PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

June 12, 2017
Report No.: AB7909

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	June 12, 2017
Estimated Date of Appraisal	September 30, 2017 (tbc)
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 including the possibility of adding a third operation to this DPL series, subject to appropriate triggers.
Other Decision	

I. Key development issues and rationale for Bank involvement

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 is also conservative, with enhanced fiscal credibility, albeit with declining fiscal revenues that this operation seeks to address. The economic outlook remains positive, supported by a projected pick-up in the global economy and recovering commodity prices, carrying both investment and exports.

Poverty and inequality dropped recently, thanks to resilient economic growth and lower inflation. The official poverty rate fell by 0.4 percentage points between September 2015 and September 2016 to 10.7 percent. However, this decline is still lower than the rates of poverty reduction achieved between 2007 and 2011, which averaged 1.1 percentage points annually. The Gini coefficient fell by 0.8 percentage points to 39.4 between September 2015 and September 2016. While government is under increasing pressure to tackle inequality, fiscal policy 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 threshold, 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 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. Itis 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). The government formed a tax reform team ('Tim Reformasi') in December 2016 to support the *Collecting More* effort in the medium-term with intensified, coherent and sustained efforts in both revenue policy and administration.

***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 12 percent of spending or 1 percent of GDP. 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. Proposed Objective(s)

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 in which government initiatives and reforms to support, focusing on those that are expected to

[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, also 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)

contribute significantly to overall fiscal reform objectives through the medium-term.

III. Preliminary Description

The ongoing DPL series is structured around the following three pillars:

- **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) improving the targeting of electricity subsidies; (iii) improving the effectiveness of social assistance programs; (iv) strengthening budget management; (v) improving the effectiveness of intergovernmental transfers; and (vi) improving the effectiveness of subnational spending.
- **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 DG Tax access to taxpayer asset and banking data for audits; (iv) strengthening the risk-based approach to compliance management; (v) investing in the core IT system to support the modernization of tax administration; and (vi) strengthening non-tax revenue administration.
- **Pillar C: Enhancing Tax Policy.** *PDO: Increasing revenue potential and economic efficiency of tax policy* by (i) deepening coordination and enhancing accountability and transparency of the revenue reform agenda; (ii) revising main tax instruments (VAT and luxury goods; Income Tax; Final tax for micro and SMEs; Excise); and (iii) taking regulatory measures against base erosion.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Fiscal policy matters for poverty and inequality reduction, but so far fiscal policy has not had the desired impact. Effective design and implementation of taxation and spending policies can directly and indirectly boost the well-being of the poor and vulnerable. However, a recent study estimated that all taxes and government spending only reduced poverty by 1.6 percentage points and lowered Gini coefficient by 3.4 points in 2014.[5] The low impact of fiscal policy on poverty and inequality is likely due to a low level of spending on social assistance and health, especially on primary health care, as well as a low rate of personal income tax collection. The proposed reforms designated in the first Fiscal DPL in this series, such as increasing the budget earmarked for health and social assistance spending and reducing VAT exemptions for some consumption goods, will contribute modestly to reducing poverty and inequality: an estimated 0.06 and 0.16 percentage points respectively.[6]

[5] 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.

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

Analysis is ongoing on the reform areas in the DPL 2 that may impact poverty and inequality reductions. An overall assessment of the impact of fiscal (tax and spending) reforms is underway, updating the earlier incidence (Commitment to Equity) analysis from DPL1 with recent household data, and will be complete early July. The main individual reform assessed is the reform on improving the quality of subnational spending by requiring local governments to allocate in their budget a minimum 25 percent for infrastructure expenditure.

The poverty and social impacts of a number of indicative triggers under a possible DPL 3 are also considered, including vehicle taxation and lowering of the VAT threshold.

Environment Aspects

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 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.

V. Tentative financing

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

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