounts	*Percentage of GDP*							
Expenditure	17.2	17.3	16.9	15.7	15.0	15.2	15.2	15.9
Revenue	15.4	15.1	14.7	13.1	12.5	12.5	13.1	13.9
General Government Balance	-1.8	-2.2	-2.2	-2.6	-2.5	-2.7	-2.2	-2.0
General Government Debt	23.0	24.9	24.7	27.4	27.9	29.2	29.0	29.1

Selected Monetary Accounts	*Annual percentage change*							
Base Money (M2)	15.0	12.8	11.9	9.0	10.0	..	..	..
Credit to non-government (eop)	22.4	22.1	14.2	..	..	..	..	..
Interest (key policy interest rate), eop[1]	5.8	7.5	7.8	7.1	4.8	..	..	..
Balance of Payments	*Percentage of GDP, unless otherwise indicated*							
Current Account Balance	-2.7	-3.2	-3.1	-2.0	-1.8	-1.7	-1.8	-1.9
Imports	23.2	23.2	22.7	19.3	17.1	17.2	17.2	17.0
Exports	23.0	22.5	22.3	19.9	18.0	18.2	18.0	17.7
Direct Investment (net, US$ billion)	13.7	12.2	14.7	10.7	16.0	19.2	32.7	42.3
Gross Reserves (US$ million, eop)	112.8	99.4	111.9	105.9	116.4	..	..	..
Months' import cover (goods)	7.6	6.8	8.0	7.7	8.8	..	..	..
As % of short-term external debt	206.4	176.6	188.8	185.5	178.8	..	..	..
External Debt	27.5	29.2	33.1	35.6	36.3	..	..	..
Term of Trade (index 2015=100)	152.5	129.7	109.5	100.0	112.0	..	..	..
Exchange Rate (average) IDR/US$	9,387	10,461	11,865	13389	13300	..	..	..
Memo items								
GDP nominal in (in billion US$)	918	913	891	861	933	1,016	1,089	1173

Source: BPS; Ministry of Finance; BI; World Bank staff projections for 2017-2019

Note: Using revised and 2010-rebased GDP. * Fiscal accounts for 2015-2018 are World Bank staff projections. [1]Bank Indonesia strengthened monetary operations by introducing a new policy rate known as the BI 7-Day (Reverse) Repo Rate, effective from 19th August 2016.

11. **Fiscal management has been generally prudent and the quality of spending is gradually improving.** The fiscal stance remains mildly expansionary, with an overall fiscal deficit of 2.6 and 2.5 percent of GDP in 2015 and 2016 respectively (primary deficit of 1 percent). Given the fiscal rule to keep the deficit below a cap of 3 percent of GDP[6], and given constraints to rapidly increasing revenue, increasing the overall *level* of public expenditure is not possible, at least in the medium-term. As such, the Government must improve the *quality* of its public expenditure if it is to achieve its development goals. Some progress in the quality of public spending is being made. The 2017 Budget sustained a higher allocation for priority spending on infrastructure, health, and social assistance, and a further reduction in energy subsidy spending. In addition, beginning 2017, sub-national Governments are required to allocate a minimum 25 percent of general transfers (general block grant and revenue sharing) for infrastructure. However, increasing spending in priority sectors will not contribute to development goals if the delivery of the spending is ineffective. Continuous improvements in budget planning and execution at central and sub-national levels are needed to ensure that increases in budget allocations for key sectors translate into improved outcomes.

12. **Weak revenue performance remains a major fiscal challenge, particularly in relation to commodity-related revenues.** In 2016, the tax-to-GDP ratio fell to 10.4 percent, from over 12

[6] The general government deficit is capped by law at 3 percent of GDP. 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.

percent before the global financial crisis. Underpinning this was the decline in natural resource related revenues, with income tax from oil and gas falling to 0.3 percent of GDP, and non-tax revenues from oil and gas falling to 0.4 percent. Prior to the oil price collapse in 2014, tax revenues collected from these sectors were over 0.8 percent of tax to GDP, and non-tax revenues contributed over 2.1 percent. Tax collection levels remains sensitive to the activity of large individual extractives companies and their business plans and asset structures.

13. **The fiscal deficit widened in 2016 as revenues fell short of target**. In response, the minister of finance revised the 2016 Budget in-year, to cut government expenditure and lower revenue targets, enhancing fiscal credibility. In addition, the 9-month tax amnesty launched in July 2016 provided some immediate respite, with redemption fees totaling IDR 135 trillion, equivalent to 10.5 percent of the Government's 2016 total tax revenues. However, collection from traditional tax sources declined between 2015 and 2016 as the tax amnesty absorbed scarce tax administration capacity.

14. **S&P upgraded Indonesia's bonds to investment grade (BBB-) on May 19, 2017**. For the first time since the Asian Financial Crisis, all three major credit rating agencies have given Indonesia's bonds an investment grade rating. The Jakarta Composite Index (JCI) jumped almost 3 percent following the announcement. The Rupiah also strengthened slightly against the U.S. dollar.

Table 2: Key Fiscal Indicators

Percentage of GDP	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	
						GoI Approved Budget	**WB Outlook**
Overall balance	-1.8	-2.2	-2.2	-2.6	-2.5	-2.4	-2.7
Primary balance	-0.6	-1.0	-0.9	-1.2	-1.0	-0.8	-1.19
Total Revenues (and grants)	15.4	15.1	14.7	13.1	12.5	12.8	12.5
Tax Revenues	11.4	11.3	10.9	10.8	10.4	10.9	10.6
Domestic tax	10.8	10.8	10.5	10.5	10.1	10.7	10.3
Income tax	5.4	5.3	5.2	5.2	5.4	5.7	5.5
Oil and gas	1.0	0.9	0.8	0.4	0.3	0.3	0.3
Non-oil and gas	4.4	4.4	4.4	4.8	5.1	5.5	5.2
Value added taxes	3.9	4.0	3.9	3.7	3.3	3.6	3.4
LGST	0.2	0.2	0.1	n.a	n.a	n.a.	n.a.
Excises	1.1	1.1	1.1	1.3	1.2	1.2	1.2
International trade tax	0.6	0.5	0.4	0.3	0.3	0.3	0.3
Non-tax revenues	4.0	3.7	3.8	2.2	2.1	1.8	1.8
Grants	0.0	0.1	0.0	0.1	0.0	0.0	0.0
Expenditures	17.2	17.3	16.9	15.7	15.0	15.2	15.2
Central govt. expenditure	11.6	11.9	11.4	10.3	9.3	9.6	9.6
Wages and compensation	2.3	2.3	2.3	2.4	2.5	2.5	2.4
Goods and services	1.6	1.8	1.7	2.0	2.1	2.0	2.2
Capital expenditures	1.6	1.9	1.4	1.9	1.3	1.6	1.5

Interest payments	1.2	1.2	1.3	1.3	1.3	1.6	1.6
Subsidies, of which:	4.0	3.7	3.7	1.6	1.4	1.2	1.2
Energy	3.6	3.3	3.2	1.0	0.9	0.6	0.7
Fuels	2.5	2.2	2.3	0.5	0.4	0.2	0.2
Electricity	1.1	1.0	1.0	0.5	0.5	0.3	0.5
Social expenditures	0.9	1.0	0.9	0.8	0.4	0.4	0.4
Other expenditures	0.0	0.0	0.1	0.1	0.1	0.3	0.3
Transfers to regions	5.6	5.4	5.4	5.4	5.7	5.6	5.6
Selected priority sectors*							
Infrastructure	1.5	1.4	1.2	2.3	2.3*	2.8**	
Health	0.5	0.5	0.6	0.6	0.7*	0.7	
Social assistance	0.3	0.3	0.3	0.5	0.4*	0.4	
Net Financing	2.0	2.5	2.5	2.8	2.7	2.4	
Domestic (net)	2.3	2.6	2.6	2.7	2.8	2.6	
of which bonds (net)	1.9	2.4	2.6	3.1	3.3	2.9	
Foreign (net)	-0.3	-0.1	-0.1	0.1	-0.1	-0.2	
Disbursement	0.4	0.6	0.5	0.7	0.5	0.4	
Amortization	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	

Notes: Using revised and 2010-rebased GDP; *2016 revised budget figures. **2017 infrastructure spending takes into account central government earmark of 25% of DBH and DAU for economic infrastructure development at sub-national government. Infrastructure and health spending refers to the definition outlined in the draft 2016 Budget Financial Note. Infrastructure spending 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; as well as 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. Social assistance follows the World Bank definition and excludes the health insurance subsidy for the poor, which is included in health spending, and the temporary compensation for fuel price increases. *Source:* Ministry of Finance as published by the Ministry of Finance.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **The macroeconomic outlook is positive with a supportive global economy and improved domestic fundamentals.** The global economy is becoming more supportive with faster economic growth, a rebound in international trade, and relatively accommodative financial conditions. These, coupled with improved domestic fundamentals, supports a positive outlook for the Indonesian economy. In the baseline forecast, real GDP growth is projected to increase from 5.0 percent in 2016 to 5.1 percent this year, and further strengthen to 5.3 percent in 2018. However, the outlook bears significant downside risks. The global recovery remains fragile with continued global policy uncertainty and the threat of increased trade protectionism. At the same time, the Indonesian economy is partially riding on the tailwinds of recovering commodity prices. These tailwinds are expected to ease in 2018 with lower coal prices and higher oil prices, and is likely to weigh on GDP growth.

16. **Most components of aggregate demand are expected to be robust.** Private consumption is forecast to advance on continued moderate inflation, a stable Rupiah, stronger consumer confidence and lower consumer lending rates. The double-digit increase in real wages observed in 2016 is also expected to have carry over effects for consumption growth in 2017. Further, exports growth is expected to stay robust this year and in 2018, lifted by stronger

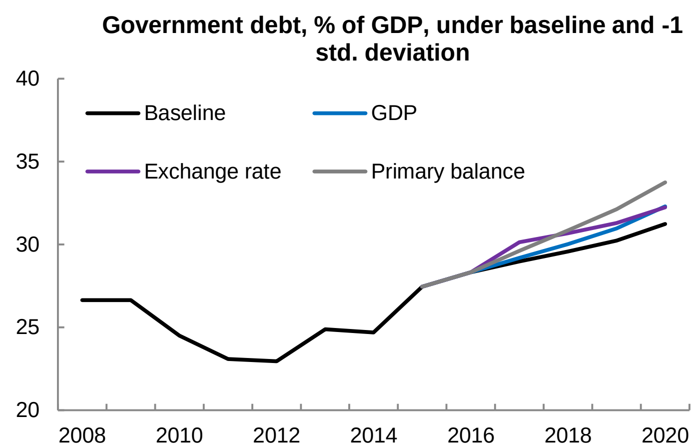
external demand in line with faster global economic growth and the rebound in global trade. Finally, lower commercial lending rates will be supporting investment.

17. **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, the fiscal framework underpinning this operation assumes the government will use space within the fiscal rule i.e. total government expenditure is equal to total revenue plus 2.8 percent of GDP. Reforms captured in the Fiscal DPL series have the potential to increase the tax-to-GDP ratio by up to 2.6 percent by 2020 in relation to the no tax reform scenario. This means total expenditure as share of GDP can rise to 16.0 percent of GDP by 2019 and 2020 – creating an additional 1.2 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, on infrastructure.

18. **Government debt sustainability is strong.** Following a decade-long steep and sustained decline on the back of small fiscal deficits (strictly adhering to the 3 percent fiscal deficit to GDP limit) and solid GDP growth, government debt-to-GDP reached 24.6 percent in 2014. The debt-to-GDP ratio remains moderate under a range of economic scenarios. Under the baseline, assuming fiscal deficit as a share of GDP is 2.5 in 2016, 2.7 percent in 2017, 2.2 percent in 2018 and 2.0 percent in 2019, the debt-to-GDP is projected to rise only slightly from the 2015 level of 27.4 percent to approximately 29.1 percent through 2019. In scenarios with one-time, permanent one standard deviation shocks to either real GDP growth or the exchange rate in 2016, government debt remains below 32 percent of GDP in the medium term. Only when a similar shock (equivalent to 0.6 percentage points of GDP) is applied to the primary balance does the debt-to-GDP ratio go above 32 percent in 2019-20. In addition to a moderate debt level, the risk profile of the government debt stock is strong, although non-resident holdings of domestic bonds are relatively high at 39 percent. The average time to maturity is relatively long, at 8.9. years. Less than 11 percent of the debt is variable rate. Currency exposure is significant, with 42 percent of total debt

Figure 1: 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 denominated in foreign currency.[7] 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.

19. **Government remains committed to structural reforms required to enhance potential growth and become less commodity reliant.** These include ongoing reforms to lift tax revenues and to improve the business environment to enhance attractiveness to investors and further reduce reliance on commodity exports. In particular, the government has rolled out 16 reform packages to improve the regulatory environment since September 2015. The measures announced to date have, for example, led to a simplification of approvals and procurement procedures for large-scale infrastructure projects and faster approval of business licenses. These reforms have partially contributed to Indonesia's improvement in the 2017 Doing Business rankings. Other important reforms, such as the reduction of Indonesia's negative investment list (DNI) has led to fewer restrictions to foreign direct investment, which has been associated with higher FDI inflows over time.

20. **Increased international trade protectionism and unexpected changes in U.S. monetary policy and possible financial volatility tilt the risks to Indonesia's economic growth outlook to the downside**. While somewhat diminished in recent months, global policy uncertainty, including the threat of increased international trade protectionism, continues to pose substantial downside risks to the nascent recovery in global trade and global economic growth. Meanwhile, as the U.S. Federal Reserve proceeds with its monetary tightening cycle, unexpected hikes in the U.S. federal funds policy rate could spark volatility in global financial and capital markets, leading to capital outflows from emerging market economies, including Indonesia. Such outflows could cause a rapid tightening of domestic financial conditions and induce volatility in the Rupiah, which would weigh on both domestic private consumption and investment.

21. **Domestic risks include adverse political economy effects.** Regional elections will be held in 2018 and legislative and presidential elections will be held in 2019. As the 2019 general election draws closer, the government will face difficult and occasionally unpopular fiscal structural policy choices that may affect Indonesia's ability to achieve higher rates of economic growth. Increased political uncertainty may also discourage investment, in particular foreign investment.

22. **The macroeconomic policy framework is considered adequate for the proposed operation.** Strong economic management has helped improve Indonesia's economic fundamentals with stable and strong real GDP growth, low inflation, a conservative current account deficit and fiscal deficit, plus enhanced fiscal credibility, recently recognized in the S&P rating upgrade. The policy mix has been consistent with macroeconomic stability and the management of risk that may arise. Monetary policy continues to be credible and responsive to inflation and external risk pressures. Similarly, the Rupiah has been remarkably stable despite recent appreciation pressures thereby decreasing exchange rate uncertainty in the immediate and medium-term. In terms of fiscal policy, the fiscal rule, the low level of debt and ongoing fiscal reforms supported by this DPL will contribute to maintaining a conducive and stable fiscal

[7] All debt profile figures are as of April 2017 (Source: Ministry of Finance).

