Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: PGD59

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF JPY 110,795 MILLION (US$ 1,000 MILLION EQUIVALENT)

TO

THE REPUBLIC OF INDONESIA

FOR THE

THIRD INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN

April 11, 2019

Macroeconomics, Trade and Investment Global Practice
East Asia and Pacific Region

REPUBLIC OF INDONESIA GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of February 28, 2019)

Currency Unit: Rupiah (IDR)

US$ 1.00 = IDR 14,065

US$ 1.00 = JPY 110.795

JPY 1 = IDR 127

ABBREVIATIONS AND ACRONYMS

AAUI	Asosiasi Asuransi Umum Indonesia (General Insurance Association of Indonesia)
ADB	Asian Development Bank
AMT	Alternative Minimum Tax
ASA	Advisory Services and Analytics
ASEAN	Association of Southeast Asian Nations
APA	Advanced Pricing Agreement
AFD	Agence Française de Développement
Bappenas	Badan Perencanaan Pembangunan Nasional (National Development Planning Agency)
BEPS	Base Erosion and Profit Sharing
BI	Bank Indonesia
BKKBN	Badan Kependudukan dan Keluarga Berencana Nasional (Demography and Family Planning Agency)
BKF	Badan Kebijakan Fiscal (Fiscal Policy Agency, MoF)
BOP	Balance of Payments
BOS	Bantuan Operasional Sekolah (School Operational Grant)
BP	Basis point (bp)
BPK	Badan Pemeriksa Keuangan (Supreme Audit Agency)
BPNT	Bantuan Pangan Non-Tunai (Non-cash Food Assistance)
BPS	Badan Pusat Statistik (Central Bureau of Statistics)
CIT	Corporate Income Tax
CFC	Controlled Foreign Companies
CPF	Country Partnership Framework
CPI	Consumer Price Index
COTS	Commercial-Off-the-Shelf
CPS	Country Partnership Strategy
DAK	Dana Alokasi Khusus (Special Allocation Fund)
DAU	Dana Alokasi Umum (General Allocation Fund)
DBH	Dana Bagi Hasil (Revenue Sharing)
DPL	Development Policy Loan
DGT	Directorate-General of Taxation
DRM	Disaster Risk Mitigation
DRFI	Disaster Risk Financing and Insurance
DSA	Debt Sustainability Analysis
DTA	Double Tax Agreement
NO&G	Non-oil and Gas
MAP	Mutual Agreement Process
MDTF	Multi Donor Trust Fund
MLI	Multi-lateral Instrument
MNE	Multi National Enterprise
MoF	Ministry of Finance
MoH	Ministry of Health
MoHA	Ministry of Home Affairs
MoSA	Ministry of Social Affairs (Kemensos)
MSME	Micro, Small, and Medium Enterprise
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
Naskah Akademik	White Paper
NDC	Nationally Determined Contributions
OECD	Organization for Economic Co-operation and Development
PBI-JKN	Penerima Bantuan Iuran-Jaminan Kesehatan Nasional (Subsidized Health Premium)
PCN	Project Concept Note
PDF	Project Development Facility
PDO	Program Development Objective
Per Pres	Presidential Regulation
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PFM-MDTF	Public Financial Management-Multi Donor Trust Fund
PIT	Personal Income Tax
PKH	Program Keluarga Harapan (Conditional Cash Transfer/Family Hope Program)
PLN	Perusahaan Listrik Negara (State Electricity Company)
PMK	Peraturan Menteri Keuangan (Ministry of Finance Regulation)
PMQA	Project Management and Quality Assurance
PP	Peraturan Pemerintah (Government Regulation)
pp	Percentage point
PPP	Public-private Partnerships
PROSPERA	Australia Indonesia Partnership for Economic Development

EBITDA	Earnings before Interest, Tax, Depreciation, and Amortization
EOP	End of Period (eop)
ESS	Environmental and Social Standards
FDI	Foreign Direct Investment
FMIS	Financial Management Information System
FY	Fiscal Year
GDP	Gross Domestic Product
GDI	Gross Domestic Income
GHG	Green House Gas
GoI	Government of Indonesia
G.R.	Government Regulation (Peraturan Pemerintah Republik Indonesia or PP)
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
IDR	Indonesian Rupiah
IMF	International Monetary Fund
IT	Information and Technology
JAMKESMAS	Health Insurance for the Poor
JICA	Japan International Cooperation Agency
JPY	Japanese Yen
KEM-PPKF	Kerangka Ekonomi Makro dan Pokok-pokok Kebijakan Fiskal (Macroeconomic Framework and Fiscal Policy Principles)
KIS	Kartu Indonesia Sehat (Indonesia Smart Card)
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
LPG	Liquified Petroleum Gas
	(AIPEG)
PSIA	Poverty and Social Impact Analysis
(R)APBN	(Rencana) Anggaran Pendapatan dan Belanja Negara ((Proposed) State Budget)
Renas PB	Rencana National Penanggulangan Bencana (National Disaster Management Plan)
RPJMN	Rencana Pembangunan Jangka Menengah Nasional (National Medium-term Development Plan)
RPJPN	Rencana Pembangunan Jangka Panjang Nasional (National Long-term Development Plan)
SCD	Systematic Country Diagnostics
SEMEFPA	Support for Enhanced Macro and Fiscal Policy Analysis
SEADRIF	Southeast Asia Disaster Risk Insurance Facility
SIKD	Sistem Informasi Keuangan Daerah (Regional Financial Information System)
SJSN	Sistem Jaminan Sosial Nasional (National Social Security System)
SN-FMIS	Sub-national Financial Management Information Systems
SOE	State-Owned Enterprise
SOP	Standard Operating Procedure
SPAN	Sistem Perbendaharaan dan Anggaran Negara (Integrated Financial Management System)
Susenas	Survei Sosial dan Ekonomi Nasional (National Socio-economic Survey)
TA	Technical Assistance
TAP	Tax Amnesty Program
TADAT	Tax Administration Diagnostic Tool
TES	Tax Expenditure Statement
TTM	Tax Treaty Model
US$	United States Dollar
VAT	Value Added Tax
WB(G)	World Bank (Group)
yoy	Year-on-year

Regional Vice President:	Victoria Kwakwa
Country Director:	Rodrigo A. Chaves
Practice Directors:	Lalita Moorty, Deborah Wetzel
Practice Managers:	Ndiame Diop, Alma Kanani
Task Team Leaders:	Derek Hung Chiat Chen, Daniel Alvarez Estrada, Ralph Van Doorn

TABLE OF CONTENTS

The Indonesia Third Fiscal Reform Development Policy Loan was prepared by a World Bank team led by Derek H. C. Chen, Daniel Alvarez Estrada and Ralph Van Doorn, and comprising of Abigail, Arun Arya, Dwi Endah Abriningrum, Rythia Afkar, Jaffar Al Rikabi, Miguel Eduardo Ceara Asuad, Evarist Baimu, Francis Addeah Darko, Ria Nuri Dharmawan, Ahmad Zaki Fahmi, Bintoro Suryo Hutomo, Ahya Ihsan, Cynthia Clarita Kusharto, Amy Chua Fang Lim, Jan Loeprick, Ornsaran Pomme Manuamorn, Jonathan Leigh Pemberton, Hari Purnomo, Silviana Puspita, Alief Aulia Rezza, Dhruv Sharma, Chau-Ching Shen, Benedikt Lukas Signer, Yulita Sari Soepardjo, Unggul Suprayitno, Kathleen Anne Whimp, Andri Wibisono, Retno Widuri, Noah Yarrow and Jian Vun. Comments and input were also gratefully received from Frederico Gil Sander (Lead Economist), Yongmei Zhou (Program Leader), Theo Thomas and Dorsati Madani (OPCS). The team gratefully acknowledges the excellent collaboration of the Government of Indonesia, and the comments of peer reviewers: Oleksii Balabushko (Senior Public Finance Specialist), Sebastian Eckardt (Program Leader) and Marijn Verhoeven (Lead Economist). The team benefited from guidance from Rodrigo A. Chaves (Country Director), Ndiame Diop (Practice Manager, MTI), Alma Kanani (Practice Manager, GOV), Rolande Pryce (Operations Manager, Indonesia) and Yogana Prasta (Operations Adviser, Indonesia).

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P167297	Yes	3rd in a series of 3

Proposed Development Objective(s)

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

This programmatic DPL series comprises of three pillars and PDOs:
Pillar A: Improving Quality of Spending. PDO: Improving the composition of spending, budget execution and efficiency of spending
Pillar B: Strengthening Revenue Administration. PDO: Increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes
Pillar C: Enhancing Tax Policy. PDO: Increasing revenue potential and economic efficiency of tax policy

This Development Policy Operation 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.

Organizations

Borrower:	REPUBLIC OF INDONESIA
Implementing Agency:	FISCAL POLICY AGENCY, MINISTRY OF FINANCE

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**1,000.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	1,000.00

INSTITUTIONAL DATA

Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Target
1. Number of PBI-JKN subsidized health insurance premium recipients	86.4 million (2014)	93 million (2020)
2. Share of ministries and agencies covered by disaster risk insurance (out of 87)	0 percent (2018)	6 percent (2020)
3. Share of ministries and agencies undertaking budget tagging for climate change adaptation (out of 87)	9 percent (2018)	14 percent (2020)
4. Number of districts and provinces piloting the new chart of accounts during the 2021 budget preparation (out of 542)	0 (2018)	10 (2020)
5. Share of VAT refund requests subject to the streamlined refund procedure, from total VAT refund requests	14.17 percent (2017)	30.6 percent (2020)
6. Status of creation of the new risk management unit (Data Management Team, Directorate level)	Non-existent (2017)	New risk management unit created (Data Management Team) (2020)
7. Share of 2017 MSME taxpayers who are filing as part of the general income tax regime	1 percent (2017)	3 percent (2020)
8. Share of tax expenditures by regulation whose revenues foregone are estimated in the Budget Financial Notes out of the identified total number	0 percent (2017)	30 percent (2020)
9. Number of treaties negotiated based on model tax treaty	0 (2017)	4 (2020)

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

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed Development Policy Loan (DPL) aims to support the Government of the Republic of Indonesia's priorities on improving the quality of spending, strengthening revenue administration and enhancing revenue potential to further the country's medium-term economic development and poverty reduction goals.** The proposed operation, in the amount of US$ 1 billion equivalent, is the third in a programmatic series of three single-tranche operations,[1] that support critical policy and institutional reforms with three development objectives: (A) improving the composition of spending, budget execution and efficiency of spending; (B) increasing tax administration efficiency, compliance management and audit capability, and reducing the cost of paying taxes; and (C) increasing revenue potential and economic efficiency of tax policy.

