PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

September 14, 2017
Report No.: 119924

Operation Name	Indonesia Fiscal Reform DPL 2
Region	EAST ASIA AND PACIFIC
Country	Indonesia
Sector	Central government administration (80%); Sub-National government administration (20%)
Operation ID	P161475
Lending Instrument	Development Policy Lending
Borrower(s)	GOVERNMENT OF INDONESIA
Implementing Agency	Ministry of Finance
Date PID Prepared	August 20, 2017
Estimated Date of Appraisal	September 14, 2017
Estimated Date of Board Approval	October 31, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation
Other Decision	

I. Country and Sector Background

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 5.2 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.

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.

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 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).

***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*) 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.

II. Operation Objectives

This is the second loan in a proposed three loan series. The 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 focuses on those reforms that are expected to contribute significantly to the overall fiscal reform objectives through the medium-term:

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

- **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. These actions are expected to lead to the following results: Sustained increase in the share of central government actual spending on infrastructure, social assistance and health after fuel subsidy reforms; Reduction in the time taken for central government monthly budget realization data to be publicly available; Availability of enabling regulatory framework for Availability Payment Contracts for infrastructure projects with the private sector; Increase in the proportion of Ministry of Public Works and Housing budget (total) delivered through multi-year contracts; Reduced deviation between indicative line ministry expenditure ceiling in a new budget and the forward estimate in the earlier planned budget; 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; Increase in the proportion of districts meeting the requirement to spend 25% of DAU and revenue sharing allocations on infrastructure; Increase in DAK disbursement in first semester.

- **Pillar B: Strengthening Revenue Administration.** *PDO: Increasing 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. These actions are expected to lead to the following results: Increase in the share of monthly VAT returns filed electronically; VAT refunds audited based on objective risk criteria; Increase in the share of annual individual income tax and corporate income tax returns filed electronically; Reduction in the number of taxpayers with multiple/duplicate IDs that can be used to file returns; Reduction in the average time taken to receive land asset and access financial information requested by DGT for audit use.

- **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. These actions are expected to lead to the following results: 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; Increase in number of new APA and MAPs concluded under new rules; Access to information on passive income improved; Number of treaties negotiated based on model treaty.

III. Rationale for Bank Involvement

The DPL is central to achieving the objectives under the CPF *Collecting More and Spending Better* engagement. The PDOs of the DPL are consistent with and contribute to the development outcomes of the engagement: <u>*Improve revenue collection*</u> *through an increase in the compliance rate for individual and corporate taxpayers); and* <u>*Improve efficiency and*</u>

<u>effectiveness of spending</u> through a rise in the central government spending on health, capital expenditure (proxy for infrastructure), and social assistance and a rise in central budget execution rates of capital spending. The DPL provides an anchor and coordination mechanism for the broader CPF engagement with the government and use of other instruments, including the Bank's knowledge services (analytical work and technical assistance). The revenue administration and tax policy pillars of the DPL also supports the WBG Domestic Revenue Mobilization (DRM) agenda.

The operation builds on fiscal reforms supported by previous DPLs in Indonesia in the last 10 years[5]. These reforms were mostly public financial management reforms in budget preparation, treasury management, accounting and internal auditing, with some tax administration. The Fiscal Reform DPL series takes a deeper focus on infrastructure spending and tax administration than in previous DPLs and includes new areas, in particular budget allocation and tax policy.

IV. Tentative financing

Source:		($m.)
Borrower		0.00
International Bank for Reconstruction and Development		300.00
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	300.00

V. Tranches *(if applicable)*

One tranche operation.

VI. Institutional and Implementation Arrangements

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

VII. Risks and Risk Mitigation

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

The overall risk rating of this operation is substantial. 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. A mitigating factor against these risks will be strong Ministry of Finance commitment and focus, e.g., during the inter-ministerial consultations and Parliament discussions, and ongoing technical assistance provided to the Ministry of Finance on tax administration and policy issues by the World Bank and other development partners. As noted above, these risks must be set against the significant benefits of improved fiscal performance in Indonesia given the challenges the sector poses for improved growth and shared prosperity.

VIII. Poverty and Social Impacts and Environment Aspects

The operation 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 operation have the potential to further improve poverty and inequality reductions. 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.[6]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. [7]

The environmental impacts of the fiscal reform actions supported by the DPL continues 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 is part of the Government of Indonesia's continuous effort to improve connectivity, public health and sanitation including solid waste management. With a better budget system, the central government will be able to monitor and assess the government's infrastructure plans based on government's prioritized project list. Municipal infrastructure investments will result in positive environmental and public health impacts. Investments in energy and transport infrastructure should lead to a more productive economy. Indonesia has the systems in place and has been developing the capacity to avoid or mitigate the negative impacts associated with infrastructure

[6] 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.
[7] Figures are from the Fiscal PSIA prepared for Fiscal DPL 1

investments. The prior actions of the revenue pillar will be environmentally neutral, and the proposed introduction of indicative triggers for a possible third DPL in the series, that relate to a new adjustable fuel excise tax and vehicle excise tax will continue to raise revenues and hence may have direct and indirect positive impacts on the environment. However, further refinement of downstream environmental regulations is needed to ensure externalities from other related sectors activities have been addressed and mitigated.

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