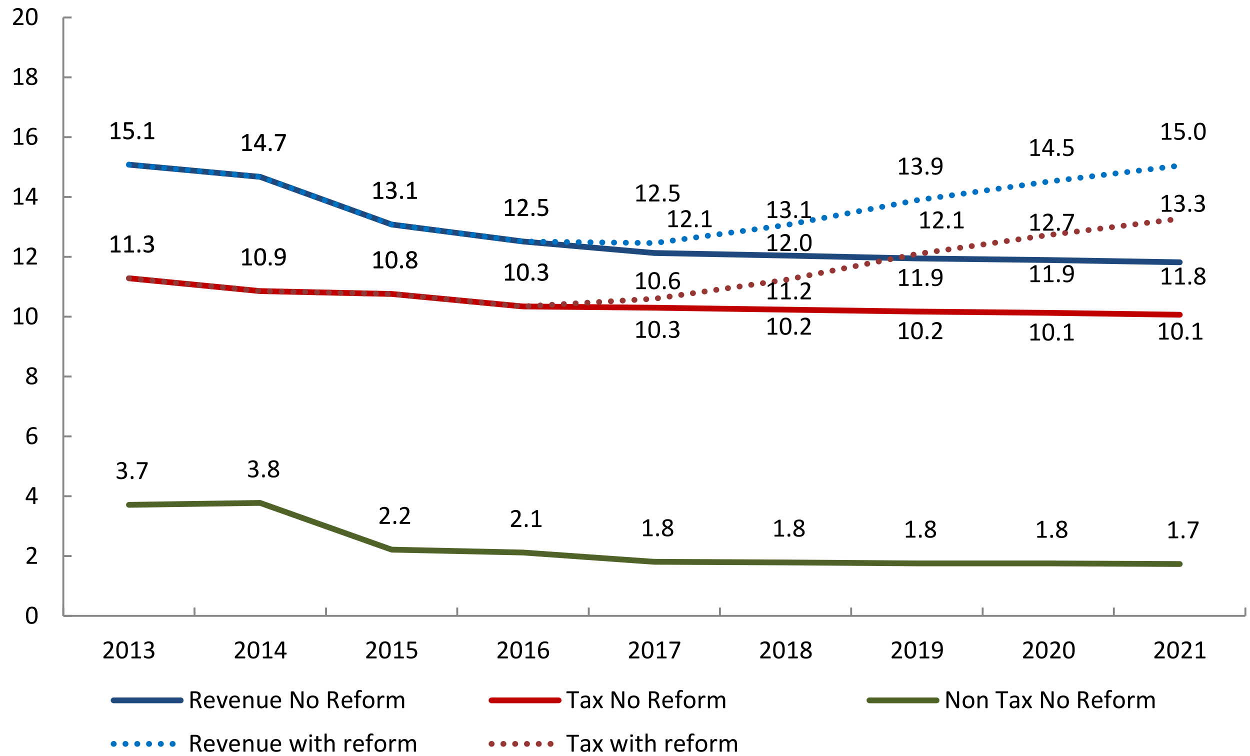
framework. Lastly, the structural reform agenda, if continued, will be able to support inclusive growth.

Table 3: Key Fiscal Indicators with 2017-20 WB Baseline and 'No reform' Projections

Percentage of GDP	2012	2013	2014	2015	2016	2017f		2018f	2019f	2020f
	Actual					GoI	WB "no revenue reform" projection			
Overall balance	**-1.8**	**-2.2**	**-2.2**	**-2.5**	**-2.6**	**-2.7**	**-2.7**	**-2.2**	**-2.0**	**-1.6**
Revenues and Grants	**15.4**	**15.1**	**14.7**	**13.1**	**14.3**	**12.8**	**12.5**	**13.1**	**13.9**	**14.5**
							12.1	***12.0***	***11.9***	***11.9***
Tax Revenues	**11.4**	**11.3**	**10.9**	**10.8**	**12.2**	**10.9**	**10.6**	**11.2**	**12.1**	**12.7**
							10.3	***10.2***	***10.2***	***10.1***
Income tax	**5.4**	**5.3**	**5.2**	**5.2**	**6.0**	**5.7**	**5.5**	**6.0**	**6.3**	**6.8**
							5.3	***5.4***	***5.4***	***5.4***
Non-oil and gas	4.4	4.4	4.4	4.8	5.6	5.5	5.2	5.7	6.1	6.6
							5.1	***5.1***	***5.1***	***5.2***
VAT (inc. LSGT)	**3.9**	**4.0**	**3.9**	**3.7**	**4.5**	**3.6**	**3.4**	**3.3**	**3.6**	**3.8**
							3.3	***3.2***	***3.1***	***3.1***
Excises	**1.1**	**1.1**	**1.1**	**1.3**	**1.2**	**1.1**	**1.2**	**1.5**	**1.7**	**1.6**
							1.2	***1.2***	***1.2***	***1.2***
Non-Tax Revenues	**4.0**	**3.7**	**3.8**	**2.2**	**2.1**		**1.8**	**1.8**	**1.8**	**1.8**
Oil, gas & mining	2.6	2.4	2.3	0.9	0.5		0.6	0.6	0.6	0.6
Expenditures: 1+2+3	**17.2**	**17.3**	**16.9**	**15.6**	**16.5**	**15.2**	**15.2**	**15.9**	**16.7**	**17.3**
							15.0.	***14.9***	***14.8***	***14.8***
1. Central govt. spending	**11.6**	**11.9**	**11.4**	**10.2**	**10.4**	**9.6**	**9.6**	**9.7**	**10.2**	**10.1**
							9.5	***9.9***	***9.9***	***9.9***
Personnel	2.3	2.3	2.3	2.4	2.5	2.5	2.4	2.5	2.5	2.5
							2.5	*2.5*	*2.5*	*2.5*
Goods and services	1.6	1.8	1.7	2.0	2.1	2.0	2.2	1.9	1.9	1.9
							2.1	*2.1*	*2.1*	*2.1*
Capital*	**1.6**	**1.9**	**1.4**	**1.9**	**1.3**	**1.6**	**1.5**	**1.5**	**1.9**	**1.9**
Subsidies, of which:	4.0	3.7	3.7	1.6	1.4	1.2	1.2	1.2	1.3	1.2
Energy	3.6	3.2	3.2	3.2	1.0	0.6	0.7	0.7	0.7	0.7
Non energy	0.5	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.6	0.5
Social expenditures	0.9	1.0	0.9	0.8	0.4	0.4	0.4	0.7	0.7	0.6
2. Transfers to regions	**5.6**	**5.4**	**5.4**	**5.4**	**6.1**	**5.6**	**5.6**	**5.6**	**5.7**	**6.0**
3. *Additional Spending (likely to increase capital expenditures)							***0.0***	***0.6***	***1.4***	***1.7***
							0.0	***0.0***	***0.0***	***0.0***

Source: 2012-2016 Actual and 2017 State Budget from Ministry of Finance, 2017-2020 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, but includes the impact of reforms captured in the first DPL operation (2015-2016). (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.

Figure 2: Reforms have the potential to increase tax-to-GDP ratio by 2.6 percent by 2020 in relation to the no tax reform scenario



Source: Ministry of Finance; World Bank analysis and projections

3. THE GOVERNMENT'S PROGRAM

23. **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 funding, making it critical to improve domestic revenue mobilization and create fiscal space. The Government also seeks to continuously improve the quality of spending, particularly in capital and non-priority spending, and more effective social protection programs. Finally, the government sets out to maintain financing sustainability which can in part be accomplished by developing more creative infrastructure financing schemes.

24. **To this end, the national budget is used as a key vehicle for expenditure reforms.** For instance, the 2017 Budget contains many improvements in the quality of public expenditure. The 2017 Budget sustains higher allocation for infrastructure, health, and social assistance relative to the pre-2015 levels, i.e. before fuel subsidy reforms. The allocation for energy subsidies in 2017 —covering fuel and electricity— fell to 0.6 percent of GDP from 0.8 percent in the revised 2016 Budget (continuing significant energy subsidy reform of previous years), reflecting continued reduction in the per liter subsidy for diesel and a reduction in the electricity subsidy for non-poor households (for 900 voltage customers). However, further decreases in energy subsides are required including below the line implicit subsidies through SOEs, as well as targeting improvements and reductions in non-energy subsidies, especially the fertilizer subsidy, Rastra[8], and the credit interest program subsidy. Supported in part by energy subsidy efficiencies, the 2017 allocation for infrastructure[9] increased to 2.8 percent of GDP from 2.6 percent in the revised 2016 Budget, although the allocations for health and social assistance remained fairly constant at 1.4 and 0.6 per cent of GDP, respectively. The 2017 Budget also contains targeting improvements to social assistance programs. The Government is starting a trial of an improved distribution framework in 2017 for the Raskin (subsidized rice for the poor) program through *E-Warung*.[10] The government is also expanding the coverage of the subsidized health insurance premium (PBI) from 92.4 million people to 94.4 million people. To close the gap of more than a decade of underspending and to address emerging development needs on infrastructure, health and social assistance sectors, it is critical for Indonesia to sustain this reform momentum and strengthen the implementation of reforms. The government's draft 2018 Budget indicates further improvements to spending quality. In particular, it highlights ongoing measures to further accelerate poverty and inequality reduction. In addition, the Government's 2018 Macroeconomic and Fiscal Policy Framework emphasizes a continued commitment to gender equality. The Government plans to pilot a program that targets an increase in female labor force participation through public provision of childcare facilities.

25. **Reform efforts on the revenue side include a one-off tax amnesty and the creation of a Reform Team (*Tim Reformasi*)**. The three-phase, nine-month Tax Amnesty[11] began in July

[8] Government subsidies rice program for the poor.

[9] This follows the Ministry of Finance definition which includes selected central line ministry spending, estimates of transfers to sub-national governments for infrastructure, and financing investment (e.g., capital injection to SOEs).

[10] Under the trial, rice purchases will occur through E-Warung—a single source from which holders of the family welfare card (Kartu Keluarga Sejahtera, KKS) can purchase rice and other subsidized goods. E-Warung allows for multiple transfers and subsidies to be integrated under one card and disbursed in one location. This is expected to reduce the leakage of such subsides and transfers to non-targeted households. The trial includes 1.2 million of the 14.3 million program beneficiary households.

[11] The program offered reduced tax liabilities for declarations made of previously undeclared assets, with lower tax rates for onshore and repatriated offshore assets, compared to non-repatriated offshore assets.

2016 and concluded on 31 March 2017 benefiting more than 973,000 participants. The Amnesty was successful in mobilizing IDR135 trillion in redemption fees, equivalent to 10.5 percent of the Government's 2016 total tax revenues. It also encouraged Indonesians to declare assets to the tune of IDR 4,882 trillion, or 122.1 percent of the Government's target. The Government was less successful in encouraging repatriation of offshore assets, with only 12.4 percent of declared offshore assets repatriated, equivalent to 14.7 percent of the Government's original IDR 1000 trillion target. The longer-term impact of the tax amnesty will depend on the ability of the tax authorities to use the newly acquired tax payer data and demonstrate credible commitment to fully enforcing the tax code.

26. **The Tim Reformasi was established in December 2016 to prepare and oversee a comprehensive tax administration and policy reform program with the ambitious goal of increasing Indonesia's tax-to-GDP ratio to 15 percent by 2020 from 10.4 percent in 2016**. The reform program under preparation is centered around five pillars: (1) organization; (2) human resources; (3) information technology; (4) business processes; and (5) legislation. The first four pillars seek to address long-standing weaknesses in tax administration through a series of transformative initiatives, including, most significantly, implementing a Customized-off-the-shelf (COTS) IT system for the Directorate General of Tax (DGT). The fifth pillar seeks to continue the momentum of tax policy reforms that Indonesia has undertaken over the past few years to further strengthen its tax regulatory environment. Overall, Tim Reformasi's program is distinguished by the noteworthy coordination efforts and political support that have been devoted by the Jokowi administration in order to enable its successful implementation.[12] The Parliament is also debating a revision to the general tax administration law including consideration of the degree of autonomy of the institution responsible for tax administration (currently DGT). In August 2017, a joint Government and IMF mission with World Bank participation began updating earlier tax system analysis and will support the prioritization of reforms, which may be reflected in the third Fiscal Reform DPL being proposed with this operation.

27. **In addition to Tim Reformasi's transformative agenda, the government is continuing to implement incremental improvements to its administrative tax system**. These include: enforcement of the universal use of the VAT e-invoice system; increasing electronic filing of income taxes; and allowing the tax authorities automatic access to tax payers' banking data for auditing. Such reforms not only bring short-term revenue gains, but also serve as a good way to transition DGT to the enhanced business processes that will come as part of adopting a COTS IT system. A continuing challenge for DGT is the lack of a systematic compliance risk management (CRM) strategy. While adopting the COTS IT system will go a significant way to enabling CRM, DGT requires more comprehensive changes including in organization and human resource management (for example, its performance evaluation and incentives system). To that end, reforms in the first two pillars of Tim Reformasi's program will need to be implemented in parallel for the full benefits of the COTS IT system to be realized.

[12] *Tim Reformasi* was launched with the backing of a Ministerial-level decree, has made its high-level vision and objectives public, and as part of its structure has included a team of advisers drawn from academia, legal experts, and tax professionals, and an additional team of international observers, including representatives from the World Bank. In contrast, previous reform programs including the *Institutional Transformation Blueprint* that DGT adopted in early 2014 were kept internal, appeared to lack sufficient political support, and had difficulties prioritizing reforms and coordinating relevant implementing agencies.

28. **In parallel, the government is also seeking to accelerate tax policy reforms after incurring some legislative delays in 2016**.[13] Policy reform priorities for 2017 include revision of the government regulation for micro, small and medium enterprises as well as continuing to implement a set of regulations on international tax that makes Indonesia one of the leading reformers amongst developing economies in this area. 2018 priorities include finalizing and submitting for parliamentary approval the revised VAT and income tax laws, as well as carrying out reforms of excise taxes, including on vehicles and possibly tobacco. Overall, these reforms aim to increase the underlying tax potential by broadening the tax base, and to ease administrative complexity and reduce economic distortions by simplifying tax structures. Moreover, the government is placing more emphasis on using tax policy as an instrument to address inequality and to boost private investment.

4. PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

29. **The ongoing Fiscal DPL series supports the Government's overall objective to collect more fiscal revenue 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, focusing on those that are expected to contribute significantly to the overall fiscal reform objectives through the medium-term.

30. **The ongoing 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 planning; (iii) conducting early procurement; (iv) improving the effectiveness of subnational spending; and (v) improving the effectiveness of intergovernmental transfers.
- **Pillar B: Strengthening Revenue Administration.** *PDO: Increasing tax administration efficiency and compliance and audit capability* by (i) strengthening VAT administration; (ii) increasing electronic tax filing; (iii) improving DGT access to taxpayer asset and banking data for audits; (iv) strengthening the risk-based approach to compliance management.
- **Pillar C: Enhancing Tax Policy.** *PDO: Increasing revenue potential and economic efficiency of tax policy* by (i) revising main tax instruments (VAT and luxury goods; Income Tax; Final tax for micro and SMEs; Excise); and (ii) taking regulatory measures against base erosion.