2. **While Indonesia has a sound macroeconomic framework, a slew of natural disasters in the second half of 2018 created an unanticipated financing requirement for the Government**. Preliminary estimates of the impact from the West Nusa Tenggara (Lombok) earthquakes and the Central Sulawesi (Palu) earthquake and tsunami, amounted to at least US$ 2.2 billion in direct damages and US$ 0.8 billion in economic losses. Total reconstruction needs are projected at about US$ 3.4 billion (0.3 percent of GDP) between 2019 and 2021.[2] These amounts exclude damages and losses from the Sunda Strait tsunami (Anak Krakatau), estimates of which were not yet available at the time of this operation's finalization. To meet this unforeseen financing requirement while preserving its strong fiscal position, the Government has requested a loan in the amount of US$ 1 billion equivalent.[3]

3. **The Government has remained committed to the implementation of the actions supported by the proposed operation in a challenging political environment and has a strong track record of effective implementation of fiscal reforms.** This third operation supports the continuation of fiscal reform efforts. Despite some delays to proposed legislations, in the run up to presidential and legislative elections in April 2019, momentum has been sustained on all three pillars of the supported reform program. Such reforms have already led to a turnaround in revenue performance, with revenues rising 18.8 percent in 2018, the largest increase since 2011. In addition, the tax-to-GDP ratio rose to 10.3 percent from 9.9 percent in 2017, after five years of year-on-year declines. Estimates indicate that reforms supported by the DPL series have contributed 0.6 percent of GDP of additional tax revenue in 2018 and will further increase revenue collections by an annual average of 0.8 percent of GDP over the medium term. Despite the imminent elections, the Government has expanded the scope of the reform

[1] The two Fiscal Reform DPLs were approved in May 2016 (World Bank, 2016a) and October 2017 (World Bank, 2017a), respectively.
[2] See Government of Indonesia (2018c) and Government of Indonesia (2019) for estimates of reconstruction costs for public and private assets from preliminary post-disaster needs assessments.
[3] DPL financing highlights support for the government reform program contained in the operation and bolsters prudential debt management by reducing the reliance on Eurobonds and portfolio flows, which are uncertain in the current global financial environment.

program with this third operation to include actions on improving natural disaster and climate resilience and fiscal transparency, as additional avenues to further enhance the quality of spending and revenue collection.

4. **The operation endorses Indonesia's continued sound macroeconomic management in the context of global financial volatility in 2018 and elections in 2018 and 2019.[4]** Indonesia's macroeconomic fundamentals remain strong, with robust economic growth, stable inflation, strong labor market conditions, narrow fiscal deficits and low debt. Indonesia's sovereign credit is rated investment grade by four major credit ratings agencies with upgrades since May 2017, corroborating the country's improved economic environment, fiscal management, and overall creditworthiness (Section 2.1). Poverty rates have steadily declined, reaching record lows at 9.7 percent in September 2018. Inequality has also continued to moderate. In addition, decisive monetary policy tightening, together with coordinated prudent fiscal and exchange rate policies, successfully steered the economy to calmer waters in the face of global financial volatility in 2018.

5. **The proposed operation is aligned with Indonesia's 2015 Systematic Country Diagnostic.** The 2015 Systematic Country Diagnostic[5] identified several pathways to reduce poverty and increase shared prosperity. They include: (i) addressing the constraints to generate stronger growth and jobs – such as the large infrastructure gap, weak business environment with numerous entry barriers, the skills gaps, and little transformation of agriculture that exerts a significant drag to overall productivity of the economy; (ii) improving service delivery and opportunity for all - which is constrained by sub-optimal levels of public spending due to low tax collection, poor spending mix at the central government level, and spending and delivery constraints at the sub-national government level; (iii) improving natural resource management - addressing the challenges imposed by remoteness, overexploitation of natural resources and exposure to climate change and natural disasters.

6. **This DPL series is also aligned with the FY 16-20 Country Partnership Framework (CPF) for Indonesia.[6]** It contributes mainly to the "Collecting More and Spending Better" Engagement Area**,** which supports the Government in addressing key policy and institutional bottlenecks to improve the quality of spending, strengthen revenue administration and enhance tax policy. Specific Prior Actions also contribute to other Engagement Areas--"Sustainable landscape management" and "Delivery of local services and infrastructure"-- and to Supporting Beams--"Shared prosperity, equality and inclusion" and "Leveraging the private sector: investment, business climate and functioning of markets".

7. **Increasing the quality of spending remains a priority to achieve the Government's medium-term development goals, despite recent progress.** The Government needs to improve the quality of its public expenditure if it is to achieve its development goals. Between 2015 and 2018 the Government had maintained a higher spending share on priority infrastructure, health, and social assistance, relative to the 2012-14 period thanks to a significant reduction in fuel subsidies, and the 2019 Budget projects a continuation of this trend. This has led to the creation of new public assets, including housing, transport and rural electrification; led to an expansion of the population coverage under the JKN, the Indonesian national health insurance; and the expansion of the Family Hope (PKH) conditional cash transfer program, which has helped improve school attendance and utilization of preventative health care services. However, low technical efficiency of spending can hinder further developmental benefits

[4] Indonesia held regional elections in 2018 and is holding General Elections, which include the Presidential Election, in 2019.
[5] World Bank (2015a).
[6] Discussed by the Board of Directors on December 5, 2015. Report No. 99172. World Bank (2015b).

from higher spending in priority sectors. Therefore, continuous improvements in budget planning and execution at central and sub-national levels and timely availability of standardized sub-national fiscal data are needed to ensure that increases in budget allocations for key sectors translate into improved outcomes.

8. **Reforms to collecting more revenue are also crucial to increase potential growth and provide basic services for all.** While improving the quality of spending is important for supporting priority development areas, there are constraints imposed by Indonesia's limited public spending envelope. Indonesia's public spending stood at 14.8 percent of GDP in 2018, compared to an average of 35.4 percent of GDP in other emerging markets. Given the fiscal rule to keep the deficit below 3 percent of GDP,[7] increasing public expenditure significantly is only possible if more revenue is collected. Despite recent improvement in revenue collection, Indonesia's tax-to-GDP ratio of 10.3 percent of GDP in 2018 is still one of the lowest among its regional and emerging market peers.[8] In addition, the country has one of the largest gaps between actual and potential revenue, with collection rates estimated to be less than 50 percent of potential tax revenues.[9] The low revenue-to-GDP ratio has also been due to weaker oil prices,[10] a large informal economy,[11] weak revenue administrative capacity, partly due to an outdated and inadequate core tax IT system, and tax policy gaps. Tax policy and administration reforms, including those supported by this operation, are needed to increase the tax-to-GDP ratio over the medium term, and to create fiscal space for spending on development priorities and for achieving development outcomes.

9. **Finally, improved resilience to natural disasters and climate change is critical for achieving Indonesia's development goals**. Indonesia is amongst the countries with the most natural disasters in the world, with hydrometeorological and climatic disasters, such as floods and droughts, making up 70 percent of disaster occurrences, and these are projected to increase with climate change. With the second longest coastline in the world, Indonesia also faces high risks from sea-level increases and coastal inundation that may affect up to 42 million people living in low laying coastal zones, which includes both rural and urban areas.[12] The central government currently spends between US$ 300 and 500 million (0.03-0.05 percent of GDP) annually on post-disaster reconstruction.[13,14] The cost of replacing or restoring public infrastructure, most of which are uninsured, is likely to increase with climate change, thus placing a significant burden on public expenditure. At the same time, changes in rainfall and temperature patterns are also associated with potentially higher public health risks from climate-sensitive diseases such as diarrhea, dengue and malaria.[15] Building resilience to natural disasters and climate change, through improved infrastructure, health and social assistance, complemented by a national-level risk financing strategy, will help vulnerable populations better

[7] 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.
[8] As a comparison, with similar tax rates to Indonesia, the Philippines collects 13.7 percent of tax-to-GDP; Cambodia collects 15.3 percent, and Malaysia collects 13.8 percent.
[9] See Mooij, Nazara and Toro (2018) and Fenochietto and Pessino (2013).
[10] Revenues fell by approximately 1.6 percentage points of GDP from 2014-2015 due to the oil price collapse.
[11] Informality is estimated at 57 percent of the workforce.
[12] GFDRR (2016).
[13] *Ibid.*
[14] Damages from natural disasters last year were exceptional and will therefore exceed by several fold the typical US$300-500 annual expenditure on post disaster reconstruction.
[15] Government of Indonesia (2016a).

prepare for shocks and withstand the impacts of short-term extreme weather events and slow-onset climate-related hazards, such as sea-level rise.

10. **Political developments and risks.** The Government implemented the reforms supported by this operation during the run up to the general elections of April 2019. During this time, overall macroeconomic-fiscal policies have remained coordinated and prudent. Structural reforms and policy improvements include the micro, small and medium-sized enterprises (MSME) tax reform and the recently launched Disaster Risk Financing and Insurance Strategy. However, there were also delays in the adjustment of retail fuel prices and postponement of politically sensitive reforms on tax policy and subnational transfers. Risks to successfully achieving the development objectives post elections remain substantial, and it is important for the World Bank to continue its capacity enhancement, technical assistance and policy dialog with the Government to help sustain reform momentum.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

11. **Indonesia's economic fundamentals continue to be sound.** After 6 years of adjusting to lower commodity prices, economic growth strengthened in 2018 to 5.2 percent, the highest in 5 years, on the back of solid domestic demand (Table 1). Private consumption edged up to a 4-year high on the back of low inflation and strong labor market conditions. Similarly, investment growth surged to a 6-year high in 2018 due to favorable domestic financing conditions and relatively robust commodity prices, particularly during the first half of the year. Government consumption growth more than doubled partly due to strong social assistance spending. In contrast to 2017, net exports contracted in line with weaker external conditions and strong capital goods imports. On the production side, the service sector continues to dominate growth. Labor market conditions also remained strong in 2018 with the employment rate reaching a two-decade high, matched by the unemployment rate falling to a 20-year low of 5.3 percent. Reflecting sound economic conditions, the poverty rate fell to a record low of 9.7 percent in 2018.

12. **The external sector has recovered from the global financial volatility that negatively impacted emerging market economies last year.** Largely due to strong capital goods imports that are commensurate with robust investment growth, the current account deficit widened to 3.0 percent of GDP in 2018, nearly double of that in 2017. While the surplus on the capital and financial accounts shrank from 2.8 percent in 2017 to 2.4 percent of GDP in 2018, there was a notable turnaround in Q4 with a rebound of portfolio investment amounting to US$ 10.4 billion, signaling a potential sustained recovery in global investor appetite for Indonesian financial assets. In line with the reversal of capital flows, the Rupiah recovered from a trough of IDR 15,237 per US$ in October last year and has hovered around 14,000 to the US$ for the most of this year. Correspondingly, international reserves rebounded from a low of US$ 114.8 billion at the end of September 2018 to reach US$ 120.7 billion in December, equivalent to 6.3 months of imports of goods and services (Table 1).

