



# Program Information Document (PID)

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Concept Stage | Date Prepared/Updated: 24-Sep-2018 | Report No: PIDC25534



**BASIC INFORMATION**

**A. Basic Project Data**

Country Indonesia	Project ID P167297	Project Name Indonesia Fiscal Reform DPL 3 (P167297)	Parent Project ID (if any) P161475
Region EAST ASIA AND PACIFIC	Estimated Board Date Mar 29, 2019	Practice Area (Lead) Macroeconomics, Trade and Investment	Financing Instrument Development Policy Financing
Borrower(s) Government of Indonesia	Implementing Agency Fiscal Policy Agency, Ministry of Finance		

**Proposed Development Objective(s)**

The objective of this operation is to support fiscal sector reforms that will support the Government of Indonesia (GOI) to achieve its medium-term economic development and poverty reduction goals.

The operation aims to do so through supporting reforms in three key policy areas: 1. Revenue Policy - Improving revenue potential by broadening the tax base, simplifying structures and optimizing tax rates; 2. Revenue Administration - Improving revenue collection by strengthening compliance enforcement and lowering compliance costs; and 3. Quality of Spending - Improving the efficiency and effectiveness of public expenditure.

In doing so it is part of the World Bank Group's overall support to the Government's efforts to improve revenue collection and quality of spending, which are central to its overall development agenda.

**Financing (in US\$, Millions)**

**SUMMARY**

<b>Total Financing</b>	300.00
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**DETAILS**

<b>Total World Bank Group Financing</b>	300.00
World Bank Lending	300.00

**Decision**

The review did authorize the preparation to continue



## B. Introduction and Context

### Country Context

**Indonesia's economic fundamentals remain strong and poverty rates have dramatically declined since the Asian financial crisis.** Indonesia's macroeconomic fundamentals continue to remain strong, with robust economic growth, stable inflation and low unemployment, and narrow fiscal deficits. Four credit ratings upgrades since May 2017 corroborate the country's improved economic environment, fiscal management, and overall credit worthiness. Poverty rates have steadily declined, from 24 percent in 1999 to 10.1 percent in 2017, using the national poverty line. The Gini index of inequality has been also easing, at 39.1 in 2017, slightly lower than the 39.4 in 2016.

**However, many development challenges remain. The 2015 Systematic Country Diagnostic<sup>1</sup> identified several pathways to reduce poverty and increase shared prosperity. They include**

- **Addressing the constraints to generate strong growth and jobs**, especially in the private sector: large infrastructure gaps, weak business environment constraining investment, skills gaps that delay Indonesia's move toward higher value-added production in many sectors, and little transformation of agriculture representing a significant drag to overall productivity of the economy.
- **Improving service delivery and opportunity for all.** This is constrained by sub-optimal levels of public spending due to low tax collection, poor spending mix at the central government level (including large energy subsidies), and delivery constraints at the sub-national government level.
- **Improving natural resource management.** Addressing the challenges imposed by remoteness, overexploitation of natural resources, and exposure to climate change and natural disasters.

**The macroeconomic policy framework is considered adequate for the proposed operation.** Strong economic management has helped improve Indonesia's economic fundamentals. The policy mix has been consistent with macroeconomic stability and the management of risks that may arise. The structural reform agenda, if continued, will be able to support inclusive growth and expand potential growth.

### Relationship to CPF

**This proposed operation is the third in a DPL series is intended to support reforms to address these fiscal challenges.<sup>2</sup> It is central to the Indonesia Country Partnership Framework (CPF) "Collecting More and Spending Better" pillar, which aims to support the Government's fiscal reforms.** More specifically, the 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. Indirectly, it will also support an improved business environment. In addition, a stronger focus on human and physical capital investment will contribute to more sustainable growth and job creation in the medium term and will build more financial capacity to manage the impact of climate change and natural disasters.

## C. Proposed Development Objective(s)

**The objective of this operation is to support fiscal sector reforms that will support the Government of Indonesia (GOI) to achieve its medium-term economic development and poverty reduction goals.** The operation aims to do so through supporting reforms in three key policy areas: 1. Revenue Policy - Improving revenue potential by broadening the tax base, simplifying structures and optimizing tax rates; 2. Revenue Administration - Improving revenue collection

<sup>1</sup> *Indonesia Systematic Country Diagnostic : Connecting the Bottom 40 Percent to the Prosperity Generation*, September 2015, World Bank, <https://openknowledge.worldbank.org/handle/10986/23117>

<sup>2</sup> The first two DPLs were approved in May 2016 (P156655, <http://projects.worldbank.org/P156655?lang=en>) and October 2017 (P161475, <http://projects.worldbank.org/P161475?lang=en>), respectively.



by strengthening compliance enforcement and lowering compliance costs; and 3. Quality of Spending - Improving the efficiency and effectiveness of public expenditure. In doing so it is part of the World Bank Group's overall support to the Government's efforts to improve revenue collection and quality of spending, which are central to its overall development agenda.

#### Key Results

**The expected results** are an improved allocation of spending focusing on the priority areas (social assistance, health and infrastructure); an improvement the alignment of planning and budgeting; the piloting of a fiscal allocation for schools in districts and provinces encouraging performance improvements; increased usage of the streamlined VAT refund procedure easing firms' cash flows; the procurement of a new core IT tax system; and expanding the function of the compliance risk management unit; an increase in revenue collected from e-commerce transactions through and from tobacco excise; an increase in fiscal transparency through the publication of tax expenditure statements with estimations of tax revenue foregone; and an increase in the number of bilateral tax treaties negotiated using a new model tax treaty.

#### D. Concept Description

**The DPL is structured around the following three pillars:**

**Pillar A: Improving Quality of Spending.** This pillar will cover policy actions maintaining the increase of spending on priority areas social assistance, health and infrastructure; improving the alignment of planning and budgeting; and increasing the efficiency of education spending by encouraging school performance improvement.

**Pillar B: Strengthening Revenue Administration.** This pillar will cover policy actions streamlining the process to obtain VAT refunds, introducing regulations enabling the procurement and deployment of a new core IT tax system; and establishing a permanent and dedicated new risk analysis unit in charge of taxpayer compliance.

**Pillar C: Enhancing Revenue Policy.** This pillar will cover policy actions applying the VAT to the digital economy, increasing the tobacco excise rate while simplifying the tier structure, introducing a tax expenditure analysis; and developing a new model tax treaty for use in bilateral tax negotiations.

#### E. Poverty and Social Impacts and Environmental Aspects

##### Poverty and Social Impacts

**The overall poverty impact of the DPL is expected to be positive with most of the proposed prior actions are broadly neutral, and some will likely have a direct impact on poverty in the short run.** In particular, the actions to maintain spending in priority areas and to increase the efficiency of spending to encourage school performance improvement have the strongest potential to reduce poverty and inequality. The action to increase tobacco excise may have a negative impact on the poor in the short run through higher prices, but this is expected to be offset by long-run benefits in form of savings on medical expenses and higher productivity if higher tobacco prices can induce behavior change.

##### Environmental Impacts

**The environmental impacts of the fiscal reform actions supported by the DPL series continue to be positive overall.** The DPL operation's proposed prior actions to accelerate and improve the quality of public infrastructure spending. Actions related to priority spending and planning and budgeting may have a positive environmental impact. Other actions are expected to increase fiscal space through increased revenue and may thus help allocate more funds to mitigate environment impact, climate and disaster mitigation.



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**APPROVAL**

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**Approved By**

Country Director:	Yongmei Zhou	12-Oct-2018
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