31. **The second operation in the DPL series builds on achievements of the first operation; a third operation is proposed as a new addition to continue supporting the government's reform momentum before the 2019 electoral cycle makes unpopular reforms more difficult to implement.** The progression of prior actions and triggers over the current fiscal DPL series is

[13] There were a few measures undertaken in 2016 to raise taxes, most notably Indonesia's adoption of the OECD-led Base Erosion and Profit Shifting (BEPS) project in July, 2016. Significantly, however, the proposed Income Tax and VAT bills were not tabled for parliamentary approval, in part because the Ministry of Finance is looking to strengthen them through additional revisions.

described in a table in Annex 5. There is continuity in the policy matrix across operations. In the case of Pillar A (Improving the Quality of Spending), each operation seeks to lock in and discourage reversal on government commitments to quality of spending, including through spending reallocations and limiting rushed election related procurement. The introduction of a prior action on the MTEF in the second operation capitalizes on a significant reform to incentivize greater collaboration between the ministries of finance and planning. In the case of the Pillar C the acceleration of the international tax reform agenda has re-invigorated efforts in otherwise lagging areas, notably VAT and broader income tax reform. Extensive World Bank analytical work and technical assistance has provided core support to the government in implementing the triggers for the second operation and designing the triggers for a potential third operation. Examples include support to micro-simulation of tax policy reform impacts, achieving minimum standards for BEPS and strengthening the tax administration IT.

32. **The government of France, represented through Agence Française de Développement (AFD) is also providing policy loans in support of the government's program, under this DPL series.** AFD signed a EURO100 million credit facility agreement with the Ministry of Finance in November 2016 following World Bank Board approval of the first operation in May 2016. Strong collaboration in preparation of the remaining loans in the series continues.

33. **The policy matrix (Annex 1) has been developed through extensive dialogue and collaboration 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 the Bank and development partners engaged on fiscal issues, in particular: Australia (AIPEG and GPF), France (AFD) and the IMF. Additional technical assistance has been initiated to support the government to design and implement reforms that may also become triggers for the proposed third operation, including on tax expenditures and non-tax revenue administration.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

34. **All eleven prior actions for the second operation have been completed.** They are summarized in Table 4 below with the analytical underpinnings. The full policy matrix is in Annex 1. As noted in this Program Document, due to Indonesia's long-standing structural challenges, there are many unfinished reforms. The proposed addition of a third Operation in this DPL series will support some of these ongoing reforms. In many of the reform areas, the prior action is followed by an indicative trigger to expand and/or sustain the reform in the proposed third operation. It is anticipated that the DPL3 indicative triggers to be completed by end of June 2018 and the result indicators reflect the expected timing of the three operations.

Table 4: Prior actions, current status and analytical underpinnings

Government reform area	Proposed prior actions	Current status	Analytical underpinnings
Pillar A— Improving Quality of Spending ***PDO A: Improving composition of spending, budget execution rates and efficiency of spending***			

Improving central government budget allocation	The Borrower has maintained the increased 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 2017 Budget Law and the Presidential Regulation 97/2016	Completed	• WB PER Update Phase I (completed October 2016) and Phase II (completed June 2017), includes an updated analysis on medium term fiscal framework, and aggregate expenditure analysis, and sectoral PERs (health, education, sub-national spending, national road, water resources, housing, credit programs for MSMEs) • WB (2016) Health Financing Study • WB (2017) Social Assistance PER Update (forth coming)
Strengthening budget planning	The Borrower has strengthened the preparation of the Medium Term Expenditure Framework ("MTEF") by: (a) using a top-down approach to better align line ministries' medium term spending with the resource envelope; (b) (i) simplifying types of expenditures in the MTEF to operating and non-operating expenditures at program and/or activity level and (ii) imposing restrictions on revisions; and (c) introducing the requirement that line ministries explain the deviations between a new budget and the earlier planned budget based on policy changes, all as evidenced through the Minister of Finance Regulation 163/2016	Completed	• PEFA 2017 (underway) • AIPEG budget management TA
Use of early procurement	The Borrower has continued to enable the increased usage of early procurement, for capital expenditure packages listed in the 2017 Budget Law, as evidenced through the Secretary General of the Ministry of Public Works and Housing's Circular Letter No. PL-0206/Sj/606 dated August 18, 2016	Completed	
Improving the effectiveness of subnational spending	The Borrower has strengthened subnational fiscal management by: (a) improving the composition of subnational spending by requiring sub-national governments to allocate a minimum 25 percent of DAU and revenue sharing for infrastructure; (b) disbursing DAK based on reports on achievements; and (c) improving DID	Completed	• WB PER Update Phase I (completed October 2016) and Phase II (completed June 2017) • Advisory and Analytical inputs into Law 33 revision

	allocation criteria, as evidenced through the 2017 Budget Law and the Minister of Finance Regulation 112/2017.		
Improving the effectiveness of intergovernmental transfers	The Borrower has issued consolidated DAK technical guidelines that were previously issued by separate line ministries to accelerate DAK implementation, as evidenced through Presidential Regulation 123/2016.	Completed	• WB PER Update Phase I (completed October 2016) and Phase II (completed June 2017) • Advisory and Analytical inputs into Law 33 revision
Pillar B---Strengthening Revenue Administration ***PDO B: Increasing tax administration efficiency and compliance and audit capability***			
Strengthening VAT administration	The DGT has strengthened VAT administration by: (a) requiring all corporate taxpayers to use the electronic invoice and electronic VAT returns; and (b) implementing a system that makes electronic VAT returns data available, within 72 hours after filing, for auditing and analysis of compliance risk, as evidenced through DGT Announcement No. Peng-04/PJ.09/2016 dated April 27, 2016.	Completed	• WB PFM-MDTF Tax administration support pillar.
Increasing electronic filing of income taxes	The DGT has required the electronic filing of: (a) corporate income tax returns by companies that are VAT taxpayers; and (b) withholding tax returns by select withholding agents, as evidenced through DGT Regulations 3/2015 and 4/2017.	Completed	
Improving DGT access to taxpayer asset and banking data for audits	The Borrower has enabled the DGT increased access to financial data for audit purposes by requiring financial institutions to submit a report on financial data to DGT beginning with each individuals' account(s) with a balance of IDR 1 billion or more, as evidenced through the Law 9/2017 and the Minister of Finance Regulation 73/2017.	Completed	
Pillar C---Enhancing Tax Policy ***PDO C: Increasing revenue potential and economic efficiency of tax policy***			
Reduce tax avoidance and evasion related to treaty abuse, tax competition and disclosure of information	The Ministry of Finance has prevented tax base erosion and profit shifting by: (a) introducing a limitation of benefits clause to deter companies from using treaties for non-economic/business reasons; (b) signing the CBC MCAA, which obliges the Borrower to share tax information aimed at combating harmful tax practices by carrying out country-by-country reporting exchange; and (c) adopting a standardized set of	Completed	• WB International Tax TA program provided to the Fiscal Policy Agency (BKF)/the Directorate General of Taxes (DGT) joint working group.

	documentation requirements for international taxation, all as evidenced through the Minister of Finance Regulation 213/2016, the CBC MCAA list of signatories and the DGT Regulation 10/2017.		
Reduce disputes with MNEs by enhancing dispute resolution mechanisms	The Ministry of Finance has: (a) enabled the implementation of APA and MAP dispute resolution mechanisms; and (b) created a sub-directorate dedicated to enable the Borrower to manage international tax disputes, as evidenced through the Minister of Finance Regulation 234/2015 and DGT Decree 36/2017.	Completed	• WB International Tax TA program provided to BKF/DGT joint working group.
Reform CFC Rules to enable taxation of passive income	The Borrower has allowed the DGT to access information on – and tax - passive income held by Indonesian companies and citizens abroad, as evidenced through the Minister of Finance Regulation 107/2017.	Completed	• WB International Tax TA program provided to BKF/DGT joint working group.

PILLAR A— IMPROVING QUALITY OF SPENDING

Improving central government budget allocation

35. **Rationale:** Indonesia has recently increased public spending on priority sectors, namely infrastructure, health and social assistance sectors following a bold fuel subsidy reform in 2015. While this is a positive development, the level of spending remains low relative to Government's ambitious development targets due to more than a decade of persistent underspending. Total government (central and subnational) infrastructure spending increased to 1.9 percent of GDP in 2016 from 1.4 percent of GDP in 2014 but this remained below the estimated needs and pre-1997 (Asian Financial Crisis) levels. Total government expenditure on health has increased to 1.4 percent of GDP in 2016 from only 1.1 percent of GDP in 2014 which was the fifth-lowest health spending-to-GDP ratio out of 188 countries[14]. Spending on social assistance programs, which is the most pro-poor and inequality-reducing type of spending[15], increased slightly to 0.7 percent of GDP in 2016 after persistently low levels (0.55[16] percent of GDP in 2014 compared to 1-2 percent of GDP among Indonesia's peers). This has meant that before 2015, social assistance programs could only provide partial and non-guaranteed protection to the vulnerable and poor from shocks and risks faced. Sustaining higher public spending on these priority sectors remains critical to support

[14] World Bank. (2016), "Health Financing System Assessment: Spend More, Spend Right, and Spend Better". 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. Total health public spending of 1.1 percent of GDP in 2014 was the fifth-lowest health spending-to-GDP ratio out of 188 countries. Despite significant progress in infant and child mortality, 37 percent of children below 5 years of age are stunted and Indonesia has one of the highest maternal mortality rates in the Asia region (190 per 100,000 live births in 2013).

[15] World Bank. (2015). "Inequality in Indonesia: Why it is rising, why it matters, and what can be done".

[16] 0.3 percent excluding health insurance for the poor and temporary compensation for fuel price rises.

growth, reduce poverty and share prosperity in the medium term and remains a policy action through the three proposed DPL operations in this series.

36. **Prior action #1:** As in 2016, the government has maintained the increased 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 2017 Budget Law and the Presidential Regulation 97/2016. The budget allocation for infrastructure[17] increased to 18.6 percent of total budget or 2.8 percent of GDP and maintained the level of allocation for health (5 percent of total budget or 0.8 percent of GDP), and social assistance (4 percent or 0.6 percent of GDP).
37. **Indicative trigger #1:** Considering Indonesia's underinvestment in the past and the significant needs in these priority sectors, sustaining these improvements first captured in Prior action #1 through the composition of the 2018 Budget and in the following years' annual budgets, would be critical to deliver the Government's national medium term development plan targets (RPJMN) 2015-2019 [18]. In particular as pressures may mount for fiscal consolidation or election related recurrent spending.
38. **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 shares of the 2016 budgeted central government spending for social assistance, health and infrastructure[19] are 3.6 percent, 7.2 percent and 19.3 percent respectively[20]. The allocation for these sectors in the 2017 Budget is 3.9 percent, 7.1 percent, and 16.3 percent, respectively – in both years above the pre-fuel subsidy baseline. The share of infrastructure in the approved budget fell in 2016 due to a large budget that was since revised down. The shares of budget allocations to priority sectors are generally maintained in *actual* spending, the results indicators are expected to remain satisfied, as we expect the shares of central government *budgeted* spending on infrastructure, social assistance and health sectors in the years 2017 and 2018 to be higher compared to the 2012-2014 baseline years (see Table 2).

Strengthening budget management

39. **Rationale:** Indonesia launched the Medium-Term Expenditure Framework (MTEF) in 2012 as part of broader public financial reform mandated by the State Finance Law (UU 17/2003). However, implementation challenges include poor quality of forward estimates submitted by line ministries and a weak link between forward estimates and policies and the resource envelope. Improved implementation of the MTEF will help align expenditure with strategic plans and the resource envelope. Specifically, the MTEF ceilings help line ministries set 3-year

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[17] This follows MoF definition which includes selected central line ministry spending, estimate of transfers to Subnational Government (SNG) for infrastructure, and financing investment (e.g., capital injection to SOEs).

[18] 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.

[19] Spending for social assistance and health sectors is defined as the spending of which the Central Government has control over allocation, thus it has been adjusted from the Government definition of social assistance and health spending in 2017 and 2016 Budget. In addition, spending for infrastructure in this term covers only spending for economic infrastructure.

[20] 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.

forward estimates for overall expenditures against resource envelopes, by program and organizational levels, and reviews annual forward estimates on a rolling basis. The recent issuance of Government Regulation #17/2017 will further strengthen the alignment between the strategic planning and medium term expenditure since it requires the Planning Ministry Bappenas and DG Budget at the Ministry of Finance (MoF) to work jointly on all steps of the budget process.

40. **Prior action #2:** The government takes measures to strengthen the preparation of the medium term expenditure framework (MTEF) through the issuance of MoF's regulation (PMK 163/2016) which introduces the following: i) use of top-down approach to prepare line ministry's medium term expenditure framework to better align medium term spending with the resource envelope, ii) simplify types of expenditure in the MTEF to operating and non-operating expenditures at program and/or activity level and with restrictions on revisions, iii) requirement that line ministries explain the deviations between a new budget (t) and the earlier planned budget (t-1) based on policy changes.

41. **Indicative Trigger #2:** To further strengthen and improve consistency between planning and budgeting earlier in the budget preparation process, the government aims to implement the MTEF based on PMK 163/2016. This will involve reporting on budget deviations from the forward estimates, as evidenced by the 2019 Budget documentation. Government Regulation (PP 17/2017) on synchronization of the planning and budgeting process will further strengthen MTEF implementation.

42. **Expected results:** The above measures are expected to incentivize use of the MTEF, improve the quality of forward estimates submitted by line ministries to the MoF, and promote better policy links between the previous budget, current budget and next planned budget as well as the three years forward estimate. Results indicators demonstrate the convergence between forward estimates and indicative budget of line ministry spending.

Conducting early procurement

43. **Rationale:** Budget execution, particularly for capital expenditure, is very end-loaded in the fiscal year. This makes executing the full budget difficult and is likely to reduce the quality of spending as line ministries prioritize spending based on ease of execution rather than development impact. One of the reasons for the end-loading is that line ministries typically begin 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 rather than approved Budget, line ministries should be in the position to sign the contracts shortly after the Budget is approved and budget warrants (DIPAs[21]) are issued in December. The early procurement initiative implemented in 2016 by the Ministry of Public Works and Housing[22] has reduced end-loading of capital expenditure. The proportion of

[21] Daftar Isian Pelaksanaan Anggaran

[22] 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 MoF circular letter (S-577/2015) on "Budget for Project Preparation for Fiscal Year 2016 and 2017" were issued to increase usage of early procurement for capital projects in the 2016 State Budget. These new regulations were followed by the instruction from the Minister of Public Works and Housing to the implementing unit (Satker) and accompanied by budget funds to do the early procurement work.

capital spending disbursed in the first half of fiscal year improved to 27 percent in 2016 from 18 percent between 2013 and 2015.