Table 1. Key Macroeconomic Indicators

	2016 Actual	2017 Actual	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Real economy							
Real GDP (% change)	5.0	5.1	5.2	5.2	5.3	5.3	5.4
Private Consumption (% change)	5.0	5.0	5.1	5.2	5.2	5.2	5.3
Government Consumption (% change)	-0.1	2.1	4.8	5.2	5.4	5.4	5.8
Gross Fixed Investment (% change)	4.5	6.2	6.7	6.5	6.7	6.8	6.6
Exports (% change)	-1.7	8.9	6.5	6.0	6.4	6.8	7.0
Imports (% change)	-2.4	8.1	12.0	8.0	8.2	8.3	8.5
Unemployment Rate (%)	5.6	6.6	…	…	…	…	
CPI (year-average, %)	3.5	3.8	3.2	3.2	3.2	3.2	3.4
Fiscal accounts of Central Government, percent of GDP							
Revenues	12.5	12.3	13.1	13.5	13.6	13.7	13.8
of which tax revenue	10.4	9.9	10.3	10.8	11.1	11.3	11.4
Expenditures	15.0	14.8	14.8	15.4	15.6	15.8	15.8
Fiscal Balance	-2.5	-2.5	-1.8	-1.9	-2.0	-2.0	-2.0
Central Government Debt	28.3	29.4	29.8	29.6	29.3	28.9	28.6
Selected monetary accounts							
Policy Interest Rate	4.6	3.3	5.1	…	…	…	…
Balance of Payments, percent of GDP unless indicated otherwise							
Current Account Balance	-1.8	-1.6	-3.0	-3.0	-2.8	-2.5	-2.6
Exports, Goods and Services	18.0	19.1	20.0	19.8	19.4	19.1	18.7
Imports, Goods and Services	-17.1	-18.0	-20.8	-20.4	-20.1	-19.7	-19.6
Net Foreign Direct Investment	1.7	1.8	1.3	1.7	1.8	1.8	1.8
Gross Reserves (months of imports of goods and services)	7.6	7.2	6.3	6.2	6.2	6.3	6.4
Terms of Trade	1.5	0.3	-5.3	…	…	…	…
Exchange Rate (IDR per US$, average)	13,308	13,381	14,250	…	…	…	…
GDP nominal in US$ (billions)	933	1,002	1,041	1,122	1,208	1,308	1,415

Note: While broadly in line, the above macroeconomic projections account for actual Q4 2018 data and hence differ slightly from the numbers in the IMF Assessment Letter (Annex 2).
Source: Ministry of Finance, Bank Indonesia, World Bank staff projections for 2018-2022

13. **The economy has benefited from a coordinated and prudent policy framework.** In response to global financial volatility and reflecting the Government's focus on maintaining external stability, Bank Indonesia decisively hiked the policy rate 5 times leading to a cumulative increase of 175 basis

points in 2018, despite annual inflation being the lowest on record. Echoing the emphasis on stability, Indonesia's fiscal position continued to strengthen in 2018. Largely due to ongoing revenue reforms and better compliance, revenues surged 18.8 percent in 2018 compared to 2017, the largest increase since 2011. As a result, revenue and tax ratios also reached recent highs in 2018 - 13.1 percent and 10.3 percent of GDP, respectively. At the same time, expenditures were contained, with immediate disaster expenditure due to the three natural disasters in late 2018 being executed within the approved budget envelope using contingency funds. As a result, the fiscal deficit shrank to 1.8 percent of GDP, the lowest since 2011.

14. **The stock of total central government debt is low and contingent liabilities are manageable, as reflected by the investment-grade rating by major ratings agencies.** The stock of total central government debt in 2018 reached 29.8 percent of GDP, well below the legal threshold of 60 percent, and below the level of its regional and emerging market peers. With 58 percent of debt denominated in local currency and only 11 percent due in the short-term, refinancing and exchange rate risks are contained. Total non-financial state-owned enterprise debt amounted to 5.4 percent of GDP by Q3 2018. Exposure to explicit contingent liabilities in the form of guarantees on PPP projects amounted to 1 percent of GDP in 2018, below the guarantee ceiling, which is mitigated by the Indonesia Infrastructure Guarantee Fund (IGGF) for guarantee risks. Indonesia's exposure to contingent liabilities from natural disasters is mitigated partly by a budget contingency for unexpected spending, while 2019 will see the first step in insuring public assets to natural disasters (Prior Action #2), as part of a new Disaster Risk Financing and Insurance Strategy (Box 1). Four major credit ratings agencies consider Indonesia's sovereign credit investment grade, all of which upgraded their ratings since May 2017,[16] corroborating the country's improved economic environment, fiscal management, and overall creditworthiness.

15. **Reforms linked to this DPL series have contributed to a turnaround in revenue performance, but there is considerable space to strengthen the tax ratio further.** After five years of year-on-year declines, Indonesia's tax-to-GDP ratio increased in 2018 by 0.4 percentage points to 10.3 percent, up from 9.9 percent in 2017. If redemption fees from the one-off Tax Amnesty Program (TAP) are excluded from 2016 and 2017 numbers, the 2018 ratio can be seen to be an even bigger improvement from both 2016 (9.5 percent) and 2017 (9.8 percent). It is estimated that improvements in tax policy and administration supported by the DPL series contributed about 0.6 percent of GDP in 2018. Nevertheless, Indonesia is still collecting significantly less revenues than comparable countries, with empirical evidence suggesting that countries with a tax-to-GDP ratio of less than 12.75 percent grow more slowly, due to a shortage of productive government spending.[17] There remains, thus, considerable space to strengthen the tax ratio further, and some of these needed gains will come from reforms captured in this third operation.

16. **The 2019 Budget projects a continued improvement in the composition of spending, while creating space for disaster reconstruction expenditure.** In line with Prior Action #1, the 2019 Budget maintained a higher allocation for priority areas such as infrastructure, health, and social assistance to accelerate infrastructure and human capital development. The government has doubled the benefit level of the conditional cash transfer program (PKH), following the rapid expansion of its coverage from 6 million in 2017 to 10 million beneficiary families in 2018. The government is also further expanding

[16] Standard and Poor's (BBB-), Fitch (BBB), Moody's (Baa2), and the Japan Credit Rating Agency (BBB).
[17] Gaspar and Wingender (2016). Indonesia is one of the countries included in the sample.

the coverage of the waiver for health insurance premium (PBI) for the poor; and continuing the transformation of streamlining the rice for the poor program through implementation of non-cash food assistance (BPNT). The budget for energy subsidies in 2019 is stable compared to the actual 2018 spending and is consistent with the formula-based fuel adjustment mechanism. Moreover, a policy successfully encouraging a structural shift in demand away from subsidized to unsubsidized fuels will reduce the potential subsidy bill over time.[18] However, it is important that retail prices are adjusted regularly to reflect global price movements to avoid passing the burden of implicit subsidies to the state-owned oil and electricity companies,[19] while protecting the poor and vulnerable from price fluctuations. This will protect priority spending, encourage more efficient production and consumption of energy, and limit pressure on the current account through fuel imports. The three natural disasters occurred late in the 2019 budget cycle, and only preliminary estimates of the damage and losses were available at the time of the budget approval. The initial response was to increase the budget contingency for natural disasters for 2019,[20] and issue a regulation to accelerate the disbursements of DAK (Special Allocation Fund) transfers to subnational governments and give them more flexibility for post-disaster responses in 2018 and 2019.[21] Further reallocations and funds disbursements may occur.[22]

Figure 1a. Revenue and grants, Ministry of Finance medium-term projections and actuals *(IDR trillion)*

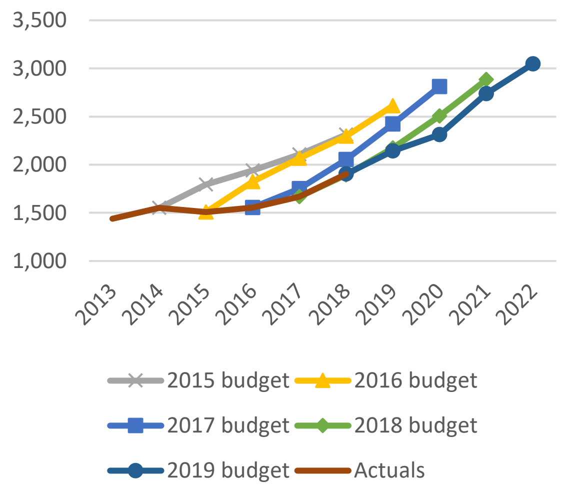
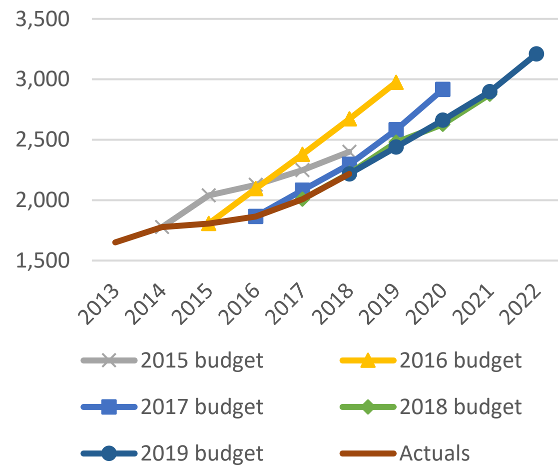


Figure 1b. Total expenditure, Ministry of Finance medium-term projections and actuals *(IDR trillion)*



Note: Forecasts shown are the simple average between the high and low forecasts published in the Financial Notes.
Source: Financial notes of the 2015 to 2019 budgets, staff calculations

[18] The Government encouraged a major structural shift in the demand for fuel from subsidized to non-subsidized grades of fuel by reducing the availability of the subsidized (RON 88) at filling stations. The strategy has proven effective with the share of the RON 88 in sales mix falling by around half from 2016 to 2017.
[19] Incomplete retail price adjustment in 2018 led to cost overruns at the state-owned oil and electricity companies, which will be reimbursed in future budgets.
[20] CNN Indonesia (2019).
[21] MoF regulation No. 145/2018 concerning distribution and use of transfers to regions and Village Funds for FY 2018 and FY 2019 to support the acceleration of post-earthquake rehabilitation and reconstruction.
[22] As reported in the media: CNN Indonesia (2019).

17. **The quality of medium-term revenue and expenditure projections has been improving, leading to more budget predictability and reducing the need for mid-year budget revisions.** Compared to earlier years, the deviations between the medium-term projections for revenue and realized revenue collections have been narrowing. This is partially driven by more realistic revenue projections. As result, the proposed 2019 expenditure budget is close to the projected 2019 expenditure level in the 2018 budget (Figures 1a and 1b).

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **Indonesia's economic outlook continues to be positive with domestic demand as the main driver of growth, despite being less favorable than before due to weaker external conditions.** Economic growth is forecast to reach 5.2 percent in 2019, and gradually strengthen to 5.3 percent in 2020 and 2021. Domestic demand is expected to continue to drive growth in the near-term, offsetting a weaker external sector. The modest acceleration in private consumption is expected to continue due to the presidential elections this year, stable inflation, and strong labor market conditions. Similarly, due to the expansion of fiscal space associated with ongoing revenue reforms, government investment is projected to strengthen. Investment growth is expected to remain robust, especially after the elections with reduced political uncertainty. Risks to the growth outlook are tilted towards the downside, with potential renewed financial volatility stemming from U.S. monetary policy, slower economic growth among the developed economies and China and further slowing of global trade.

