Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 17-Dec-2021| Report No: PIDC33140

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Indonesia	P177726	Indonesia Fiscal Reform Development Policy Loan (P177726)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
EAST ASIA AND PACIFIC	Apr 27, 2022	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Republic of Indonesia	Ministry of Finance		

Proposed Development Objective(s)

The objectives of this operation are to increase fiscal space for development spending and to improve the efficiency and fairness of the fiscal system.

Financing (in US$, Millions)

SUMMARY

Total Financing	500.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. **Despite impressive advances in development achievement over the last two decades, Indonesia still faces large human capital and infrastructure gaps that impede its competitiveness, and its ability to create jobs and reduce poverty in the medium term.** Indonesia's level of human capital and public infrastructure per capita are far below its aspirations

and below those of its peers. The recent COVID-19 pandemic and constrained fiscal space have exacerbated these challenges. After the poverty rate fell from 19.1 percent in 2000 to 9.4 percent by 2019, the pandemic immediately led to a sharp increase in poverty peaking at 10.2 percent in September 2020 and remaining high at 10.1 percent in March 2021. Cuts to public infrastructure spending to accommodate the COVID-19 fiscal response will lead to delays in infrastructure development, while school closures will erode learning outcomes. Low and volatile public revenues as well as spending misallocations constrain the fiscal space available to government. Tax revenue, at just 8.3 percent of GDP in 2020, has been systematically low compared to peers, as is spending on public investment, health and social protection. Consequently, reforms to tax policy and administration and public expenditure are important prerequisites for government to be able to deliver on its development priorities.

2. **Recently approved and implemented tax and expenditure reforms are expected to increase revenue and the efficiency and effectiveness of government spending.** The government issued Law on Harmonization of Tax Regulations (hereafter Tax Harmonization Law) which expands the tax base, increases tax rates, introduces a carbon tax, and improves the overall fairness of the tax system. The Law on Intergovernmental Finance aims to reform the subnational fiscal transfer system. Public financial management reforms will improve the link between planning and budgeting. These reforms are taking place at the mid-point of the current administration's term (2019-2024).

3. **The macroeconomic policy framework is adequate for the purposes of the proposed operation.** Prudent macroeconomic and fiscal management has resulted in improved economic fundamentals and macroeconomic stability. The authorities' balanced policy strategy of accommodative monetary policy, including fiscal financing, while managing external risks is appropriate in the current exceptional economic circumstances. Implementation of the recently approved Tax Harmonization Law is paramount to improve fiscal space, debt sustainability, and deliver the government's commitment to fiscal consolidation. The authorities also complement these policies with structural reforms, which are important to boost recovery and improve potential growth.

Relationship to CPF

4. **The proposed DPL is aligned with the World Bank's Country Partnership Framework (CPF) FY 21-25 in two engagement areas.** The CPF is built around four engagement areas – strengthen economic competitiveness and resilience; improve infrastructure; nurture human capital; strengthen management of natural assets, natural resources-based livelihoods, and disaster resilience. The proposed DPL contributes to achieving the objectives of *Engagement Area 1: Strengthening Economic Competitiveness and Resilience*. The objectives are achieved through attaining higher revenue collection and fiscal and debt sustainability, as well as through increasing efficiency, equity and effectiveness of spending. The pandemic resulted in a higher primary deficit, an elevated debt level and, in turn, a rising interest expense burden, which have all reduced the fiscal space available for recovery spending. The proposed reforms under this DPL will support a resilient recovery along with a sustainable fiscal framework. The proposed DPL also contributes to *Engagement Area 2: Improving Infrastructure* by supporting achievement of *Objective 2.2 – Transition to Low Carbon Energy and Attain Universal Access to Reliable and Sustainable Energy* through the introduction of a carbon tax.