44. **Prior action #3:** The Ministry of Public Works and Housing issued a Circular Letter (Surat Edaran Sekjen Kementerian PUPR PL 0206-Sj/606) on August 18, 2016 to continue the practice of early procurement for the 2017 Budget.

45. **Expected results:** Earlier procurement should reduce the heavy end-loading of capital spending and reduce risks to implementing projects in the budget year. The value of Ministry of Public Works and Housing's contractual packages procured in the first semester is expected to increase from 70 percent in 2014 to 90 percent in 2016 -2018.

Improving subnational fiscal management (intergovernmental transfers and effectiveness of subnational government spending)

46. **Rationale:** Transfers to sub-national government have increased more than 3-fold in real terms between 2001 and 2016 (or from 4.6 percent of GDP to 6.3 percent of GDP). Transfers accounted for 37 percent of central government spending in 2016. Therefore, the design of intergovernmental transfers (including allocation and implementation) is an important policy tool for influencing better allocation of resources at the subnational level. To this end, the current design and implementation of Indonesia's intergovernmental system still needs improvement. The Dana Alokasi Umum (DAU) formula does not cater to needs of regions which have large population and the basic allocation component incentivizes local governments to spend more on personnel. In 2016, subnational government spent 40 percent of their budget on personnel expenditure, leaving limited space for spending on priority social and economic infrastructures such as water and sanitation, local roads, schools, public health centers. In addition, most transfers including DAK, Village Funds (DD), DID, and special autonomy funds do not use any performance criteria, making reporting and assessment challenging. Finally, the implementation of DAK is often delayed due to the late issuance of technical guidelines by line ministries, which contribute to under execution of DAK allocation by the end of fiscal year.

47. **Prior action #4:** MOF has strengthened subnational fiscal management through MoF Decree No. 50/2017 (amended by PMK 112/2017) and 2017 State Budget, that include provisions on: (a) improving the composition of subnational spending by requiring sub-national governments to allocate a minimum 25 percent from DAU plus revenue sharing for infrastructure; (b) disbursing DAK based on reports on achievement (c) improving criteria for allocating grants (Dana Insentif Daerah – DID) to sub-national governments by, among others, rewarding "improvement" in performance instead of absolute levels of performance". Preliminary analysis indicates that in 2016 districts had already allocated on average 27 percent of DAU plus revenue sharing to infrastructure[23], indicating that there is fiscal capacity for this reform. However, the application by districts varied widely and a significant number of districts (58 percent) allocated less than 25 percent showing reforms can have impact at the individual district level.

[23] Infrastructure's definition follows the Ministry of Finance regulation (PMK 50/2017) which is capital expenditure excluding those for administrative functions.

48. **Prior action #5:** The Borrower has consolidated the DAK technical guidelines that were previously issued by separate line ministries to accelerate DAK implementation, as evidenced through Presidential Regulation 123/2016.

49. **Indicative trigger #3.** MoF submits to Parliament the draft revision of Law 33/2014 on Fiscal Decentralization including: (a) per capita based allocation, and (b) elimination of basic allocation component thereby improving the effectiveness of inter-governmental fiscal transfers.

50. **Expected results**: The above measures are expected to improve the design and implementation of intergovernmental transfers: i) improved reporting and monitoring of selected transfers such as DAK, DID, special autonomy funds, ii) improved coordination and implementation of DAK fisik. This policy action is also expected to improve the composition of sub-national spending by helping the government achieve a higher allocation of infrastructure spending, from 17 percent in 2014 to more than 20 percent of total sub-national spending in 2018, while not overburdening those local governments with more limited fiscal space.

PILLAR B - STRENGTHENING REVENUE ADMINISTRATION
Strengthening VAT administration for compliance management

51. **Rationale:** The VAT compliance rate has been estimated at between 53% (IMF, 2014) and 57% in 2013 (Sugana and Hidayat, 2014). With an average VAT-to-GDP collection of 3.8 percent (2012-2014), this means approximately 3 percent of GDP is lost because of non-compliance. Reasons for the low compliance rate, include: 1) The manual VAT invoice form contains little information to evaluate the accuracy of returns and has encouraged fraud because of insufficient detail on the items acquired; 2) Acceptance of many manual VAT returns has strained the capacity of DGT, and limits their ability to monitor tax compliance risk; and 3) Lack of a risk-based approach to auditing VAT refunds - by auditing even low-risk returns, scarce audit resources are taken away from higher-risk, higher return audits.

52. **Prior action #6:** Building on the progress achieved with the launch of e-VAT invoicing, DGT has strengthened VAT administration by: (a) requiring all corporate taxpayers to use electronic invoice and VAT returns; and (b) implementing a system that makes VAT return data available, within 72 hours after filing, for auditing and analysis of compliance risk. Moreover, DGT is currently developing an e-invoice web system and a host-to-host version of e-invoicing. This system is in the piloting stage, with results expected in August. Data collected from e-invoicing will feed into a compliance risk management (CRM) system that is also in the development stage. A pilot of the new CRM system is planned for the second half of 2017.

53. The next step (**Indicative trigger #4**) is for DGT to develop and implement a risk-based approach to auditing VAT refunds by (a) developing a risk management blueprint for VAT refunds; and (b) piloting the gradual adoption of the new system. As part of the VAT blueprint, DGT will seek to develop VAT risk profiles that identify low and high risk taxpayers. Together these measures would help DGT begin to move towards a risk based culture for tax collection, releasing scarce collection resources, and preparing to be applied electronically if and when a new core IT system is created to manage e.g. VAT refunds. When created, that system would then grant automatic refunds when no inconsistencies are found, and identify taxpayers where inconsistencies are found for further investigation by DGT. Improving DG Tax's risk-engine/risk profiling in this way is a critical step to enabling a more strategic approach to compliance management, including risk-based auditing of VAT refunds.

54. **Expected results:** DGT report that use of e-invoicing is at 96%. More than 95% of VAT Returns filed through the Application Service Provider (ASP) are available on DGT's database system less than 72 hours after they have been filed. However, in part because of IT capacity constraints and in part because of administrative constraints, the ASP system has been pulled offline for several periods in 2016-2017. Developing DGT's IT infrastructure and undertaking complementary measures in institutional strengthening are thus needed over the medium term to ensure important building blocks like e-invoicing can come fully to fruition. Developing a risk-engine for VAT should dramatically reduce the costs of compliance management and improve the effectiveness of DGT to identify and target noncompliant taxpayers.

Increase electronic filing of tax returns

55. **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 (in terms of time) for taxpayers to file. 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[24]. In the first stage of implementation of e-filing, Indonesia has focused on large and medium corporate taxpayers. The next step is to enforce e-filing for withholding agents. As e-filing enforcement is increasingly expanded, DGT will develop and implement data integration mechanisms that integrate data on withholding tax returns filed electronically to enable matching of tax instruments for compliance management.

56. **Prior action #7:** The DGT has required the electronic filing of: (a) corporate income tax returns by companies that are VAT taxpayers; and (b) withholding tax returns by select withholding agents (DGT Regulations 3/2015 and 4/2017). The implementation process will be gradual, starting from 10-15 selected withholding agents on 1 July 2017, and gradually due to roll out nation-wide on 1 January 2020.

57. As a next step (**indicative trigger #5**) DGT develops and implements an IT application that integrates data on withholding tax returns filed electronically for matching tax instruments. This matching of different income tax filers may be expanded once a full IT system is in place, allowing matching between income tax and VAT payers for instance.

58. **Expected results:** If DGT is able to substantially increase the number of taxpayers who file electronically (it targets increasing from 2.57 million for 2014 tax year to 3.5 million for 2015 tax year), there will be significant impacts on data quality, administrative cost and taxpayer compliance costs (by reducing the return processing time from few months[25] to only days). Having the IT application then enables that matching of tax instruments and will serve as another critical component in enhancing DGT's compliance management capabilities.

Improving DGT access to taxpayer asset and banking data for audits

[24] 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).

[25] 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.

59. **Rationale:** Timely access to relevant third-party data, in particular fixed asset data and banking data, is critical for effective audits, especially in Indonesia where a large proportion of the wealth of high-net worth individuals is held in fixed assets. DGT and Financial Services Authority (OJK) have an existing MOU for DGT to access banking data for taxpayers under audit. However, in practice, there are often delays in receiving this data, taking an average of 1 year, which hinders considerably the auditing process.

60. **Prior action #8:** MoF has issued PMK-235/PMK.03/2016 and No. KMK-12/KMK.03/2017 which dictate that the OJK submit data information to DGT within 30-days. An IT application is currently being developed which will enable implementation of this regulation. Government Law 9/2017 and the Minister of Finance Regulation 39/2016 have also been issued. These require financial institutions to submit a report on financial data to DGT, and require banks to share banking information on customers automatically to the MoF for audit purposes for accounts higher than IDR 1 Bn (by April 2018).

61. **Indicative trigger #6:** MoF improves the definition of risk used in DGT for compliance management, audit extensification and collection, and develops a system for implementation. DGT sets out to do this by adopting a comprehensive 'compliance improvement plan' that: (i) identifies compliance risks with potentially high revenue-impact across different segments (taxpayers by size; type of sector, etc.); (ii) agrees specific actions to bring the identified compliance risks under control; and (iii) sets targets for improving compliance across these identified segments. This broad risk management approach may also include macroeconomic and corruption risk assessments.

62. **Expected results:** If the trigger is achieved, it should be feasible to reduce the average time it takes to receive banking data requested by DGT for audit use from 1 year to all financial institutions financial data for audit purposes automatically. Gaining assured access to bank customer data as well as land asset data for audit purposes will strengthen DGT's capability to conduct audits.

PILLAR C---ENHANCING TAX POLICY

Taking regulatory measures against base erosion

63. **Rationale:** Similar to many other countries, the Indonesian Government finds it challenging to assess tax liabilities linked to 'related party transactions'[26], including for multinational corporations operating in Indonesia as well as Indonesian-owned corporations with subsidiaries abroad. Until 2016, transactions for these companies were difficult to identify, let alone adjudicate if the right amount of documentation was lodged and if the corresponding level of tax was paid. The Government of Indonesia took the bold step to join a number of global initiatives designed to enhance tax transparency, and to adopt now globally accepted rules and instruments to identify these hard to tax transactions, to audit transactions, and strengthen dispute resolution mechanisms.

[26] The OECD defined 'related party transactions' as those involving parties who can control the terms of a transaction in their favour potentially at the cost of the company. They include management, board members and controlling shareholders. For more, see: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/relatedpartytransactionsandminorityshareholderrights.htm

64. In particular, Indonesia was an early adopter of the Base Erosion and Profit Shifting (BEPS) project, developed and endorsed by the OECD and G20. BEPS involves a set of 15 actions designed to equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. In addition to agreeing to implement some of the BEPS actions, Indonesia was an early adopter of the Global Forum for Tax Transparency and Exchange of Information, which will facilitate exchange of information for tax purposes between governments globally.

65. The Government is keen to tackle multiple sources of base erosion resulting from related party transactions and has concluded an inventory of current anti-BEPS laws and regulations[27] in order to identify further reforms to complement PMK 169/2015 (supported under the first Fiscal DPL operation (DPL1))[28]. The Bank is providing ongoing technical assistance to MoF in this process.

66. Specifically, Indonesia signed up to the Inclusive Framework (July 2016) to implement the BEPS project requiring at least the implementation of four minimum standards. MoF has since exerted considerable will and effort to implement these actions. At present, outside the OECD countries, Indonesia is one of only a few countries that has adopted each of the minimum standards described below (out of a pool of over 100 signatories to the convention). Each of the reforms are strong in their own right, but taken together they form the core of a newly enhanced international tax regime, one which will broaden the tax base to include more resident and non-resident multinationals, and which will limit tax base erosion. Grouping these reforms as three separate prior actions and considering each in turn:

67. **Prior Action #9**. MoF has prevented base erosion and profit shifting by:

(a) introducing a limitation of benefits clause to deter companies from using treaties for non-economic/business reason, known as 'tax treaty shopping' (BEPS Action 6);

(b) signing the CBC MCAA, which obliges the Borrower to share tax information aimed at combating harmful tax practices by carrying out country-by-country reporting exchange. This action will help Indonesia collaborate with other countries to identify harmful tax practices. This will reduce tax avoidance by multinationals.

(c) adopting a standardized set of documentation requirements (BEPS Action 13, Minister of Finance Regulation 213/2016). This will facilitate identification of possible tax evasion/avoidance by requiring more information. CBCR will allow Indonesia to see if a multinational's operation in Indonesia has economic impact or is a tax planning structure.

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[27] As part of the agreement from the ASEAN Forum on Taxation in Yogyakarta, Sept 29-30, 2015.

[28] 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 – DGT 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.

68. **Prior Action #10.** MOF has issued revisions of PMK240/2015 and PMK7/2015 as well as used Minister of Finance Regulation 234/2015 and DGT Decree 36/2017 in order to implement dispute resolution mechanisms (BEPS Action 14): In particular, the Borrower has: (a) implemented Advanced Pricing Agreement (APA) and Mutual Agreement Procedure (MAP) dispute resolution mechanisms; and (b) created a sub-directorate dedicated to enable Indonesia to manage international tax disputes. This will enhance and strengthen Indonesia's ability to adjudicate both taxpayer-government and government to government disputes. Enhanced dispute resolution mechanisms result in both more revenues and an improved investment climate, giving investors security that there are internationally accepted rules for dispute resolution.

69. **Prior Action #11**. MOF has issued Minister of Finance Regulation 107/2017 to allow DGT to access information on - and tax - passive income held by Indonesian companies and individuals abroad. It will enhance the size of the tax base and information.

    Similarly, **Indicative Triggers#10 and #11** MoF develops a model treaty for use in Double Taxation Agreement (DTA) and Multi-Lateral Instrument (MLI) negotiations as part of a general treaty policy reform. The model treaty can then be used as a basis for renegotiating priority country treaties. In this way, the model treaty allows the Government to better prepare for and conduct negotiations with countries of treaties that help prevent transfer pricing by multinational enterprises (MNEs) resident in those countries.

70. **Expected results:** According to ongoing assessment, revenue losses from BEPS is estimated at between 4 to 10 percent of global corporate income tax (CIT).[29] The losses arise from a variety of causes, including aggressive tax planning by some MNEs, the presence of some contradictions between domestic and international rules on foreign holdings, lack of transparency and coordination between tax administrations, limited country enforcement resources and harmful tax practices. The impact of the prior actions and triggers in Indonesia are thus expected to be high in terms of reducing the risks of base erosion from tax avoidance strategies. Several results indicators can be tracked, including:

    - Fewer adjustments will made after documentation requirements are improved by the changes, after clear requirements for country-by-country reporting are in place (BEPS Action 13) and after CFC rules go into effect. Measurement should control for the increase in underlying number of cases (first results--end 2018).
    - Fewer incidents of evoking limitation of benefits after harmful tax competition, and an increase in amounts collected by limitation of benefits invoked by 2018.
    - Increased number of new Advanced Pricing Agreements (APAs) concluded under new rules (2018/2017) and increased number of new Mutual Agreement Procedure (MAP) cases after new rules (2018/2017).