19. **Even though decisive and coordinated policy actions have significantly increased resilience to financial market volatility, Indonesia's shallow financial sector and relatively low levels of exports and foreign direct investment imply that pressures from capital outflows will persist.** The current account deficit is expected to remain stable at 3.0 percent of GDP in 2019, structurally above the recent average deficit of 1.8 percent of GDP between 2015-17. This reflects a structural upward shift in imports reflecting increased imports of intermediate and capital goods for investment. Measures to impose withholding taxes on imports and delay public investments may have some impact but only in the medium term. These measures may in fact have some unintended consequences considering Indonesia's need to expand exports, which requires facilitating imports, and to close the large infrastructure gap. External financing needs over the forecasting horizon are expected on average to be financed by FDI providing about 52 percent of gross external financing needs, along with 23 percent by global bonds, sukuk and program loans, 22 percent by other portfolio flows (equity and securities), 12 percent by project loans and 25 percent by net private sector loans (Table 2).

Table 2. BoP Financing requirements and sources
(US$ million)

	2016 Actual	2017 Actual	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Current account deficit	16,952	16,196	31,060	33,484	33,711	33,244	36,255
Scheduled debt amortization	5,193	5,007	8,370	10,640	9,272	10,620	10,673
Errors and omissions	305	950	1,272	535	411	287	163
Total financing needs	**22,450**	**22,153**	40,702	44,660	43,394	44,150	47,090
Total financing sources	**22,450**	**22,153**	40,702	44,660	43,394	44,150	47,090
Net FDI inflows	16,136	18,502	13,841	19,544	21,526	23,819	26,117
Project loan disbursements	1,847	2,033	1,097	4,715	5,495	5,911	5,974
Portfolio flows excluding Eurobonds (net)	8,476	9,995	-1,168	9,453	9,870	10,354	10,875
Private sector loans (net)	-5,282	2,064	9,503	10,240	11,024	11,932	12,912
Bonds, sukuks, program loans	13,292	12,677	17,028	10,478	9,113	9,803	9,907
Other external financing	71	-11,531	-6,729	-5,086	-5,476	-5,927	-6,413
Use of FX reserves	-12,089	-11,586	7,131	-4,684	-8,158	-11,742	-12,282

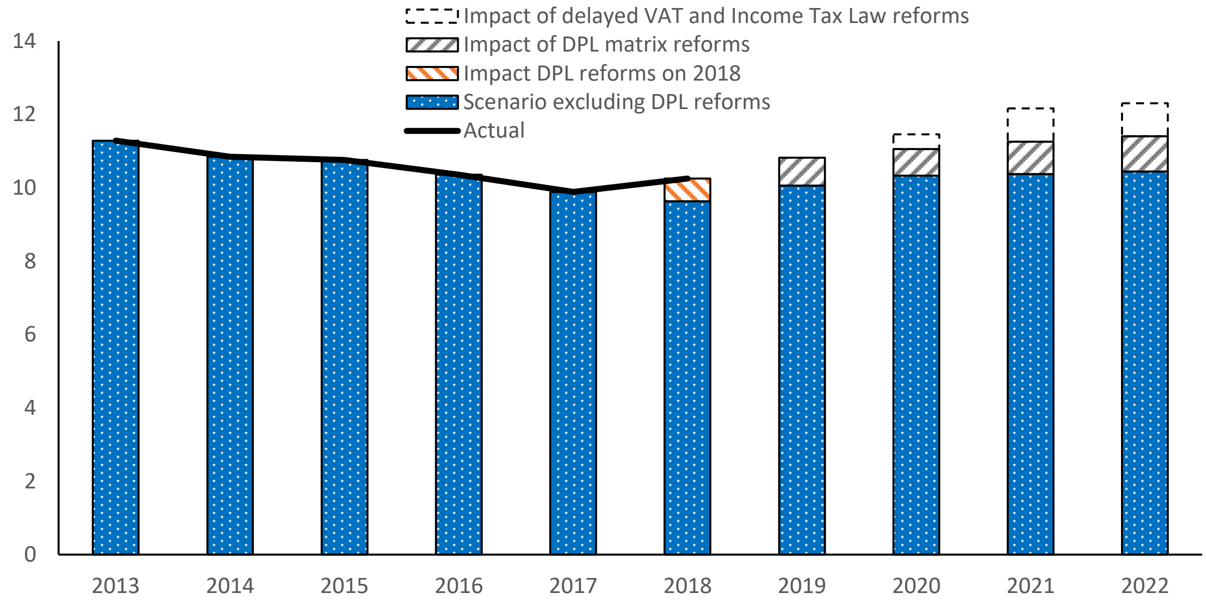
Note: Change in reserves: "-" denotes an accumulation; "+" denotes a reduction.
Source: BPS; Ministry of Finance; BI; World Bank staff projections for 2018-2022

20. **Both monetary and fiscal policies are expected to be neutral in 2019, but still responsive to economic conditions.** In line with the pause in U.S. monetary policy tightening and some easing in trade tensions, Indonesia's monetary and fiscal policies are projected to take a more neutral stance in the near term, while still remaining responsive to economic conditions. Meanwhile, staff expects reforms to enhance space for supportive fiscal and monetary policies to continue, further improving the country's menu of stabilization tools should further global volatility arise.

21. **The baseline fiscal framework includes the expected substantial short- and medium-term impact of the tax reforms supported or initiated as part of this DPL series.** It is estimated that tax administration and tax policy reforms supported by this programmatic DPL series (1, 2 and 3) contributed to an increase in tax revenue of 0.6 percent of GDP in 2018 (Figure 2). Staff estimates indicate that the combined impact of the tax reforms supported by the DPL series will average 0.8 percent of GDP annually between 2019 and 2022 (Section 4.1).[23]

[23] Additional reforms initiated as part of the previous DPL operations that are no longer included in the matrix due to implementation delays could add another 0.6 percent of GDP on average, if implemented.

Figure 2. Estimated and expected future impact of reforms on the tax-to-GDP ratio in the DPL policy matrix and delayed reforms, compared to a no further reform scenario
(Percent of GDP)



Note: Dashed lines not counted in baseline tax-to-GDP projections.
Source: Ministry of Finance; World Bank staff analysis and projections

22. **Revenue collection has seen a significant turnaround as a result of the reforms and will increase fiscal space for expenditure.** Tax administration and policy reforms supported by this DPL series have already led to a turnaround in revenue performance, with revenues surging 18.8 percent in 2018, the largest increase since 2011. In addition, the tax-to-GDP ratio rose to 10.3 percent from 9.9 percent in 2017, after five years of year-on-year declines. On the expenditure side, preliminary estimated reconstruction costs of the West Nusa Tenggara and Central Sulawesi disasters (excluding the Sunda Strait tsunami) is around US$ 3.4 billion between 2019 and 2021.[24] Apart from this, staff projects that capital spending will grow to accommodate infrastructure needs, social assistance will be maintained at a higher level than 2016-17, and that energy subsidy spending will stabilize to well below the 2012-14 level (0.9 percent of GDP compared to 3.3 percent of GDP), largely due to projected stable commodity prices, while structural shifts in fuel demand are projected to moderate demand growth for subsidized fuel. The baseline projects the primary fiscal deficit to average at 0.4 percent of GDP and the fiscal deficit to average at 2.0 percent of GDP for the years 2019-22, which is consistent with a stable level of central government debt (Table 3).

[24] See footnote Table 3.

Table 3. Medium-term fiscal framework (central government), including the tax reforms
(Percent of GDP)

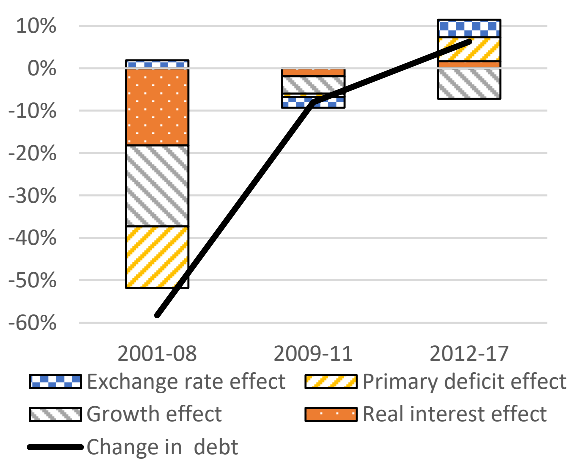
	2016 Actual	2017 Actual	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Revenue	**12.5**	**12.3**	**13.1**	**13.5**	**13.6**	**13.7**	**13.8**
Tax Revenue	**10.4**	**9.9**	**10.3**	**10.8**	**11.1**	**11.3**	**11.4**
Income Tax	5.4	4.8	5.1	5.4	5.6	5.8	6.0
Sales Tax (VAT)	3.3	3.5	3.6	3.8	3.9	3.9	3.9
Excises	1.2	1.1	1.1	1.1	1.1	1.1	1.1
International Trade Tax	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other taxes	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Receipts	**2.1**	**2.3**	**2.7**	**2.7**	**2.6**	**2.5**	**2.4**
Grants	**0.1**	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Total expenditure	**15.0**	**14.8**	**14.8**	**15.4**	**15.6**	**15.8**	**15.8**
Primary Expenditure	**13.6**	**13.2**	**13.1**	**13.8**	**14.1**	**14.2**	**14.3**
Central Government Expenditure	**7.8**	**7.7**	**8.0**	**8.6**	**8.9**	**9.0**	**9.1**
Personnel	2.5	2.3	2.3	2.3	2.3	2.3	2.3
Material	2.1	2.1	2.3	2.3	2.3	2.3	2.3
Capital	1.4	1.5	1.2	1.8	2.2	2.4	2.5
Disaster reconstruction	…	…	…	0.1	0.1	0.1	0.0
Non-disaster capital	1.4	1.5	1.2	1.8	2.0	2.2	2.5
Subsidy	1.4	1.2	1.5	1.4	1.4	1.4	1.4
Energy	0.9	0.7	1.0	1.0	1.0	1.0	0.9
Non-energy	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Grant expenditure	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Social assistance	0.4	0.4	0.6	0.6	0.6	0.6	0.5
Others	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Transfers to sub-national	**5.7**	**5.5**	**5.1**	**5.2**	**5.2**	**5.2**	**5.1**
Interest	**1.5**	**1.6**	**1.7**	**1.6**	**1.6**	**1.6**	**1.6**
Primary fiscal balance	-1.0	-0.9	0.0	-0.3	-0.4	-0.4	-0.5
Overall fiscal balance	**-2.5**	**-2.5**	**-1.8**	**-1.9**	**-2.0**	**-2.0**	**-2.0**
Net financing	**2.5**	**2.5**	**1.8**	**1.9**	**2.0**	**2.0**	**2.0**
Investment in financial assets	-0.6	-0.5	-0.4	0.0	0.0	0.0	0.0
Net borrowing	3.0	3.0	2.2	1.9	2.0	2.0	2.0
Net local currency borrowing	…	…	…	1.4	1.6	1.6	1.6
Net foreign currency borrowing	…	…	…	0.4	0.5	0.4	0.4
Central government debt	28.3	29.4	29.8	29.6	29.3	28.9	28.6
Memo:							
Projected reconstruction needs in US$ mn	…	…	…	682	1,347	1,333	..