C. Proposed Development Objectives

5. **The objectives of this operation are to increase fiscal space for development spending and to improve the efficiency and fairness of the fiscal system.**

Key Results

6. **The expected results** are: an increase in VAT revenue, increased PIT revenue from Indonesia's highest income earners, taxation of carbon emissions, and improved tax compliance, a more equitable allocation of subnational transfers, reduced deviation between the government work plan and budget, and a reduction in the number of spending with small capital budget allocations.

D. Concept Description

7. **The proposed operation consists of two pillars aligned with the program development objectives:**

- *Pilar 1: to increase tax revenue and improve the overall fairness of the tax system by broadening the base (including through a carbon tax), increasing rates.* Several prior actions will increase revenue by broadening the tax base, by eliminating VAT exemptions, by increasing consumption taxes on all households and income taxes on the ultra rich, by facilitating tax compliance, and by introducing a carbon tax.
- *Pillar 2: To strengthen institutions for a better integration of planning and budgeting of expenditures and the legal framework for a more equitable distribution of fiscal transfers*. The prior actions will increase the efficiency of spending by improving capital budget execution and by increasing the efficiency, accuracy and transparency of budget planning and implementation, and increase the effectiveness of spending by improving the allocation of resources to subnational governments and by better aligning planning and budgeting.

8. **The proposed policy matrix is aligned with the Ministry of Finance's 2020-2024 strategy.** The Ministry of Finance (MoF)'s strategic plan 2020-2024 includes five policy directions: 1) sound and sustainable fiscal management; 2) optimum state revenues; 3) management of quality state expenditures; 4) management of treasury, state assets, and accountable and productive financing with controllable risks; and 5) an agile, effective and efficient bureaucracy and public services. Pillar 1 of the proposed policy matrix is aligned with MoF Policy Directions 1 and 2, while pillar 2 of the proposed matrix is aligned with MoF Policy Direction 3.

E. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

9. **The overall poverty impact of the DPL is likely to be positive in the long term, but steps should be taken to mitigate negative short-term impacts.** The prior actions are expected to generate additional government revenues that could finance new infrastructure development and improve the access to, and quality of, basic public services. This would generate long-term social economic benefits, and contribute to poverty reduction and sustainable development, while improving access to markets, jobs, and public services. However, action should also be taken to mitigate the short run negative impacts of the supported reforms. The increase of the VAT rate and the removal of VAT exemptions may have distributional consequences, but negative impacts could be offset by increased social assistance spending targeted at poor and vulnerable households, using part of the additional revenue generated. In the short term, the introduction of the carbon tax has the potential to reduce employment creation and wages as well as an increase in poverty. However, the reduction in carbon can increase life expectancy, lower health expenditure burdens, and improve productivity by reducing losses of working days due to air related sickness. The team will analyze the distributional impact of the carbon tax in the short and medium term.

Environmental, Forests, and Other Natural Resource Aspects

10. **Four of the reform actions under this DPL are expected to have overall positive impacts on the environment.** The removal of VAT exemptions for mining and gas and oil drilling and the introduction of a carbon tax will potentially reduce the direct impacts of extractive industries on the environment, forests, and other natural resources, as well as reduce emissions of carbon and air pollutants. The former reform may create a risk of cutbacks in the environmental budgets of extractive industries, but this can be mitigated by diligent monitoring and enforcement of management and reporting requirements. The benefits of the latter reform can be further enhanced through faster development of Carbon Tax Roadmaps in sectors beyond coal-fired powerplants and raising the carbon tax rate to a more level that reflects the negative externalities of carbon emissions. Reforming the General Allocation Grant (DAU), strengthening the link between planning and budgeting, and consolidating spending units to improve capital budget execution could lead to improved alignment of public funding allocations with government priorities in climate change mitigation and resilience. However, the former reform could lead to a weakening of environmental monitoring and enforcement functions in districts that will experience a reduction in subnational transfers. This could be mitigated through “safe harbor” provisions that are already in the proposed legislation, augmented by a phase-in implementation period that the Bank has recommended.

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APPROVAL

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