    All of these reforms should also make the international tax system more transparent and should help improve the business climate. To demonstrate this, a business satisfaction survey may be launched in 2019.

Improving Micro and SME Tax Policy

[29] OECD/G20 Base Erosion and Profit Shifting Project, Explanatory Statement (2015 Final Report).

71. **Rationale:** The special final tax regime for micro and SMEs introduced in 2013 (under the government regulation PP46) erodes significantly the tax base for the standard income tax because of the extremely high threshold of IDR 4.8 billion (equivalent to average USD 404,550 in 2014[30]) 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 revenue that has been collected from the final tax from new taxpayers has been far less than expected by DGT and less than the revenue foregone from taxpayers who were previously in the standard income tax net[31].

72. **Indicative Trigger #7:** The Government issues a revision of Government regulation PP 46/2013 that aims to bring in new taxpayers and reduce the number of standard income taxpayers migrating to the final tax regime though a number of measures: a) Voluntary use by taxpayer of the standard income tax regime; b) A sunset clause limiting amount of time using final tax; c) Expand exclusions e.g. to cover professional services, d) Apply special, simplified final tax regime for micro enterprises.

73. **Expected results:** This trigger has significant potential positive impact on increasing the tax base compared to the current regime, while reducing potential distortions in the business structure caused by the presumptive final tax regime.

Improve VAT Policy and Luxury Goods Sales Tax Policy

74. **Rationale:** VAT represents more than one third of tax revenue in Indonesia. However, the VAT-to-GDP ratio (3.9 percent in 2014) has been stagnant since 2012 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 as well as improving VAT policy[32] (DPL1 Prior action #6 and #10, and DPL3 Indicative Trigger #10 and #11). Overall, while the current 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, and therefore VAT potential, 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).

75. **Indicative Trigger #8:** Government submits to Parliament for deliberation a draft revision of VAT Law No. 42 of 2009 containing the proposed reforms from the Naskah Akademik VAT: a) Broadening VAT base by rationalizing exemptions and limiting MoF's discretion in granting exemptions; (b) Replacing vehicle LGST with vehicle excise tax; (c) Incorporating remaining LGST goods into VAT regime. And in advance of the submission of the law, MoF issues a PMK

[30] Based on average 2014 exchange rate of 11,865 IDR/USD.

[31] DG Tax presentation, October 2015: IDR 533 billion was collected from new taxpayers between July 2013 and October 2015 (equivalent to 0.05 percent of income tax from non-oil and gas in this period).

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

that lowers the VAT threshold to 1billion by 2020 and introduces an option to pay a simplified VAT (turnover tax of 1%) for VAT payers with turnover between 1billion to 2.5billion, substantially broadening the VAT base and providing more information on taxpayers to DGT on VAT threshold.

76. **Expected results:** Lowering the VAT threshold, when implemented, would significantly improve VAT performance, broadening the tax base and reducing the distortionary effects the current regime has on growth of medium businesses.

Improve Income Tax Policy

77. **Rationale:** Non-oil and gas income tax collection has been steady at 4.4 percent of GDP between 2012 and 2014, comprising of corporate income tax (2.1 percent), final tax (0.8 percent[33]), withholding taxes (0.6 percent) and personal income tax (1 percent). The complex tax structure with multiple corporate income and personal income tax rates adds administrative complexity. The special final tax regime for not only micro and SMEs, but also for specific sectors and economic activities (construction, shipping, airlines, etc.) results in significant revenue loss, creates major distortions, and reduces equity of the income tax regime. The revenue that has been collected from the final tax from new taxpayers has been far less than expected by DGT and less than the revenue foregone from taxpayers who were previously in the standard income tax net[34].

78. **Indicative trigger #9:** The Government intends to submit a revision of the Income Tax Law No.36 of 2008 to the Parliament in 2017/18. This presents an opportunity to simplify the tax structures, broaden the tax base, and improve compliance. For example, the IMF (2014) recommends applying the single (25%) CIT rate to all those in the standard CIT regime and introducing an Alternative Minimum Tax to improve compliance. Other proposed reforms include extending the coverage of the top PIT rate (30%) by reducing the threshold for the top PIT rate to include the third bracket. The World Bank is providing technical assistance to the development of the revised draft of the Income Tax[35].

79. **Expected results:** This trigger has significant potential positive impact on increasing the tax base and tax potential of the standard income tax in Indonesia, reducing its complexity and thus associated compliance costs, and reducing potential economic distortions that currently arise out of the different preferential regimes that some sectors enjoy over others.

Developing a Roadmap for Tax Expenditure Statements

80. In addition to the administration and policy reforms above, the Government intends to develop a roadmap for including tax expenditure statements linked to the formal budget process. Tax expenditures are special provisions (incentives) that operate as exceptions to the standard prevailing tax rules. Examples of tax expenditures include tax deductions, tax credits, and tax exemptions. While tax expenditures may bring some economics benefits, they result in foregone tax revenue, create economic distortions (both intended and unintended), and

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

[34] The Bank is working with DGT on analyzing micro-returns. Preliminary results demonstrate that the final tax regime is a major contributor to tax expenditure.

[35] The Bank has provided several policy notes that cover key issues on income tax. The Bank is also working closely with the Ministry of Finance on the new proposed revisions.

undermine the equity of the tax system. Tax expenditure statements help to address concerns with tax expenditures by quantifying the costs of these incentives, and by making them public, increase transparency and controls, with the end goal of supporting fiscal sustainability. The World Bank is providing technical assistance to the development of this tax expenditure roadmap, including through helping quantify the costs associated with income tax and VAT tax expenditures.

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

81. **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.

82. **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 DGT on tax administration reforms, and the World Bank is an observer on the Government's Team Reformasi established in December 2016 to guide these reforms. 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 AND COLLABORATION WITH DEVELOPMENT PARTNERS

83. **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 have been discussed with industry (associations and individual companies).

84. **In addition to the parallel financing arrangement with AFD, the Bank team is collaborating closely with other development partners supporting the *Government's Collecting More and Spending Better* agenda**: 1) the Australia Indonesia Partnership for Economic Governance (AIPEG) have embedded advisors in DGT and DG Budget. The Bank team coordinates with AIPEG, for example, jointly delivering analysis and capacity building on policy simulations and revenue impact. AIPEG is also funding two senior Indonesian public policy and tax experts at the request of the Head of the Fiscal Policy Agency (BKF) to support the MoF to prepare the DPL working closely with the Bank team; 2) The Australia GPF (Governance Partnership

Facility) program places Australian Treasury advisors at 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. A mission building on this analysis took place in August 2017 with the participation of the World Bank and other development partners. The Bank's advisory support and the DPL design have been informed by and are consistent with recommendations in the original 2014 report and follow up. 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[36]; 4) The US Treasury is embarking on providing TA to DGT, 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 DGT.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

85. **The impact of fiscal policy for poverty and inequality reduction in Indonesia has been positive but could have been greater with better design.** Effective design and implementation of taxation and spending policies can directly and indirectly boost the well-being of the poor and vulnerable. A recent study estimated that all taxes and government spending in Indonesia reduced poverty by 1.6 percentage points and lowered Gini coefficient by 3.4 points in 2014.[37]Reforms in the First Fiscal Development Policy Operation (DPL1), such as increasing the budget earmarked for health and social assistance spending and reducing VAT exemptions for some consumption goods, were estimated to reduce poverty and inequality further by about 0.06 and 0.16 percentage points respectively. [38]

86. **Requiring local governments to spend 25 percent of their DAU and Shared Revenue on infrastructure may have a positive impact on the poor and vulnerable but the impact is difficult to measure.** Increased investments in infrastructure can reduce transportation costs and connect markets which will be good for the poor because of lower prices and possible new jobs. However, the impact is difficult to measure due to data and methodological challenges. Infrastructure investments can potentially benefit disadvantaged groups but depending on a number of factors such as: 1) whether the project meets the needs of the poor and vulnerable; 2) the location and accessibility of the infrastructure for the poor; 3) whether the poor can afford to access the benefits of the project e.g. by being able to meet

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[36] 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).

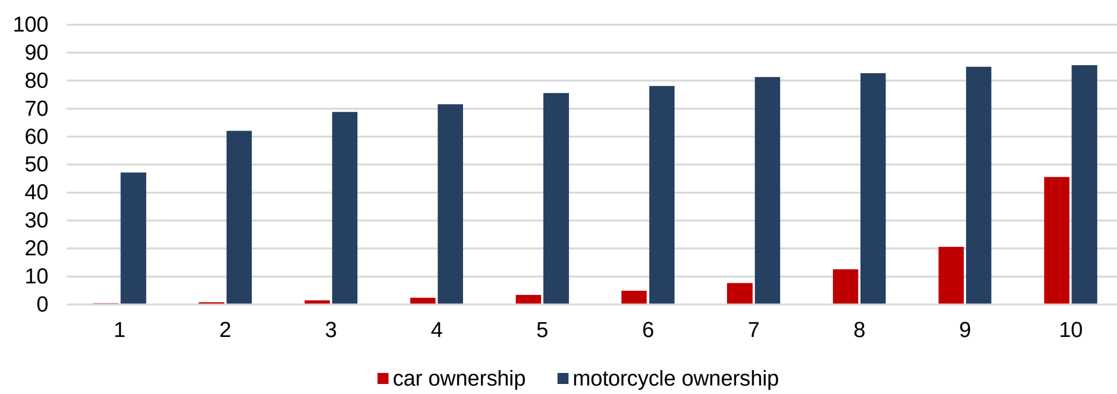
[37] Taken from recent fiscal incidence analytical work updated up to 2014 data. For 2015 and 2016 data, due to changes in the National Socio-economic household survey (Susenas), some further revisions are still going to be made and not yet ready to be published.

[38] Figures are from the Fiscal PSIA prepared for Fiscal DPL 1.

transportation cost. Local governments on average spend about 17 percent of their budget on infrastructure. With hard budget constraints, a 25 percent threshold may require some reallocation which may affect sectors such as health or social sectors. Fiscal impact analysis however shows that a limited number of districts will be forced to make significant reallocations. In addition, tradeoffs should be taken into consideration already in the budget planning process and prior to any infrastructure project execution. A careful planning process that considers the pressing needs of the poor first will inform which sector is prioritized and how the budget may ultimately meet that priority.

87. **Replacing the vehicle Luxury-goods Sales Tax (LGST) with a new broad-based vehicle (including motorcycles) excise tax may have a small effect on poverty and inequality.** The car ownership rate only reached just under 2 percent in 2014 and it did not change up to 2016 (Figure 3). Car ownership among the two highest income quintiles is only just over 20%. Broadening a vehicle tax over a range of cars will have no impact on poverty and inequality given how small a share of the poor own a car. However, according to the 2015 Unified Data Base, 37 percent of the poorest 20 percent of Indonesians own motorcycles. As a mitigating measure for the poor the government can seek to exempt the poor from a vehicle tax payment especially for low to medium sized motorcycles which are more common among the poor

Figure 3: Vehicle ownership for each household per capita consumption quintile in 2016



Source: 2016 March Susenas

88. **Lowering the VAT threshold and giving an option to pay a simplified tax for VAT payers can have a negative impact on poverty and inequality reduction but is offset by other reforms.** By lowering the VAT threshold, SMEs with turnover between IDR 300 million to IDR 4.8 billion will be affected. However, based on the micro and small enterprises survey (IMK) only around 10.5 percent of micro and small enterprises fall into this category. In addition, it is unlikely that the poor and vulnerable will own a business with annual turnover beyond IDR 300 million looking at the amount of property they own.[39] However, the poor and vulnerable will be indirectly affected by consuming goods and services produced by these SME VAT payers, especially if the majority of these goods and services fall into a consumption basket of the poor. A VAT removal exercise over a range of goods and services (intermediate and final products) could lead to an increase in poverty and the Gini coefficient by approximately 0.19

[39] Micro and Small Enterprises Survey (2014 IMK).

percentage point and 0.03 point respectively[40].These impacts are likely to be offset by increased spending on health and social assistance which resulted in a modest positive total impact to poverty and inequality reduction.[41] New figures will be drawn from the updated Indonesia fiscal incidence analysis(CEQ) which is expected to become available for DPL3.

89. **When considering the social spending that tax increases may help finance, DPL 2 is likely to have positive overall impacts on poverty and inequality.** Coupled with potential improvements in the poverty and inequality reduction coming from the selected components of the first operation, the proposed reforms in this DPL 2 have the potential to further improve poverty and inequality reductions.

5.2 ENVIRONMENTAL ASPECTS

The environmental impacts of the fiscal reform actions supported by the DPL are likely to be positive overall.

90. **The environmental impacts of the fiscal reform actions supported by the DPL continue to be positive overall**. The DPL operation's proposed prior actions to accelerate and improve the quality of public infrastructure spending do not target specific infrastructure sectors. This includes supporting and accelerating the GOI's continuous effort to bring positive impacts in the environment and public health sectors by improving mass transit infrastructure, more efficient vehicle movement, better solid waste and wastewater management, and wider access to reliable and safe water supply.

91. **Indonesia has a comprehensive legal and institutional framework for environmental impact assessment and licensing of infrastructure development, including for the management of direct, induced and cumulative impacts.** Institutions in general embody international standards. However, thin capacity can hinder enforcement of the existing legal framework by government agencies. The Ministry of Environment and Forestry have issued Regulation 5/2012 for large infrastructure projects to conduct environmental impact assessments during the feasibility stage of the project preparation. For mitigation during project implementation, the same regulation also requires project owners to prepare Environmental Impact Assessments (AMDAL) and to obtain environmental licensing prior to implementation. More specifically, capacity gaps to prepare, review, monitor and enforce AMDALs varies from one local or regional government to another. Other issues included adequate budget for local agencies for enforcement and supervision, lack of trained staffs and training etc. Besides community health and safety risks associated with infrastructure projects, other primary risks are associated with land acquisition.

92. **Continuous efforts by the government, including with support from development partners such as the World Bank have strengthened the government's environmental risk mitigation capacity.** For example the World Bank supported environmental appraisals of PPPs through the PPP unit of the Ministry of Finance (MOF) to establish project support facilities which include the development of environmental and social frameworks to manage induced, direct and cumulative impacts from PPP projects. The ADB had been supporting GoI through technical assistance grants to conduct an extensive assessment on strengthening and use of

[40] World Bank Commitment to Equity analysis, forthcoming.