Note: 2018 disaster reconstruction needs estimates only include the West Nusa Tenggara and Central Sulawesi disasters, and exclude the Sunda Strait tsunami. Reconstruction expenditure projected to come from cities, districts, provinces, national budget, disaster management agency (BNPB) and donor grants are allocated to fiscal spending, and the rest to the private sector. Distribution of the reconstruction needs across 2019-21 based on projections from the Central Sulawesi post-disaster needs assessment.
Source: Government of Indonesia (2018c, 2019), World Bank staff projections.

23. **After a rapid decline between 2000 and 2012, central government has stabilized between 25 and 30 percent of GDP.** Indonesia's central government debt-to-GDP ratio is currently estimated at 29.8 percent of GDP at end-2018, only a third of its level just after the Asian financial crisis (89 percent of GDP at end-2000). The drivers of this decline have changed over time. From 2000 to 2008, the key factors were a post-crisis growth recovery, low real interest rates (including through concessional financing), a relatively stable exchange rate and primary fiscal surpluses. The debt-to-GDP ratio declined by 58 percent over that period. From 2008 to 2011, growth slowed, and real interest rates started to rise, leading to smaller decline in the debt-to-GDP ratio. Between 2012 and 2017, the debt-to GDP ratio rose gently, driven by primary deficits, rising real interest rates with the shift to commercial borrowing and currency depreciation, while real growth recovered (Figure 3a).

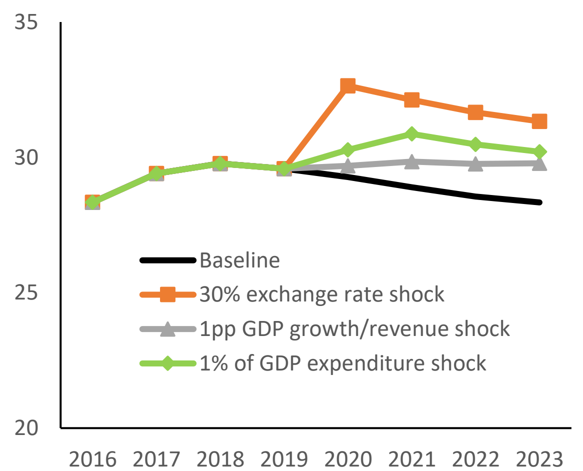
24. **Due to the low debt level and the low share of foreign exchange-denominated debt, medium-term fiscal policy remains sustainable under the baseline scenario and under exchange rate, GDP growth and fiscal shock scenarios.** In the medium term, the baseline scenario projects the level of debt to fall from 29.8 percent of GDP at end-2018 to 28.6 percent of GDP by 2022 with a stable fiscal deficit of around 2 percent of GDP. A permanent 30 percent exchange rate depreciation shock in 2020 would increase the debt-to-GDP ratio to 32.6 percent of GDP after which it would decline again. A temporary, negative GDP growth shock of 1 percentage points (reducing growth to level not seen in the last 17 years) compared to the baseline, leading to a proportional revenue decline, would put debt on a moderately increasing path peaking at 29.8 percent of GDP in 2021, and then decline. A temporary, positive expenditure shock of 0.5 percent of GDP lasting two years, perhaps due a large natural disaster and subsequent reconstruction efforts, would increase the level of debt for 2 years, peaking at 30.8 percent of GDP, after which the debt would return to a declining path (Figure 3b).

Figure 3a. Decomposition of central government debt-to-GDP ratio, 2000-2017
(Percent of GDP)



Source: Ministry of Finance, Bank Indonesia, World Bank staff calculations

Figure 3b. Projected central government debt-to-GDP ratio under baseline and shocks
(Percent of GDP)



Source: Ministry of Finance, Bank Indonesia, World Bank staff calculations

25. **Despite strong macro fundamentals, there are downside risks to economic growth from the global environment and natural disasters**. Pressures from global uncertainty could elicit additional tightening of macroeconomic conditions with downside risks to economic growth. Such uncertainty could again result in a weaker currency, which may help contain the current account deficit by curbing imports, but may also dampen consumer confidence and increase inflation, leading to slower consumption growth. Higher bond yields would lead to costlier financing for corporates, which could dampen the nascent credit recovery and private investment. Escalating protectionism also poses strong risks to Indonesia through either slower growth of exports or through negative spillovers from slower regional growth – in part through weaker commodity prices. Despite their high frequency in Indonesia, natural disasters historically mainly present a fiscal risk (Table 4 in Box 1), and while regional growth may be affected, the risk to national economic growth is low.

26. **However, strong policy coordination and sound fundamentals mitigate these risks.** Foreign reserves remain at a healthy 6.3 months' worth of imports of goods and services at end-2018. Despite intervening to minimize volatility, Bank Indonesia had been conserving reserves throughout 2018 by allowing market-driven depreciation rather than defending a fixed level of the exchange rate, and decisively tightened monetary policy to maintain interest rate differentials with the United States Federal Funds Rate. Likewise, fiscal policy has been consistently prudent: deficits have remained low and government debt is less than half of the legal threshold of 60 percent of GDP, of which 58 percent is denominated in local currency. At the same time, the banking and financial sectors remain sound; credit growth is increasing moderately, and banks are well capitalized with low rates of non-performing loans. Most importantly, fiscal and monetary authorities, as well as the executive, have given consistent and strong signals that they prioritize stability and will continue to act accordingly.

27. **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 fiscal deficit, plus enhanced fiscal credibility, recognized by the four recent credit rating upgrades. The policy mix has been consistent with macroeconomic stability and the management of risks that may arise. Monetary policy continues to be credible and responsive to inflation and exchange rate pressures. 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 framework. Lastly, the structural reform agenda, if continued, will be able to support inclusive growth and expand potential growth.

3. GOVERNMENT PROGRAM

28. **Since taking office, the current administration has set out a series of ambitious development goals, including boosting competitiveness, developing infrastructure and enhancing social assistance.** The revised National Medium-term Development Plan (RPJMN) for 2015-2019 sets out national development goals and the main policy directions 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. But developing infrastructure and expanding social assistance require significant funding, well beyond the capacity of the government to finance through revenue or debt, at a time when global monetary conditions are tightening, and the government is carefully managing its public debt. This has brought to the fore domestic revenue mobilization efforts, which are

important for creating fiscal space, and improving the quality of spending, so that funds are allocated to priority sectors and are spent the right way, while trying to attract private sector finance.[25]

29. **The government made reforming quality of spending a key priority, reallocating spending away from energy subsidies and towards health, social protection and infrastructure.** Due to a marked reduction in the energy subsidy bill,[26] there has been increased fiscal space for higher spending on infrastructure, health, and social assistance, which was maintained throughout 2016-2018 and in the approved 2019 budget, compared to the pre-energy subsidy reform years (2012-14). This increase priority spending has already resulted in improved outcomes. Higher spending on infrastructure has led to the creation of new public assets, including housing, transport and rural electrification. A higher allocation to health expenditure has led to the expansion of the population coverage under the JKN, the Indonesian national health insurance, as well as better hospitals and health centers. Higher social assistance spending has contributed to the expansion of the Family Hope (PKH) conditional cash transfer program that has helped to improve school attendance and utilization of preventative health care services. These improvements can have persistent effects on the accumulation of human capital and hence longer-term productivity effects.

30. **However, there is still room to improve the efficiency of spending.** Improving budgeting and planning has received an equally high priority to better align development priorities to resource allocation through closer coordination between the Ministry of Planning (Bappenas), the Ministry of Finance, and line ministries. The central government is increasingly using incentive-based fiscal transfers to stimulate a better mix of spending by local governments, such as the BOS Kinerja initiative that rewards schools for improved performance. However, these efforts are being inhibited by the quality of fiscal data at the level of subnational governments. The reform to introduce a standard chart of accounts for local governments will lay the foundation for consistent fiscal data.

31. **The Government of Indonesia has also set an ambitious climate change mitigation policy goal**. Indonesia's GHG emissions were estimated to be 1.453 GtCO2e in 2012, with the main contributing sectors being land-use change followed by energy.[27] As articulated in the country's first Nationally Determined Contributions (NDC) document, Indonesia pledged to reduce emissions by 26 percent on its own and by 41 percent with international support against the business-as-usual scenario by 2020, and by 29 and 41 percent respectively, by 2030.[28] Towards these targets, the Government has implemented several initiatives. Among them, the fuel and electricity subsidy reform introduced in 2015 would also have contributed to lower consumption of fuels than would otherwise have been the case, thus contributing to the reduction of greenhouse gas emissions. More recently, the Government is considering introducing a number of green taxes.

32. **Adapting to the impacts of climate change is also a high priority of the Government of Indonesia.** The NDC document articulates clear climate adaptation policy objective to reduce risks from climate change on all development sectors, including health, public service, and infrastructure, by 2030.[29] In line with this adaptation policy objective, the government has launched new initiatives to improve resilience to climate change and natural disasters. These include expansion of budget tagging

[25] The World Bank has finalized an Infrastructure Sector Assessment Program (InfraSAP) identifying the opportunities and obstacles to attracting private sector participation in infrastructure development.
[26] Energy subsidies averaged 0.9 percent of GDP in 2015-2018 down from an average of 3.3 percent of GDP in 2012-2014.
[27] Government of Indonesia (2016b).
[28] *ibid*.
[29] *ibid*.

from mitigation-related activities to cover adaptation-related activities, development of a Disaster Risk Financing and Insurance (DRFI) Strategy, and a Bappenas-led disaster risk management master plan, which includes management of climate-related disaster risks.

33. **The government is pursuing a comprehensive approach to better manage fiscal and financial risks due to frequent and large climate shocks and natural disasters.** The Ministry of Finance launched its Disaster Risk Financing and Insurance strategy during the WB-IMF Annual Meetings in October 2018.[30] This strategy includes several complementary financial mechanisms and instruments, including insurance of key public assets, including administrative buildings, hospitals, schools and bridges. In December 2018, Indonesia, together with Cambodia, Japan, Lao PDR, Myanmar, and Singapore agreed to establish the Southeast Asia Disaster Risk Insurance Facility (SEADRIF), a regional platform to provide ASEAN countries with financial solutions and technical advice to increase their financial resilience to climate and disaster risks (Box 1).