[41] Overall impacts of DPL 1 selected components are reduction in poverty and Gini coefficient by 0.06 and 0.16 points respectively.

the country safeguard system. The follow-up of the assessment is the WB-ADB joint partnership on the establishment of the Indonesia Environmental and Social Safeguard Learning Center. This is part of the capacity building support to implement the safeguard network of learning centers (NSLC) and addresses capacity gaps in managing environmental and social impact.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

93. **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.**

94. **Steady progress has been made in recent years in the way Indonesia's public finances are managed and in increasing transparency and independent oversight.** The last successive assessment of the Public Expenditure and Financial Accountability (PEFA) was conducted in 2012, following a first assessment in 2007. An assessment using the new PEFA 2016 framework is underway and is expected to be finalized before the end of this calendar year. The results of the 2012 report 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). The implementation of the Treasury Single Account for revenue and expenditure since 2010 significantly improved the cash management, accounting and reporting systems. 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. The 2016 GOI financial statements have received a clean audit opinion, as opposed to qualified opinion since 2009 and a disclaimer before. In FY 2016, 74 out of 88 central agencies (84%) had unqualified audit opinions.

95. **The foreign exchange control environment is assessed to be generally satisfactory**. BPK expressed an unqualified opinion (again) on BI financial reports for FY 2016. 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.

96. **The borrower is the Republic of Indonesia and this operation is a single-tranche IBRD loan of US$300 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.

97. **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 DPL. 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 excluded 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

98. **The program to support fiscal sector reforms in Indonesia has three pillars: improving the quality of spending, strengthening revenue administration, and enhancing tax policy.** Policy dialogue and regular coordination meetings with Government have already been undertaken. The proposed third and final program loan in the series is expected to be completed by December 2018. The second DPL operation is scheduled to go to the World Bank Board in Q4 of calendar year 2017 and to close in mid-2018. The monitoring of progress on indicative triggers and result indicators will be done on a quarterly basis, and will be coordinated by BKF. The main counterpart is the Ministry of Finance, with engagement with DGT on VAT administration and BKF on expenditure and revenue reform and ESDM (non-tax revenue) administration. The Ministry of Public Works and Housing is also responsible for one of the trigger events related to early procurement.

99. **Grievance Redress.** Communities and individual 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 mechanism, or the WB's Grievance Redress Service (GRS). The GRS ensures that the 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

100. **The overall risk rating of this operation is substantial based on the following major risks**: While macroeconomic risks have subsided significantly since the DPL1, others remain elevated including (a) political economy and governance challenges, (b) sector strategies, in particular on tax policy; (c) weak institutional and implementation capacity, 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 (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.

101. **Macroeconomic risks**: Macroeconomic risks, notably fiscal risks, have subsided since DPL1. The 2016 revenue and expenditure targets were revised down by government to more

realistic levels and the 2017 budget is credible. Indonesia's economy has also been resilient to recent market disruptions caused by global political and policy uncertainty in in 2016 and 2017. Attesting to this, S&P in May 2017 raised Indonesia's sovereign rating to investment grade with a stable outlook, for the first time in 20 years. External risks from the uncertain path of US interest rate normalization, commodity prices and slower than expected growth in major trading partners nevertheless persist.

102. **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. The Parliament is involved in several triggers which generates significant uncertainty and risks, including possible changes to the substance of Law 33. Whereas the government is responsible for drafting the revised VAT, the Parliament will be more involved in the drafting of the revised income tax law. Furthermore, 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 MoF is needed to maintain the integrity of the laws and regulations through the inter-ministerial consultations and Parliament discussions. 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 DGT 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. Uncertainty also remains around the capacity and method for procuring a large core Tax IT system and the pace at which some degree of independence is being sought for the tax administration institution. Finally, with regional elections to be held in 2018 and legislative and presidential elections in 2019, the political environment may make it increasingly more challenging for the Government to undertake difficult and occasionally unpopular fiscal structural policy reforms.

103. **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 may lead 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, a broad over-reliance on tax policy to boost investment , 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 . 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.

104. **Institutional capacity for implementation and sustainability:** The capacity for DGT 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 and planned acceleration in parallel ASA support to DGT 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, MoF has not yet finalized how such investments would be financed or procured. The Bank has been providing technical advice on potential IT solutions. Second, although DGT 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.

Table 5: Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (H, S, M or L)
1	Political and governance	S
2	Macroeconomic	M
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

ANNEX 1: POLICY AND RESULTS MATRIX

<table>
<tr><th colspan="3">Prior actions and Triggers</th><th rowspan="2">Results</th></tr>
<tr><th>Prior Actions under DPL 1</th><th>Prior Actions for DPL 2</th><th>Indicative Triggers for DPL 3</th></tr>
<tr><td colspan="4">Pillar 1 – Improving Quality of Spending
Program Development Objective A: Improving composition of spending, budget execution and efficiency of spending</td></tr>
<tr><td>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.</td><td>Prior action #1. The Borrower has maintained the increased 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 2017 Budget Law and the Presidential Regulation 97/2016</td><td>Indicative Trigger #1. The Borrower has proposed an increase in the share of central government budget allocated to infrastructure, social assistance and health sectors compared to pre-fuel subsidy reform years (2012-2014), and has taken measures in the proposed 2018 Budget to further improve the efficiency of central government spending through “flat budget policy” for material expenditure.</td><td>Result Indicator A1: Sustained increase in the share of central government budget allocated to infrastructure, social assistance and health after fuel subsidy reforms:
• 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
• Final Target (2018):
o Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase): => 4.5 percent
o Health (including health insurance for the poor (JKN): => 7.4 percent
o Infrastructure: => 19.5 percent
Note: Central government share to the above items in the proposed 2018 Budget are as follow:
• Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase) => 3.6 percent
• Health (including health insurance for the poor or JKN) => 7.0 percent
• Infrastructure (including earmarking 25 percent of general transfer fund for infrastructure)=> 23.1 percent</td></tr>
</table>

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
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. • Final 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 Regulation 190/2015, Head of Bappenas Regulation 4/2015 and Head of LKPP Regulation 19/2015.			**Result Indicator A3:** Availability of enabling regulatory framework for Availability Payment Contracts for infrastructure projects with the private sector: • Baseline (2014): No • Final Target (2016): Yes
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% • Final Target: >17%

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
	Prior action #2. The Borrower has strengthened the preparation of the Medium Term Expenditure Framework ("MTEF") by: (a) using a top-down approach to better align line ministries' medium term spending with the resource envelope; (b) (i) simplifying types of expenditures in the MTEF to operating and non-operating expenditures at program and/or activity level and (ii) imposing restrictions on revisions; and (c) introducing the requirement that line ministries explain the deviations between a new budget and the earlier planned budget based on policy changes, all as evidenced through the Minister of Finance Regulation 163/2016.	**Indicative Trigger #2**. The Government implements the Ministry of Finance's regulation (PMK 163/2016) to strengthen the implementation of the medium-term expenditure framework (MTEF) as reflected in the formal 2018 budget document and the Government Regulation (PP 17/2017), to better synchronize the planning and budgeting process by the issuance of implementing ministerial regulations.	**Result Indicator A5:** Reduced deviation between indicative line ministry expenditure ceiling in a new budget and the forward estimate in the earlier planned budget: • Baseline (2016): 22% • Target: (2019): <22%
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.	**Prior action #3.** The Borrower has continued to enable the increased usage of early procurement, for capital expenditure packages listed in the 2017 State Budget, as evidenced through the Secretary General of the Ministry of Public Works and Housing's Circular Letter No. PL-0206/Sj/606 dated August 18, 2016.		**Result Indicator A6:** 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% • Final Target (2018): >90%

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
	Prior action #4. The Borrower has strengthened subnational fiscal management by: (a) improving the composition of subnational spending by requiring sub-national governments to allocate a minimum 25 percent of DAU and revenue sharing for infrastructure; (b) disbursing DAK based on reports on achievements; and (c) improving DID allocation criteria, as evidenced through the 2017 Budget Law and the Minister of Finance Regulation 112/2017.	**Indicative Trigger #3**. MoF submits to Parliament the draft revision of Law 33/2014 on Fiscal Decentralization including: (a) per capita based allocation, and (b) elimination of basic allocation component thereby improving the effectiveness of inter-governmental fiscal transfers.	**Results Indicator A7:** (a) Increase in the proportion of districts meeting the requirement to spend 25% of DAU and revenue sharing allocations on infrastructure: • Baseline (2016): 42% of districts • Target (2019): 60% of districts Note: In 2016, 42% of individual sub national governments comply with the mandate to spend at least 25% on infrastructure in 2017 and 2018. DG Fiscal Balance confirmed 45% is a stricter definition of infrastructure (capital expenditures excluding those in general government function, and deducting DAK Physical). (b) Percentage of DAK physical realization in infrastructure sectors at the end of fiscal year: • Baseline (Nov 2016): 60.5% • Target (2019): >= 70% (c) Average improvement in NER for Junior Secondary School for Districts that received DID: • Baseline (2016): 0.06 percentage point • Target (2019): 0.08 percentage point
	Prior action #5. The Borrower has issued consolidated DAK technical guidelines that were previously issued by separate line ministries to accelerate DAK implementation, as evidenced through Presidential Regulation 123/2016.		**Results Indicator A8:** Increased proportion of contracted value of DAK by July of each year • Baseline (2014): 67% • Target (2019): 80%

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
Pillar B---Strengthening Revenue Administration ***Program Development Objective B: Increasing tax administration efficiency, compliance management and audit capability***			
Prior action #6. The Directorate General of Taxes (DGT) 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 DGT Decree 136/2014.	**Prior action #6.** The DGT has strengthened VAT administration by: (a) requiring all corporate taxpayers to use the electronic invoice and electronic VAT returns; and (b) implementing a system that makes electronic VAT returns data available, within 72 hours after filing, for auditing and analysis of compliance risk, as evidenced through DGT Announcement No. Peng-04/PJ.09/2016 dated April 27, 2016	**Indicative Trigger #4.** DGT implements a risk-based approach to auditing VAT refund requests by (a) developing a risk management blueprint for VAT refunds (including development of risk profiles), (b) piloting the gradual adoption of risk based VAT refund audits.	**Result Indicator B1:** Increase in the share of monthly VAT returns filed electronically: Monthly VAT returns • Baseline: (2014): 0% • Target: (From end 2016 to end 2018): 90% **Result Indicator B2:** VAT refunds audited based on objective risk criteria • Baseline: No VAT risk profiles in place; all VAT refund requests are audited • Target: VAT risk profiles developed; a sample of VAT returns are chosen for pilot use of new risk-based system.
Prior action #7. DGT 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 DGT Regulation 41/2015.	**Prior action #7.** The DGT has required the electronic filing of: (a) corporate income tax returns by companies that are VAT taxpayers; and (b) withholding tax returns by select withholding agents, as evidenced through DGT Regulations 3/2015 and 4/2017.	**Indicative Trigger #5.** DGT develops and implements a data integration mechanism that integrates data from withholding tax returns filed electronically with data from VAT returns for the purpose of data matching.	**Result Indicator B3:** Increase in the share of annual individual income tax and corporate income tax returns filed electronically. Individual income tax (simple form) returns: • Baseline (2014 tax year): 27% (2.6 million filed electronically out of a total of 9.8 million returns) • Target (2016 tax year filed in 2017): 48% (5.5 million filed electronically out of an estimated total of 11.5 million returns).

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
			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 #8. DGT 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 DGT Circular Letter SE 44/2015.			**Result Indicator B4:** 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.

<table>
<tr><th colspan="3">Prior actions and Triggers</th><th rowspan="2">Results</th></tr>
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<tr><td>Prior action #9. DGT and National Land Office (BPN) have implemented an electronic data exchange to enable DGT to access taxpayers' land asset data held by BPN for compliance purposes in a systematic manner.</td><td>Prior action #8. The Borrower has enabled the DGT increased access to financial data for audit purposes by requiring financial institutions to submit a report on financial data to DGT beginning with each individuals' account(s) with a balance of IDR 1 billion or more, as evidenced through the Government Law 9/2017 and the Minister of Finance Regulation 73/2017.</td><td>Indicative Trigger #6. DGT improves its compliance risk management by adopting a comprehensive 'compliance improvement plan' that: (i) identifies compliance risks with potentially high revenue-impact across different segments (taxpayers by size; type of sector, etc.); (ii) agrees specific actions to bring the identified compliance risks under control; (iii) sets targets for improving compliance across these identified segments.</td><td>Result Indicator B5: Reduction in the average time taken to receive land asset and access financial information requested by DGT 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.

Financial information:
• Baseline (2015): no data
• Final Target: all financial institutions to submit financial data for audit purposes automatically.</td></tr>
<tr><td colspan="4">Pillar C --- Enhancing Tax Policy
Program Development Objective C: Increasing revenue potential and economic efficiency of tax policy</td></tr>
<tr><td></td><td></td><td>Indicative Trigger #7. The Government issues a revision of Government regulation PP 46/2013 that aims to bring in new taxpayers and reduce the number of standard income taxpayers migrating to the final tax regime through a number of measures: a) Voluntary use by taxpayer of the standard income tax regime; b) A sunset clause limiting amount of time using final tax; c) Expand exclusions e.g. to cover professional services, d) Apply special, simplified final tax regime</td><td>Result Indicator C1: Increase in the number of new (previously not registered) taxpayers joining the MSME final tax regime and reduction in the number of standard income taxpayers moving to the regime.
• Baseline:
○ (end Oct 2015) # of new taxpayers who paid final tax: 68,000
○ (2014) % of previous standard income taxpayers who paid final tax: 13.5%
• Target:
○ (end 2017) # of new taxpayers paying final tax: 100,000
○ (2019) % of previous standard income taxpayers paying final tax: 5%.</td></tr>
</table>

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
		for micro enterprises.	
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 #8**. Government submits to Parliament for deliberation a draft revision of VAT Law No. 42 of 2009 containing the proposed reforms from the Naskah Akademik VAT: a) Broadening VAT base by rationalizing exemptions and limiting MoF's discretion in granting exemptions; (b) Replacing vehicle LGST with vehicle excise tax; (c) Incorporating remaining LGST goods into VAT regime. And in advance of the submission of the law, MoF issues a PMK that lowers the VAT threshold to 1 billion by 2020 and introduces an option to pay a simplified VAT (turnover tax of 1%) for VAT payers with turnover between 1 billion to 2.5 billion, substantially broadening the VAT base and providing more information on taxpayers to DGT on VAT threshold.	**Result Indicator C2:** The VAT regime is revised to reduce the share of final consumption exempt from standard VAT. • Baseline (2015): 16.3% in the current VAT regime • Target (2019): 9.0% in the revised VAT regime **Result Indicator C3:** Replacement of the vehicle LGST with a vehicle excise tax • Baseline (2015): Vehicle LGST in place • Target (2019): 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.			**Result Indicator C4:** The Income Tax regime is revised to reduce tax base erosion and broaden the tax base. • Baseline (2017): Few anti-tax base erosion measures in place: only controlled foreign company (CFC) rule • Target (2019): Increase in anti-tax base erosion measures in place: CFC and thin capitalization rules in place
		Indicative Trigger #9. The Government submits to the	**Result Indicator C5:** The Income Tax regime is revised to reduce tax base erosion and broaden the tax base.