Box 1. Natural disasters, climate change and building financial resilience

Indonesia is amongst a group of countries that suffers from a high prevalence of natural disasters. On average, there have been 289 significant natural disasters each year between 2000 and 2014, and an annual average death toll of 852 between 1989 and 2018, excluding the impact of the 2004 Aceh Tsunami disaster (Table 4).[31] Almost all regions in Indonesia are exposed to high risks of the nine major disasters: earthquakes, tsunamis, extreme weather, floods, landslides, volcanic eruptions, fires, storm surges, and drought. The National Disaster Management Plan (Renas PB) notes that between 2004–2013, Indonesia experienced total disaster losses of IDR 126.7 trillion. Across the country, over 200 million people live in disaster-prone areas. Further, hydrometeorological and climatic disasters such as floods and droughts, which currently make up 70 percent of disaster occurrences in Indonesia, are projected to increase with climate change. With the second longest coastline in the world, Indonesia also faces a high risk of sea level rise and coastal inundation that may affect up to 42 million people living in low laying coastal zones.

Such natural disasters impact poverty by directly reducing income and wealth levels of households and government revenue, and by indirectly, negatively impacting savings, investment, education, health, savings and investment and economic growth. Estimates suggest that, at the district level, a one standard deviation increase in disaster harm can increase the poverty rate by 0.8 percent and the poverty gap by 2.3 percent.[32] In 2010, 55 percent of poor people were not poor the year before, and frequent natural disasters was a major contributor.[33]

The Government currently spends between US$ 300-500 million annually on post-disaster reconstruction, with spending during major disaster years reaching 0.3 percent of the GDP; and as high as 45 percent of provincial Gross Regional Product (GRP).[34] A significant part of the economic cost of natural disasters is borne by the national government budget due to the need for reconstruction of destroyed core assets, which often have no or inadequate insurance coverage. Meanwhile, subnational governments often lack the financial resources to respond effectively in the aftermath of natural disasters due to their limited size and economic base. The legal framework for the division of responsibilities for post-disaster financing between the central and subnational governments is defined by Law 24/2007 on Natural Disaster Management and implementing regulations, while Law 33/2004 stipulates how subnational governments can request emergency funds from the central

[30] Government of Indonesia (2018a).
[31] Global Facility for Disaster Risk Reduction (GFDRR). According to EM-DAT, an international disasters database, the total death toll over this period was 191,266, of which the 2004 Aceh Tsunami accounted for 87 percent.
[32] Rush (2013).
[33] World Bank (2014).
[34] GFDRR (2016).

government in case of a disaster.[35] However, the implementing G.R. 58/2005 did not provide clear guidance on subnational transfers and expenditures for post-disaster recovery. G.R. 12/2019 (Prior Action #4) provides clearer guidance on recognizing government transfers as subnational revenue, and provides flexibility for disaster emergency expenditures without advance formulation in the subnational ministries' programs and budget plans.

Table 4. Major natural disasters between 2004 and 2018

Major Events (Year of Occurrence)	Direct Damages		Direct impacts on people
	(US$ billion)	(% of GDP)	
Aceh Tsunami (2004)	4.5	1.63	165,708 fatalities; 533,000 affected
Yogyakarta Earthquake (2006)	3.1	0.80	5,778 fatalities; 3.2 million affected
Jakarta Flood (2007)	1.0	0.21	68 fatalities; 217,000 affected
Padang Earthquake (2009)	2.2	0.38	1,195 fatalities; 2.5 million affected
Jakarta Flood (2013)	3.0	0.33	34 fatalities; 249,000 affected
Wildfires (2015)	1.0	0.12	19 fatalities; 410,000 affected
West Nusa Tenggara Earthquakes (2018)	0.9	0.12	514 fatalities; 440,000 affected
Sulawesi Earthquake and Tsunami (2018)	1.3	0.16	2,101 fatalities; 137,000 affected
Sunda Strait Tsunami (2018)	not yet available	not yet available	430 fatalities; 24,000 affected

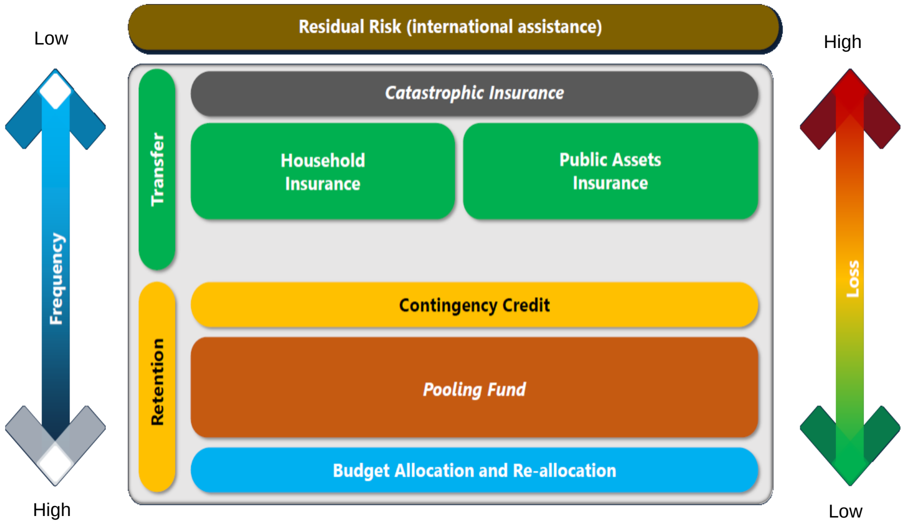
Source: Estimates from BNPB – National Disaster Management Authority, Recapitulation of Earthquake Damage and Losses, West Nusa Tenggara (October 12, 2018) and Impact of the Earthquake, Tsunami and Liquefaction in Central Sulawesi Province (January 30, 2019)

This high exposure to both severe and recurring events makes disaster management activities—including activities in disaster risk reduction, preparedness, and disaster risk financing—a government priority. The importance of managing disaster risks is articulated in several government plans and policies such as (i) The Long-Term National Development Plan (RPJPN) 2005–2025 includes disaster management under its eighth national development plan; (ii) The disaster management agenda is listed in the previous Medium-Term National Development Plan (RPJMN), for 2010–2014, and in the most recent plan for 2015–2019. Over these two periods of development planning, this agenda has become a national development priority. The government also regularly issues the National Disaster Management Plan (Renas PB), most recently for the 2015–2019 period.

The Government recently introduced a Disaster Risk Financing and Insurance (DRFI) strategy to protect state finances and the population through sustainable and efficient risk financing mechanisms that meet disaster-related expenditures in a planned and timely manner, and that deliver well-targeted and transparent assistance following shocks (Figure 4). The strategy estimates that the Government faces an annual funding gap for disaster-related expenditures of IDR 20 trillion. The DRFI strategy sets out the combination of risk financing instruments and mechanisms that the Ministry of Finance will put in place to ensure cost-effective and timely funding to meet post-disaster needs. This strategy is supporting a fundamental shift to become a proactive risk manager rather than emergency responder to natural disaster shocks. This includes an equal focus on building financial and physical resilience to shocks. As part of this agenda, the Government integrated early plans to strengthen the Disaster Risk Financing and Insurance Framework in its annual Macroeconomic Framework and Fiscal Policy Principles (KEM-PPKF) submission to the Parliament in March 2018. Prior Action #2 enables the implementation of part of the DRFI (Public Assets Insurance), which will cover against the increased risk from climate-related disasters.

[35] World Bank (2011).

Figure 4. Indonesia's Disaster Risk Financing and Insurance Strategy



Source: Government of Indonesia (2018a).

34. **Domestic revenue mobilization efforts have involved implementing administration reform roadmaps with gradual, deliberate steps towards a tax system that raises more revenues in an efficient, equitable, transparent, growth-friendly way.** Work on identifying key reform areas across tax administration and policy began in late 2014, with a series of government meetings and consultations taking place, including with the World Bank, the International Monetary Fund, and other development partners and senior tax advisors. The Reform Team (*Tim Reformasi*), established in December 2016, has since led the coordination of reforms and has integrated the work of the Directorate General of Taxes (DGT), the Directorate General of Customs and Excise (DGCE) and the Fiscal Policy Agency (BKF) to produce a sound governance framework that the government has adequate capacity to implement well.[36] In a bid to generate short-term revenue and improve compliance, the government first introduced a 9-month long tax amnesty program in H2 2016 - Q1 2017, which it positioned as a one-off in the lead-up to its implementation of the automatic exchange of information (AEOI).[37] Next, it has been using the tax amnesty data combined with newly-accessed third-party data, to apply stricter enforcement of tax rules and effective compliance management. As a key component of its road map, *Tim Reformasi* has undertaken a far-reaching reform program to modernize DGT operations aimed at overcoming low compliance rates through an ambitious and far-reaching institutional transformation underpinned by the deployment of a new core tax IT system to support modernized business processes, and the design and implementation of a new compliance risk management (CRM) system. To improve business climate and reduce compliance costs, early results from ongoing CRM system's reform has

[36] The team was formed based on the Minister of Finance Decree (KMK) Number 885 / KMK.03 / 2016 concerning the Formation of the Tax Reform Team. The Customs and Excise Reform Strengthening Team was formed based on KMK Number 909 / KMK.04 / 2016 concerning the Establishment of Customs and Excise Reform Strengthening Teams. *https://peraturanpajak.com/2017/01/18/pmk-885kmk-032016/*

[37] Indonesia began exchanging tax information with tax authorities worldwide starting in September 2018. The AEOI provided the Government with a credible threat of increased detection of taxpayers evading taxes via parking their assets overseas, strengthening participating in the Government's tax amnesty program.

enabled a streamlined Value Added tax (VAT) refund system allowing more businesses to receive timely response from DGT to their refund requests, which is expected to ease their cash flow, while ensuring a proper implementation of the VAT.

35. **Reform of tax policy has followed similar principles and has also been implemented gradually.** The Government has broadened the base of its direct taxes by expanding the scope of income taxes by registering more micro, small and medium enterprises in a simplified final tax regime with a lower tax burden, then facilitating their graduation to the general income tax regime through a sunset clause. In parallel, the Government is strengthening efforts to mitigate the risk of tax avoidance by multinational enterprises through renegotiation of some of its existing double tax treaties. Furthermore, the publication of the first ever tax expenditure statement (TES) made existing incentives in the tax system transparent, with the Government committing to do this annually. The TES is mobilizing a discussion on the costs and benefits of existing tax incentives, supporting efforts to rationalize and simplify the tax system. Gradual base-broadening measures, combined with increased simplicity, transparency and efficiency, have thus been the hallmarks of the Government's policy reforms.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

36. **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 over the medium-term.

37. **The ongoing DPL series is structured around the following three pillars and set of objectives:**

- **Pillar A: Improving Quality of Spending.** Pillar objectives: Improving (i) composition of spending; (ii) budget execution; and (iii) efficiency of spending.
- **Pillar B: Strengthening Revenue Administration.** Pillar objectives: Increasing (i) tax administration efficiency; (ii) compliance management and audit capability; and (iii) reducing the cost of paying taxes
- **Pillar C: Enhancing Tax Policy.** Pillar objectives: Increasing (i) revenue potential; and (ii) economic efficiency of tax policy.

38. **The DPL series has made good progress towards meeting the program development objectives.** Annex 1 describes the progression of prior actions and triggers and the progress towards meeting the results over the DPL series.

39. **The prior actions in this operation build on the reforms implemented in the first two operations in the series. However, there are number of adjustments to the program compared to what was envisaged in DPL 2.** These changes partly reflect the challenging political environment close to the Presidential and Parliamentary elections in April 2019, the strengthening of the tax

administration reforms as compared to their indicative triggers, and a new focus on climate change and natural disaster resilience (Table 5).

- Indicative Triggers on three legislative measures were replaced or dropped from the policy matrix. The Indicative Triggers for DPL 3 envisaged submission to Parliament of draft revisions to the Fiscal Decentralization Law, the VAT Law and the Income Tax Law. While the Government completed the technical work, it decided not to submit these law revisions considering the political risks associated with the upcoming elections.[38] However, in the current policy matrix, a Government Regulation reforming the Public Financial Management Framework for subnational governments replaced the Fiscal Decentralization Law, which will have an impact on the quality of spending, fiscal transparency and disaster preparedness.
- In order to focus on the most critical prior actions of the reform program, the Indicative Trigger on the alignment of planning and budgeting was dropped from the policy matrix, although the action was implemented during the preparation of this operation.
- Two prior actions related to tax administration were strengthened compared to the Indicative Triggers, and one Trigger was dropped. These actions reflect ongoing reform momentum to improve tax compliance, which is a major reason for the low tax-to-GDP ratio of Indonesia.
- This DPL includes new Prior Actions reflecting the Government's focus on improving natural disaster and climate change resilience, and the focus on improving fiscal transparency through producing statements on tax expenditure.

Table 5. Revision of indicative triggers from DPL2 compared to prior actions for DPL 3

Indicative trigger for DPL 3	Revised prior action for DPL 3	Change
Pillar A: Improving Quality of Spending		
#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.	**#1. Composition of Spending.** The Borrower has increased the shares of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-energy subsidy reform years (2012-2014), as evidenced through the 2019 Budget Law and Presidential Regulation 129/2018.	**No material change.** Removed reference to flat budget policy, and updated budget year from 2018 to 2019.
#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	**Dropped from the matrix.**	**Material change**. The PMK to improve the alignment of planning and budgeting has been issued and is being put into practice during the 2020 budget preparation. However, the framework to implement the MTEF was

38 Given the political context, there is a substantial risk to the tax measures being significantly watered down, if the measures were submitted to Parliament before the elections. In addition, the Government preferred a resolution on the KUP law on tax administration that was being discussed in Parliament, before submitting the two tax laws to Parliament.

document and the Government Regulation (PP 17/2017), to better synchronize the planning and budgeting process by the issuance of implementing ministerial regulations.		not included, but is expected to be included in the next 2021 budget year. While the action is important in its own right, the operation is now focusing on the most critical reforms.
	#2. Disaster risk insurance. The Borrower has enabled the purchase of disaster risk insurance for the Borrower's assets, as evidenced through the Minister of Finance Regulations 247/2016 and 142/2018.	**New action.** New prior action, to support the government's efforts to improve resilience to natural disasters, which has become a critical priority given the number of natural disasters in 2018.
	#3. Climate finance budget tagging. The Borrower has expanded the climate finance budget tagging initiative from tagging only for climate change mitigation to climate change mitigation and adaptation, as evidenced through the Climate Budget Tagging Manual.	**New action.** New prior action, to support the government's efforts to improve the quality of spending and improve the monitoring, planning and budgeting of climate finance.
#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.	**#4. Standardization of subnational budget chart of accounts.** The Borrower has adopted the framework for standardizing and harmonizing the subnational budget chart of accounts, as evidenced through the Government Regulation 12/2019.	**Material change.** The current prior action still focuses on the fiscal relationship between the national and subnational governments and is an essential reform to improve the quality of spending and performance management across the national and subnational levels of government. The draft Decentralization Law was not submitted to Parliament with this operation's timeline, but the World Bank continues to support the government.
Pillar B: Strengthening Revenue Administration		
#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.	**#5. VAT refunds.** The Borrower has broadened the coverage of taxpayers subject to a streamlined procedure for VAT refunds by: (a) increasing the refund value threshold; (b) expanding the criteria to be considered a low risk VAT taxpayer; and (c) allowing partial refunds, as evidenced through the Minister of Finance Regulation 39/2018.	**Material change.** The current prior action also focuses on VAT refunds and has been substantially strengthened.
#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.	**Dropped from the matrix.**	**Material change.** Once new data integration mechanisms are developed, the next step for DGT is to translate new data matching capabilities into better enforcement actions through an improved risk management framework. Hence the policy action on data integration is dropped off, and the reform's chain of results move forward

		to the next reform stage: compliance risk management.
#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.	**#6. Compliance risk management.** The Borrower has created a risk management unit (Data Management Team) within the Directorate General of Taxes, as evidenced through the Minister of Finance Decree 67/2019.	**Material change.** While compliance improvement plan has been developed, it has not been formally adopted. This prior action has been strengthened as it now focuses on setting up a new Directorate under the Director-General of Tax, which is an institutional reform to improve compliance risk management structurally.
Pillar C: Enhancing Tax Policy		
#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.	**#7. MSME presumptive tax regime.** The Borrower has enabled the expansion of the general income tax base, including by: (a) introducing sunset clauses for the MSME final tax; and (b) allowing MSME taxpayers to opt for taxation under the general regime, as evidenced through the Government Regulation 23/2018.	**No material change.**
#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.	**Dropped from the matrix.**	**Material change.** The Government has prepared a draft of the VAT Law but has not been able to place it in 2019's parliamentary legislative agenda with the Presidential elections due in April 2019.[39] The reform is expected to be implemented in due course.
#9. The Government submits to the		**Action dropped.** Work on finalizing the

[39] See footnote 38.

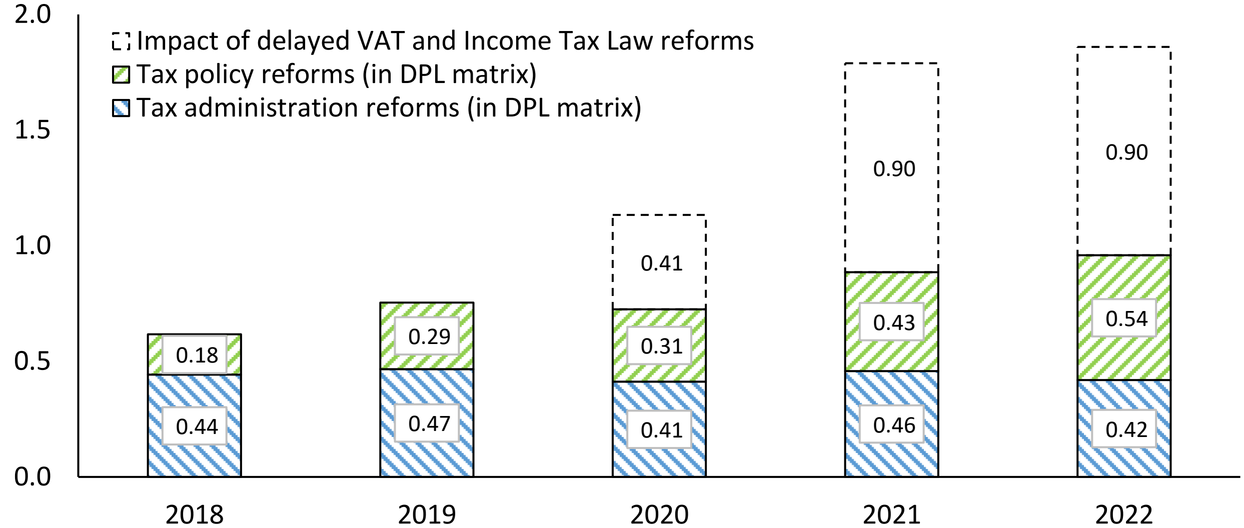
Parliament for deliberation the draft revision of the Income Tax Law No. 36 of 2008. The proposed reforms set out to further address tax base erosion and broaden the tax base, including by: (a) introducing an Alternative Minimum Tax (AMT) for corporates; and (b) replacing the general PIT deduction with a nonrefundable tax credit.		new Income Tax Law is ongoing, with the Government unable to complete it in time for submission in this year's parliamentary legislative agenda.[40] Following the elections, the reform is expected to be implemented in due course.
#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.	**#8. Tax expenditure.** The Borrower has increased fiscal transparency by: (a) identifying all the tax expenditure across its major taxes; (b) publishing its first tax expenditure statement; and (c) adopting its sustainability strategy, as evidenced through the Financial Note for 2019 Budget, Minister of Finance Official Note ND-315/KF/2018 and Indonesia tax expenditure report.	**Material change.** The Government has agreed to make several new legislative changes to strengthen measures in place to tackle base erosion and profit shifting (BEPS). However, the Government has decided that these measures are best introduced as part of the Income Tax Law (so that they have the strongest possible legal status). Delays in passage of the Income Tax Law have thus delayed the implementation of these new measures. As an alternative reform measure, the Government increased the transparency of its tax system through producing its first ever tax expenditure statement, made public on the Ministry of Finance website, and summarized in the Budget Financial Note 2019.
#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.	**#9. Model Tax Treaty.** The Borrower has strengthened measures against base erosion and profit shifting by developing a model tax treaty for use in double tax agreements, as evidenced through the Minister of Finance Official Note ND-471/KF/2018.	**No material change**. Refined language of the Prior Action captures the same reform: the development of a tax treaty strategy, encompassed by the development and use of the model tax treaty. The new model treaty reflects commitments Indonesia made to fight base erosion and profit shifting as part of the MLI which it signed in June 2017 and provides greater clarity and stability for investment.

40. **Despite the changes in the policy matrix, this operation builds on reforms set out in DPLs 1 and 2 and to meet the PDOs of this series.** The tax reforms supported by the DPL series under Pillars B and C are expected to have substantial positive short and medium-term impact. Revenue collection will continue to benefit from longer-term policy and administrative measures. Estimates show that tax administration and tax policy reforms supported by this programmatic DPL series (1, 2 and 3) contributed to an increase in tax revenue of 0.6 percent of GDP in 2018 and will increase tax revenue

[40] See footnote 38.

by 0.8 percent of GDP (or US$ 10.9 billion), on average, annually from 2019 and onwards, compared to a baseline scenario that only includes the core tax IT system modernization reform (Figure 5). In addition, if the Government implements reforms that were part of the previous DPL matrices but are no longer included due to implementation delays,[41] tax revenue may rise by an additional 0.6 percent of GDP (or US$ 7.6 billion) annually compared to the no reform scenario. The baseline fiscal framework does not include the impact of these delayed reforms.

Figure 5. Reform gains come from both revenue administration improvements (Pillar B) and tax policy reforms (Pillar C), with additional gains anticipated from delayed reforms
(Percent of GDP)



Source: Ministry of Finance; World Bank analysis and projections

41. **The policy matrix (Annex 1) has been developed through extensive dialog, analytical work and collaboration between the Government and the World Bank.** Substantial advisory and analytical work (Table 7) by the Bank and development partners engaged on fiscal issues, in particular, Australia (PROSPERA), France (Agence Française de Développement) and the International Monetary Fund (IMF) underpin the matrix.