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	

		Parliament for deliberation the draft revision of the Income Tax Law No. 36 of 2008. The proposed reforms set out to further address tax base erosion and broaden the tax base, including by: (a) introducing an Alternative Minimum Tax (AMT) for corporates; and (b) replacing the general PIT deduction with a non-refundable tax credit.	• Baseline (2017):
			  ○ Average rate of growth of nominal NO&G Income Tax revenues 2012-2017: 11.1%
			  ○ General PIT deduction of non-taxable income (PTKP) of IDR 54 million (2017)
			• Target (2019):
			  ○ Ceteris paribus, rate of growth of nominal NO&G Income Tax revenues 2019: 15%
			  ○ General PIT deduction removed. Instead, non-refundable tax credit in place with equivalent amounts

	Prior action #9. The Ministry of Finance has prevented tax base erosion and profit shifting by: (a) introducing a limitation of benefits clause to deter companies from using treaties for non-economic/business reasons; (b) signing the CBC MCAA, which obliges the Borrower to share tax information aimed at combating harmful tax practices by carrying out country-by-country reporting exchange; and (c) adopting a standardized set of documentation requirements for international taxation, all as evidenced through the Minister of Finance Regulation 213/2016, the CBC MCAA list of signatories and the DGT Regulation 10/2017.	**Indicative Trigger #10.** MoF issues new PMK/PER to strengthen transfer pricing and interest deduction rules by: (a) MoF upgrading PER 32 into PMK to strengthen the legal basis for transfer pricing adjustments; (b) issuing/revising regulation to limit interest deduction through an EBITDA rule.	**Result Indicator C6:** The Income Tax regime is revised to reduce tax base erosion and broaden the tax base. • Baseline (2017): Few anti-tax base erosion measures in place: only CFC rule • Final Target (2019): Increase in anti-tax base erosion measures in place, including LoB clause in treaties and requirements for standardized documentation
	Prior action #10. The Ministry of Finance has: (a) enabled the implementation of APA and MAP		**Result Indicator C7:** Increase in number of new APA and MAPs concluded under new rules.

Prior actions and Triggers			Results
Prior Actions under DPL 1	**Prior Actions for DPL 2**	**Indicative Triggers for DPL 3**	
	dispute resolution mechanisms; and (b) created a sub-directorate dedicated to enable the Borrower to manage international tax disputes, as evidenced through the Minister of Finance Regulation 234/2015 and DGT Decree 36/2017.		• Baseline (2016): a) Number new APAs concluded under old rules (2016): 0 b) Number of new MAP cases before new rules (2016): 39 • Final Target (2019): (a) Number new APAs concluded under new rules (2018): 7 (b) Number of new MAP cases after new rules (2018/2017): 70
	Prior action #11. The Borrower has allowed the DGT to access information on - and tax - passive income held by Indonesian companies and citizens abroad, as evidenced through the Minister of Finance Regulation 107/2017.		**Result Indicator C8:** Access to information on passive income improved • Baseline (2016): Average rate of growth of nominal NO&G Income Tax revenues 2012-2017: 11.1% • Final Target (2019): Ceteris paribus, rate of growth of nominal NO&G Income Tax revenues by 2019: 17%
		Indicative Trigger #11. Develop a model treaty for use in double tax agreements (DTA) and the Multi-Lateral Instrument (MLI) negotiations as part of a general treaty policy reform and renegotiate priority country treaties on the basis of this model treaty.	**Result Indicator C9**: Number of treaties negotiated based on model treaty • Baseline (2016): 0 treaties based on model treaty • Final Target (2019): 6 treaties renegotiated using model treaty.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA

LETTER OF DEVELOPMENT POLICY

MINISTRY OF FINANCE

Jakarta, 18 September 2017

No.: S-764.../MK.08/2017

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, including from partners such as Australia and France. We would also like to request the support of the International Bank for Reconstruction/World Bank in the form of the Second 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 4.9 percent in 2015, before beginning to pick up again with the economy growing at 5.0 percent in 2016. The deceleration was 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 2016. Indonesia has made good progress on reducing poverty with the national poverty rate falling from 24 percent in 1999 to just under 11 percent in 2016. 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 with the Gini coefficient only recently beginning to fall again, to just over 39 percent in 2016.

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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 2016 to protect our tax revenues, non-tax revenues fell from approximately 4 to 2 percent of GDP in 2016. 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 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 and 2017 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 2018 proposed budget. It has also proposed to include gender responsive budgeting approach to improve gender outcomes in the proposed 2018 Budget.

8. *Facilitating private sector financing for public infrastructure:* The comprehensive 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 Minister for Economic Affairs, 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 has established 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 and 2016 to increase usage of early procurement for capital projects in the 2016 and 2017 State Budget. By October 2015 the Directorate General of Highway at the Ministry of Public Works and Housings had started early procurement for over a third of their total 2016 budget, with this success repeated in 2017 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 Directorate General of Treasury (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.

12. *Strengthening budget management through MTEF implementation*: The government has taken measures to further incentivise implementation of its 2012 MTEF to strengthen the quality of forward budget estimates submitted by line ministries by in turn strengthening the links between forward estimates and policies embodied in our strategic plans and with the resource envelope. Specifically, the MTEF ceilings help line ministries set 3-year forward estimates for overall expenditures against resource envelopes, by program and organizational levels, and reviews annual forward estimates on a rolling basis with a commitment to reporting on any divergences.

Strengthening tax administration processes and capability

13. Strengthening tax administration processes and capability is critical to improving our revenue performance. Directorate General of Tax (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 (taxpayer registration) 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.

14. *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. 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.

15. *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 to increase e-filing rates of corporate income tax returns and withholding tax returns by withholding agents.

16. *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.

17. *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 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. The government has further improved timeliness of access to banking data for audit purposes, by requiring banks to share banking data, in some cases automatically.

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

18. 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.

19. *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 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 expand the tax base and better address environmental externalities, and incorporating the remaining LGST goods into the VAT regime to improve tax administrative efficiency. The Government planned to submit to Parliament for deliberation the draft revision of the VAT and LGST Law before the end of 2016.

20. *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 the first half of 2018. 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. 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. More broadly, Indonesia was an early adopter of the Base Erosion and Profit Shifting (BEPS) project, developed and endorsed by the OECD and G20. BEPS involves a set of 15 actions designed to equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. In addition to agreeing to implement some of the BEPS actions, Indonesia was an early adopter of the Global Forum for Tax Transparency and Exchange of Information, which will facilitate exchange of information for tax purposes between governments globally

21. In parallel, the Government intends to issue a revision of the government regulation (PP 46/2013) for the final tax on MSMEs in the first half of 2018, 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

22. 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.

23. 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

Sri Mulyani Indrawati

Cc:

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

ANNEX 3: FUND RELATIONS ANNEX

Indonesia—Assessment Letter for the World Bank
August 1, 2017

Recent Developments and Outlook

Macroeconomic developments and outlook. Macroeconomic performance in 2017 has been satisfactory. On the back of the partial recovery of commodity prices, real GDP growth rose to 5 percent in 2017:Q1 (from 4.9 percent in 2016:Q4), led by net exports, even as private investment remained subdued. Growth for 2017 is expected to pick up slightly to 5.2 percent on account of higher net exports and fiscal spending. Supportive capital inflows and the recent S&P sovereign ratings upgrade to investment grade have buoyed financial markets, while the current account deficit has narrowed and international reserves have risen. Inflation has risen to 4.4 percent in June, mainly due to improved targeting of electricity subsidies.

Risks to the outlook. The balance of risks remains tilted to the downside. The main risks are external and include uncertainty about policies in advanced economies, including U.S. monetary policy normalization, heightened financial volatility, lower commodity prices, slowdown of growth in China, and higher geopolitical risk. Domestic risks include tax revenue shortfalls and lower fiscal space due to higher international and domestic interest rates.

Policy Framework and Settings

Fiscal policy. The revised budget for 2017 submitted to Parliament aims at a higher general government deficit (2.9 percent of GDP, compared to 2.4 percent in the original budget), reflecting lower projected revenues (0.3 percent of GDP) and somewhat higher expenditures on subsidies, public investment, and natural disaster contingency (0.2 percent). The authorities expect that the actual deficit will be near 2.7 percent of GDP due to the traditional underperformance of spending. The revised budget puts on hold the policy of rebuilding fiscal buffers and makes use of most of the available fiscal space, although there are no imminent risks to confidence or fiscal sustainability from the shift. Downside risks to tax revenues remain, including due to the reliance on commodity revenues, which will require careful monitoring of spending to continue to meet the statutory limit on the fiscal deficit (3 percent of GDP). At the same time, the authorities are aware of the essential need to put in place a comprehensive medium-term revenue strategy that includes both tax and additional tax administration reforms and are working towards the preparation of such a strategy. Further progress has been achieved with subsidy reforms, including better targeting of electricity subsidies and shifts from price subsidies to direct transfers for foodstuffs.

Monetary policy. Inflation has risen in recent months due to the adjustment of administered prices, although at 4.4 percent in June (y/y) it remains within the official target band (3–5 percent). Core inflation slowed to 3.1 percent (y/y) in June. Against this backdrop, the stance of monetary policy is appropriate, with BI interest rate policy on hold. Nonetheless, the authorities should stand ready to raise interest rates if inflationary or external pressures materialize. In addition, maintaining flexible exchange rates and market-determined government bond yields will be critical to help the economy navigate through volatile external financial conditions. Monetary operations reforms have continued, including the move to place all BI securities through auctions and partial averaging of banks' reserve requirement.

External assessment. The external position of Indonesia in 2016 was assessed to be broadly consistent with medium-term fundamentals and desirable policies.

Financial sector. Financial sector indicators show a profitable and liquid financial sector and relatively low levels of systemic risk, although pockets of vulnerabilities remain among medium- and small-sized banks. Loan growth has started a weak recovery (9.2 percent (y/y) in 2017:Q1), while NPLs and restructured loans appear to have stabilized since 2016:Q4. Nonetheless, bank asset quality needs to be closely monitored. The authorities also need to watch corporate vulnerabilities carefully, even as they appear to have abated somewhat in recent months. The government promulgated several regulations related to the Financial System Crisis Prevention and Mitigation (FSCPM) Law.

Macrostructural issues. Promoting inclusive growth will require further efforts in structural reforms. There has been some progress in raising public investment in infrastructure as a result of an improved institutional framework. Continued infrastructure development, combined with an enhanced regulatory framework and a further opening of sectors to domestic and foreign investment will support the diversification of the economy and boost growth. The authorities should continue their efforts to strengthen human capital, including by improving the quality of education and reducing rigidities in the labor markets.

IMF Relations

The 2016 Article IV consultation was concluded by the IMF's Executive Board on January 25, 2017.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions for DPL 2	Significant Positive or Negative Environment Effects (Yes/No/To be Determined)	Significant Poverty, Social or Distributional Effects Positive or Negative (Yes/No/To be Determined)
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 maintained the increased 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 2017 Budget Law and the Presidential Regulation 97/2016	**No**	**Yes positive, not significant**
Prior action #2. The Borrower has strengthened the preparation of the Medium Term Expenditure Framework ("MTEF") by: (a) using a top-down approach to better align line ministries' medium term spending with the resource envelope; (b) (i) simplifying types of expenditures in the MTEF to operating and non-operating expenditures at program and/or activity level and (ii) imposing restrictions on revisions; and (c) introducing the requirement that line ministries explain the deviations between a new budget and the earlier planned budget based on policy changes, all as evidenced through the Minister of Finance Regulation 163/2016	**No**	**Yes positive, not significant**
Prior action #3. The Borrower has continued to enable the increased usage of early procurement, for capital expenditure packages listed in the 2017 State Budget, as evidenced through the Secretary General of the Ministry of Public Works and Housing's Circular Letter No. PL-0206/Sj/606 dated August 18, 2016	**No**	**Yes positive, not significant**

Prior Actions for DPL 2	**Significant Positive or Negative Environment Effects (Yes/No/To be Determined)**	**Significant Poverty, Social or Distributional Effects Positive or Negative (Yes/No/To be Determined)**
Prior action #4. The Borrower has strengthened subnational fiscal management by: (a) improving the composition of subnational spending by requiring sub-national governments to allocate a minimum 25 percent of DAU and revenue sharing for infrastructure; (b) disbursing DAK based on reports on achievements; and (c) improving DID allocation criteria, as evidenced through the 2017 Budget Law and the Minister of Finance Regulation 112/2017.	**No**	**Yes positive, not significant**
Prior action #5. The Borrower has issued consolidated DAK technical guidelines that were previously issued by separate line ministries to accelerate DAK implementation, as evidenced through Presidential Regulation 123/2016.	**No**	**Yes positive, not significant**
Pillar B---Strengthening Revenue Administration ***Program Development Objective B: Increasing tax administration efficiency, compliance management and audit capability***		
Prior action #6. The DGT has strengthened VAT administration by: (a) requiring all corporate taxpayers to use the electronic invoice and electronic VAT returns; and (b) implementing a system that makes electronic VAT returns data available, within 72 hours after filing, for auditing and analysis of compliance risk, as evidenced through DGT Announcement No. Peng-04/PJ.09/2016 dated April 27, 2016	**No**	**Yes positive, not significant.**
Prior action #7. The DGT has required the electronic filing of: (a) corporate income tax returns by companies that are VAT taxpayers; and (b) withholding tax returns by select withholding agents, as evidenced through DGT Regulations 3/2015 and 4/2017.	**No**	**Yes positive, not significant**

Prior Actions for DPL 2	Significant Positive or Negative Environment Effects (Yes/No/To be Determined)	Significant Poverty, Social or Distributional Effects Positive or Negative (Yes/No/To be Determined)
Prior action #8. The Borrower has enabled the DGT increased access to financial data for audit purposes by requiring financial institutions to submit a report on financial data to DGT beginning with each individuals' account(s) with a balance of IDR 1 billion or more, as evidenced through the Government Law 9/2017 and the Minister of Finance Regulation 73/2017.	**No**	**Yes positive, not significant**
Pillar C---Enhancing Tax Policy ***Program Development Objective C: Increasing revenue potential and economic efficiency of tax policy***		
Prior action #9. The Ministry of Finance has prevented tax base erosion and profit shifting by: (a) introducing a limitation of benefits clause to deter companies from using treaties for non-economic/business reasons; (b) signing the CBC MCAA, which obliges the Borrower to share tax information aimed at combating harmful tax practices by carrying out country-by-country reporting exchange; and (c) adopting a standardized set of documentation requirements for international taxation, all as evidenced through the Minister of Finance Regulation 213/2016, the CBC MCAA list of signatories and the DGT Regulation 10/2017.	**No**	**No**
Prior action #10. The Ministry of Finance has: (a) enabled the implementation of APA and MAP dispute resolution mechanisms; and (b) created a sub-directorate dedicated to enable the Borrower to manage international tax disputes, as evidenced through the Minister of Finance Regulation 234/2015 and DGT Decree 36/2017.	**No**	**No**
Prior action #11. The Borrower has allowed the DGT to access information on - and tax - passive income held by Indonesian companies and citizens abroad, as evidenced through the Minister of Finance Regulation 107/2017.	**No**	**No**

ANNEX 5: EVOLUTION OF PRIOR ACTIONS AND TRIGGERS THROUGH THE FISCAL DPL SERIES

<table>
<tr><th colspan="4">Prior Actions and Triggers</th><th rowspan="2">Result Indicators</th></tr>
<tr><th>Prior Actions under DPL 1</th><th>Indicative Triggers for DPL 2</th><th>Prior Actions for DPL 2</th><th>Indicative Triggers for DPL 3</th></tr>
<tr><td colspan="5">Pillar A— Improving Quality of Spending
Program Development Objective A: Improving composition of spending, budget execution and efficiency of spending</td></tr>
<tr><td>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.</td><td>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.</td><td>Prior Action #1. The Borrower has maintained the increased 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 2017 approved Budget Law and the Presidential Regulation 97/2016.</td><td>Indicative Trigger #1. The Borrower has proposed an increase in the share of central government budget allocated to infrastructure, social assistance and health sectors compared to pre-fuel subsidy reform years (2012-2014), and has taken measures in the proposed 2018 Budget to further improve the efficiency of central government spending through “flat budget policy” for material expenditure.</td><td>Result Indicator A1: Sustained increase in the share of central government budget allocated to infrastructure, social assistance and health after fuel subsidy reforms:
• 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
• Final Target (2018):
o Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase): => 4.5 percent
o Health (including health insurance for the poor (JKN): => 7.4 percent
o Infrastructure: => 19.5 percent
Note: Central government share to the above items in the proposed 2018 Budget are as follow:</td></tr>
</table>

				• Social assistance (excluding health insurance for the poor and temporary compensation for fuel price increase) => 3.6 percent • Health (including health insurance for the poor or JKN) => 7.0 percent • Infrastructure (including earmarking 25 percent of general transfer fund for infrastructure)=> 23.1 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 • Final 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 Regulation 190/2015, Head of Bappenas Regulation 4/2015 and Head of LKPP Regulation 19/2015.	**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 support line ministries to do PPPs on the priority list by financing Final Business Case and transaction advisory services.			**Result Indicator A3**: Availability of enabling regulatory framework for Availability Payment Contracts for infrastructure projects with the private sector: • Baseline (2015): No • Final Target (2018): Yes

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% • Final Target: 17%
		Prior Action #2. The Borrower has strengthened the preparation of the Medium Term Expenditure Framework (“MTEF”) by: (a) using the top-down approach to better align line ministries’ medium term spending with the resource envelope; (b) (i) simplifying types of expenditures in the MTEF to operating and non-operating expenditures at program and/or activity level and (ii) imposing restrictions on revisions; and (c)	**Indicative Trigger #2.** The government implements the Ministry of Finance’s regulation (PMK 163/2016) to strengthen the implementation of the medium-term expenditure framework (MTEF) as reflected in the formal 2018 budget document and the Government Regulation (PP 17/2017), to better synchronize the planning and budgeting process by the issuance of implementing	**Result Indicator A5**: Reduced deviation between indicative line ministry expenditure ceiling in a new budget and the forward estimate in the earlier planned budget: • Baseline (2016): 22% (tbc) • Target (2019): < 22% (tbc)

		introducing the requirement that line ministries explain the deviations between a new budget and the earlier planned budget based on policy changes, all as evidenced through the Minister of Finance Regulation 163/2016.	ministerial regulations.	
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.	**Prior Action #3.** The Borrower has continued to enable the increased usage of early procurement, for capital expenditure packages listed in the 2017 Budget Law, as evidenced through the Secretary General of the Ministry of Public Works and Housing's Circular Letter No. PL-0206/Sj/606 dated August 18, 2016.		**Result Indicator A6**: 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% • Final Target (2018): >90%
		Prior Action #4. The Borrower has strengthened subnational fiscal management by: (a) improving the composition of subnational spending by requiring sub-national governments to allocate a minimum 25 percent of DAU and revenue sharing for infrastructure; (b) disbursing DAK based on reports on achievements; and (c) improving DID allocation criteria, as evidenced through the 2017 Budget Law and the Minister of Finance Regulation	**Indicative Trigger #3.** MoF submits to Parliament the draft revision of Law 33/2014 on Fiscal Decentralization including: (a) per capita based allocation, and (b) elimination of basic allocation component thereby improving the effectiveness of inter-governmental fiscal transfers.	**Results Indicator A7**: (a) Increase in the proportion of districts meeting the requirement to spend 25% of DAU and revenue sharing allocations on infrastructure: • Baseline (2016): 42% of districts • Target (2019): 60% of districts Note: In 2016, 42% of individual sub national governments comply with the mandate to spend at least 25% on infrastructure in 2017 and 2018. DG Fiscal Balance confirmed 45% is a stricter definition of infrastructure (capital expenditures excluding those in general government function, and

		112/2017.		deducting DAK Physical). (b) Percentage of DAK physical realization in infrastructure sectors at the end of fiscal year: • Baseline (Nov 2016): 60.5% • Target (2019): >= 70% (c) Average improvement in NER for Junior Secondary School for Districts that received DID: • Baseline (2016): 0.06 percentage point. • Target (2019): 0.08 percentage point
		Prior Action #5. The Borrower has issued consolidated DAK technical guidelines that were previously issued by separate line ministries to accelerate DAK implementation, as evidenced through Presidential Regulation 123/2016.		**Results Indicator A8**: Increased proportion of contracted value of DAK by July of each year. • Baseline (2014): 67% • Target (2019): 80%
Pillar B---Strengthening Revenue Administration ***Program Development Objective B: Increasing tax administration efficiency, compliance management and audit capability***				
Prior Action #6. The Directorate General of Taxes (DGT) 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	**Indicative Trigger #4.** DGT 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	**Prior Action #6.** DGT has strengthened VAT administration by: (a) requiring all corporate taxpayers to use the electronic invoice and electronic VAT returns; and (b) implementing a system that makes VAT returns data available, within 72 hours	**Indicative Trigger #4.** DGT implements a risk-based approach to auditing VAT refund requests by (a) developing a risk management blueprint for VAT refunds (including development of risk profiles), (b) piloting the gradual adoption of risk based VAT	**Result Indicator B1**: Increase in the share of monthly VAT returns filed electronically. Monthly VAT returns: • Baseline: (2014): 0% • Target: (From end 2016 to end 2018): 90% **Result Indicator B2**: VAT refunds

through the DGT Decree 136/2014.	after filing for auditing and analysis of compliance risks.	after filing, for auditing and analysis of compliance risk, as evidenced through DGT Announcement No. Peng-04/PJ.09/2016 dated April 27, 2016.	refund audits.	audited based on objective risk criteria: • Baseline: No VAT risk profiles in place; all VAT refund requests are audited • Target: VAT risk profiles developed; a sample of VAT returns are chosen for pilot use of new risk-based system
Prior Action #7. DGT 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 DGT Regulation 41/2015.	**Indicative Trigger #5.** DGT 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 #7.** The DGT has required the electronic filing of: (a) corporate income tax returns by companies that are VAT taxpayers; and (b) withholding tax returns by select withholding agents, as evidenced through DGT Regulations 3/2015 and 4/2017.	**Indicative Trigger #5.** DGT develops and implements a data integration mechanism that integrates data from withholding tax returns filed electronically with data from VAT returns for the purpose of data matching.	**Result Indicator B3**: Increase in the share of annual individual income tax and corporate income tax returns filed electronically. Individual income tax (simple form) returns: • Baseline (2014 tax year): 27% (2.6 million filed electronically out of a total of 9.8 million returns) • Target (2016 tax year filed in 2017): 48% (5.5 million filed electronically out of an estimated total of 11.5 million 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 #8. DGT has abolished the statement of regional information in the taxpayer identification number so that taxpayers will not receive new tax IDs				**Result Indicator B4:** Reduction in the number of taxpayers with multiple/duplicate IDs that can be used to file returns: • Baseline (2014): 500,000 duplicate 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.				• 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. DGT and the National Land Office (BPN) have implemented an electronic data exchange to enable DGT to access taxpayers' land asset data held by BPN for compliance purposes in a systematic manner.	**Indicative Trigger #6.** DGT and government agencies take measures to increase DGT access to asset registration data and financial data for audit purposes: (a) DGT 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) the Financial Services Authority (OJK) issues a circular to share credit card information with DG Taxes.	**Prior Action #8.** The Borrower has enabled the DGT increased access to financial data for audit purposes by requiring financial institutions to submit a report on financial data to DGT beginning with each individuals' account(s) with a balance of IDR 1 billion or more, as evidenced through the Government Law 9/2017 and the Minister of Finance Regulation 73/2017.	**Indicative Trigger #6.** DGT improves its compliance risk management by adopting a comprehensive 'compliance improvement plan' that: (i) identifies compliance risks with potentially high revenue-impact across different segments (taxpayers by size; type of sector, etc.); (ii) agrees specific actions to bring the identified compliance risks under control; (iii) sets targets for improving compliance across these identified segments.	**Result Indicator B5**: Reduction in the average time taken to receive land asset and access financial information 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 Financial information: • Baseline (2015): no data • Final Target: all financial institutions to submit financial data for audit purposes automatically
Pillar C---Enhancing Tax Policy ***Program Development Objective C: Increasing revenue potential and economic efficiency of tax policy***				
	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		**Indicative Trigger #7.** The Government issues a revision of Government regulation PP 46/2013 that aims to bring in new taxpayers and reduce the number of standard income taxpayers migrating to the final tax regime though a number of measures: a)	**Result Indicator C1**: 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: ○ (end Oct 2015) # of new

	regime.		Voluntary use by taxpayer of the standard income tax regime; b) A sunset clause limiting amount of time using final tax; c) Expand exclusions e.g. to cover professional services, d) Apply special, simplified final tax regime for micro enterprises.	taxpayers who paid final tax: 68,000 ○ (2014) % of previous standard income taxpayers who paid final tax: 13.5% • Target: ○ (end 2017) # of new taxpayers paying final tax: 100,000 ○ (2019) % of previous standard income taxpayers paying final tax: 5%
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.		**Indicative Trigger #8.** Government submits to Parliament for deliberation a draft revision of VAT Law No. 42 of 2009 containing the proposed reforms from the Naskah Akademik VAT: a) Broadening VAT base by rationalizing exemptions and limiting MoF's discretion in granting exemptions; (b) Replacing vehicle LGST with vehicle excise tax; (c) Incorporating remaining LGST goods into VAT regime. And in advance of the submission of the law, MoF issues a PMK that lowers the VAT threshold to 1 billion by 2020 and introduces an option to pay a simplified VAT (turnover tax of 1%) for VAT payers with turnover between 1 billion to 2.5 billion, substantially broadening the VAT base and	**Result Indicator C2**: The VAT regime is revised to reduce the share of final consumption exempt from standard VAT. • Baseline (2015): ○ 16.3% in the current VAT regime • Target (2019)*:* ○ 9.0% in the revised VAT regime **Result Indicator C3**: Replacement of the vehicle LGST with a vehicle excise tax • Baseline (2015): ○ Vehicle LGST in place • Target (2019)*:* ○ Vehicle excise tax established

			providing more information on taxpayers to DGT on VAT threshold.	
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 C4**: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base. • Baseline (2017): Few anti-tax base erosion measures in place: only controlled foreign company (CFC) rule • Target (2019)*:* Increase in anti-tax base erosion measures in place: CFC and thin capitalization rules in place
			Indicative Trigger #9. The Government submits to the Parliament for deliberation the draft revision of the Income Tax Law No. 36 of 2008. The proposed reforms set out to further address tax base erosion and broaden the tax base, including by: (a) introducing an Alternative Minimum Tax (AMT) for corporates; and (b) replacing the general PIT deduction with a non-refundable tax credit.	**Result Indicator C5**: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base. • Baseline (2017): ○ Average rate of growth of nominal NO&G Income Tax revenues 2012-2017: 11.1% ○ General PIT deduction of non-taxable income (PTKP) of IDR54 million (2017) • Target (2019)*:* ○ Average rate of growth of nominal NO&G Income Tax revenues 2012-2017: 15% ○ General PIT deduction removed. Instead, non-refundable tax credit in place with equivalent amounts
		Prior Action #9. The MoF has prevented base erosion and profit shifting by: (a) introducing a limitation of benefits clause to deter	**Indicative Trigger #10.** MoF issues new PMK/PER to strengthen transfer pricing and interest deduction rules by: (a) MoF upgrading PER 32	**Result Indicator C6**: The Income Tax regime is revised to reduce tax base erosion and broaden the tax base. • Baseline (2017): ○ Few anti-tax base erosion

		companies from using treaties for non-economic/business reasons; (b) signing the CBC MCAA, which obliges the Borrower to share tax information aimed at combating harmful tax practices by carrying out country-by-country reporting exchange; and (c) adopting a standardized set of documentation requirements for international taxation, all as evidenced through Minister of Finance Regulation (PMK) No. 213/2016, the CBC MCAA list of signatories and the DGT Regulation 10/2017.	into PMK to strengthen the legal basis for transfer pricing adjustments; (b) issuing/revising regulation to limit interest deduction through an EBITDA rule.	measures in place: only CFC rule • Final Target (2019): ○ Increase in anti-tax base erosion measures in place, including LoB clause in treaties and requirements for standardized documentation.
		Prior Action #10. The Ministry of Finance has: (a) enabled the implementation of APA and MAP dispute resolution mechanisms; and (b) created a sub-directorate dedicated to enable the Borrower to manage international tax disputes, as evidenced through the Minister of Finance Regulation 234/2015 and DGT Decree 36/2017.		**Result Indicator C7**: Increase in number of new APA and MAPs concluded under new rules. • Baseline (2016): c) Number new APAs concluded under old rules (2016): 0 d) Number of new MAP cases under old rules (2016): 39 • Final Target (2019): (c) Number new APAs concluded under new rules (2018): 7 (d) Number of new MAP cases after new rules (2018/2017): 70
		Prior Action #11. The Borrower has allowed the DGT to access information on - and tax -		**Result Indicator C8**: Access to information on passive income

		passive income held by Indonesian companies and citizens abroad, as evidenced through the Minister of Finance Regulation 107/2017.		• Baseline (2016): Average rate of growth of nominal NO&G Income Tax revenues 2012-2017: 11.1% • Final Target (2019): Ceteris paribus, rate of growth of nominal NO&G Income Tax revenues by 2019: 17%
			Indicative Trigger #11. Develop a model treaty for use in double tax agreements (DTA) and the Multi-Lateral Instrument (MLI) negotiations as part of a general treaty policy reform and renegotiate priority country treaties on the basis of this model treaty.	**Result Indicator C9**: Number of treaties negotiated based on model treaty. • Baseline (2016): 0 treaties based on model treaty • Final Target (2019): 6 treaties renegotiated using model treaty