42. **This proposed operation incorporates lessons from previous DPLs.** The World Bank approved 3 DPLs in the past 3 years: the First and Second Fiscal Reform DPLs and the Second Logistics Reform DPL.[42] Some early lessons include: (a) the need to ensure strong analytical underpinning and a well thought out implementation plan; (b) the need for strong continuous engagement; and (c) content selectivity guided by counterpart capacity and reform ownership.

[41] These include the VAT and Income Tax Laws that were dropped from this operation's policy matrix.
[42] World Bank (2018a).

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar A - Improving Quality of Spending

43. The prior actions under this pillar contribute to Pillar A objectives to improve (i) the composition of spending; (ii) budget execution; and (iii) efficiency of spending. An improved budget allocation of spending towards priority sectors such as infrastructure, social assistance and health, will also improve physical and social resilience to climate change and natural disasters (Prior Action #1). Insuring public assets will help build financial resilience to natural disasters and protect priority spending (Prior Action #2). A key ingredient to improving the quality of spending is better information. The mainstreaming of budget tagging of climate change mitigation and adaptation activities (Prior Action #3) is expected to increase future spending in these areas and contribute to systematic integration of climate change considerations in the country's budgeting system, in line with the country's development goals and international climate commitments.[43] Likewise, the standardization of the chart of accounts at the subnational level will also support improved spending on priority areas (Prior Action #4). In addition, all 4 prior actions in this pillar contribute to climate change mitigation and adaptation. Together, these actions will play an important role to achieve Indonesia's NDC mitigation commitments.

Improving central government budget allocation

44. **Rationale:** The government needs to significantly improve the composition of spending relative to the pre-subsidy reform period, by reallocating subsidy spending to other priority areas (Figure 6) where the government had under-spent in the past and development outcomes are poor. Such spending increases on priority areas should be sustained in the long-term to produce the expected impact.

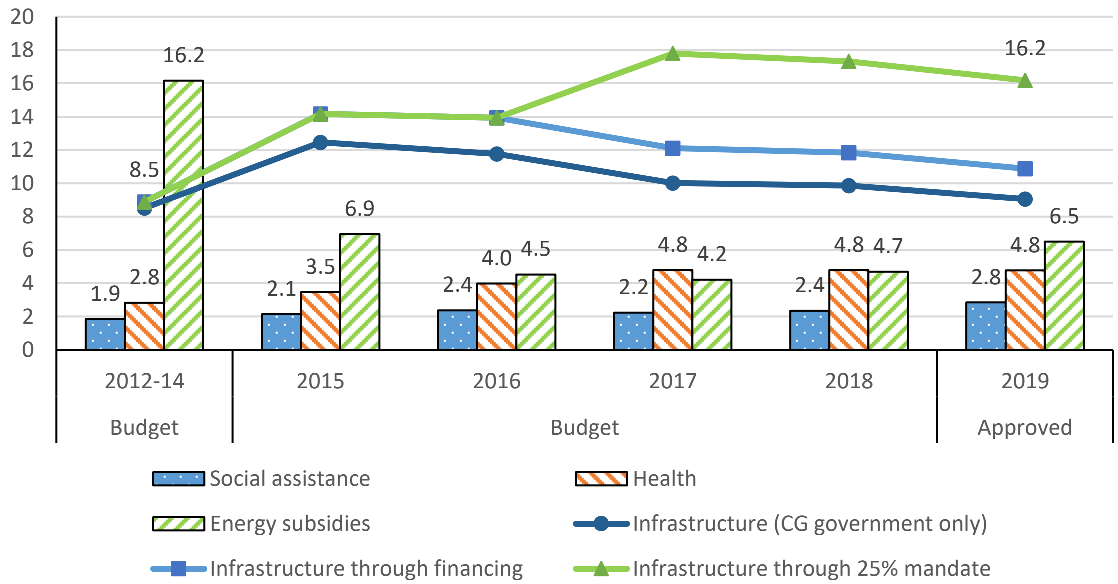
45. **The additional spending on priority sectors would have a significant impact beyond the short term.** Improvements in physical and human capital can have persistent effects. Increased spending since 2015 has already achieved the following impact:

- **Infrastructure:** Increased infrastructure spending has created new public assets, including housing, transport and rural electrification, which is reflected in the recent increase in the perceived quality of infrastructure.[44]
- **Health:** The increase in expenditure on health has resulted already in an expansion of the population coverage under the JKN, the Indonesian national health insurance, from 52 percent (2014) to 78 percent (2018). It also helped improve the overall supply-side readiness of regional government primary care facilities (*puskesmas*), although for some districts the correlation between spending and supply-side readiness is low.[45]

[43] Government of Indonesia (2006b).
[44] World Economic Forum (2017).
[45] Supply-side readiness is measured by a set of tracer indicators across five domains: basic amenities, basic equipment, standard precautions for infection prevention, diagnostic capacity and essential medicines. Based on a comparison between the 2011 facilities survey (*Rifaskes*) and the 2016 facilities census (Quantitative Service Delivery Survey, QSDS). This is discussed further in the ongoing Indonesia Public Expenditure Review.

- **Social assistance:** A large part of the increase of PKH, the conditional cash transfer program, between 2015-2018 went into expanding coverage. In line with World Bank recommendations, the government doubled the PKH benefit level in the 2019 budget to bring the beneficiaries closer to or above the poverty line. The expansion of PKH has helped improve school attendance and utilization of preventative health care services, such as maternal care and immunization, reduced school drop-out and child labor and increased consumption. The PKH reform fits in a broader set of major reforms moving from in-kind transfers (Rastra) to better targeted e-vouchers (BPNT) for 15.6 million beneficiary families by the end of 2019, and there are plans to initiate a similar reform for subsidized LPG in 2020.

Figure 6. Expenditure composition of energy subsidies and priority areas
(Percent of total central government expenditure including transfer to subnational governments)



Source: Ministry of Finance, Bank staff calculations

46. **Beyond increasing spending on priority sectors, Indonesia needs to improve its spending efficiency.**[46] For social assistance, efficiency has improved with better targeting of the poor and vulnerable households by moving from in-kind to cash transfer programs. In infrastructure, the World Economic Forum's perceived infrastructure quality index for Indonesia has increased in recent years compared to other Emerging Market Economies (EMEs) and ASEAN economies, due to in part to increased budgets, improved capital budget execution and early procurement arrangements (Prior Action #5 from DPL 1). However, there are still more efficiency gains possible, as there is a 37 percent efficiency gap in terms of infrastructure quality when compared with the most efficient peer country. In health, the scope for more efficient spending is large as well, as outlined in the ongoing Public Expenditure Review (PER).

[46] As assessed by the ongoing Public Expenditure Review and a recently concluded Public Investment Management Assessment mission.

47. **Going forward, increased spending could lead to more physical and social resilience to climate change and natural disasters.** Thanks to the Ministry of Finance's climate change mitigation and adaptation budget tagging initiative, the share of expenditure on climate change mitigation in the infrastructure sector, such as irrigation networks, geothermal and renewal energy development, has increased from 5.3 percent in 2016 to 16.9 percent in 2018 (Table 6). Therefore, based on historical experience, a higher budget allocation to infrastructure development should also imply increased expenditures on climate change mitigation. Meanwhile, increased social spending has made poor families more resilient to natural disasters than would otherwise be the case. Finally, the increased allocation for health is expected to strengthen Indonesia's primary health care capacity for a more adaptive public health system, as well as the community it serves in preventing and coping with climate-sensitive diseases such as diarrhea, dengue and malaria.[47] As outlined in the NDC, the Government considers such increases in health and social spending a key part of the strategy to strengthen social resilience to climate change.

Table 6. Expenditures associated with infrastructure for climate change mitigation (directly and indirectly decreasing greenhouse gas emission)
(IDR billion)

Line ministry	Sub-section	2016 (actual)	2017 (actual)	2018 (budget)
Ministry of Agriculture	Agriculture	992	0	160
Ministry of Energy and Mineral Resources	Energy	1,158	1,363	943
Ministry of Public Works and Housing	Infrastructure	7,589	3,036	19,921
Ministry of Transportation	Transportation	3,833	18,090	43,715
Total		**13,572**	**22,490**	**64,738**
Share of infrastructure spending (%)		**5.3**	**6.2**	**16.9**

Note: No output associated with infrastructure climate change mitigation can be identified in the Ministry of Industry and Ministry of Environment and Forestry
Source: Ministry of Finance, World Bank staff estimations

48. **Prior Action #1: The Borrower has increased the shares of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-energy subsidy reform years (2012-2014), as evidenced through the 2019 Budget Law and Presidential Regulation 129/2018.**

49. **Description:** Between 2015 and 2019, the government maintained an increased budget allocation for infrastructure, health, and social assistance to support human and physical capital investment for growth, jobs, and poverty reduction, compared to the pre-energy subsidy reform years (Figure 6).[48]

[47] The World Bank is supporting the Ministry of Health in achieving Indonesia's climate change adaptation objectives through its Indonesia – Supporting Primary Health Care Reform (i-Sphere) Program-for-Results operation (World Bank, 2018b). The Program will help Indonesia's primary health care system, amongst others, be better prepared for existing and new climate-induced health risks, thereby increasing adaptive capacity of the public health system and reducing vulnerability of the populations it serves. This includes the lagging region of Eastern Indonesia, which is at very high risk of climate change-related diseases.
[48] The proposed 2019 Budget reflects sustained higher allocation for priority areas (compared to pre-2015 but slightly below the 2018 levels). The government decision not to adjust subsidized fuel prices according to the formula, despite rising oil prices

50. **Results:** The sustained increase in spending on infrastructure is expected to result in improved infrastructure across different sectors and regions, through investments mainly by the Ministry of Public Works and Housing, Ministry of Transport and SOEs, and through subnational investments in rural electrification and other infrastructure projects. The expected result of the sustained increase in health spending is an increase in the number of poor and near-poor households covered by the JKN health insurance scheme, thanks to larger central government subsidies for premiums that rose from 86.4 million in 2014 to 93 million in 2020.[49] The expected result of the sustained increase in social assistance spending is an increase in the number of beneficiary families of the PKH conditional cash transfer program from 2.8 million in 2014 to 10 million in 2020. This is aligned with a Disbursement-Linked Indicator in the ongoing World Bank Indonesia Social Assistance Program-for-Results operation and is therefore not repeated as a result indicator for this DPL.[50]

Insuring public assets against natural disasters

51. **Rationale:** Losses from major climate-related and non-climate-related disasters can have a large economic impact. The frequency and severity of hydrometeorological disasters, such as floods, e.g., from increased rainfall and sea-level rise, are also projected to worsen significantly due to climate change. Refurbishment of public assets are one of the largest contributors to government expenditures following disasters, especially in middle- and high-income countries. These assets include public buildings such as schools and hospitals, as well as infrastructure such as roads, and costs to the government are especially high in countries where insurance coverage for such assets is low.[51] Improving the resilience of the budget to these climate- and non-climate-related disasters and other shocks is an important step to strengthen budget execution and effectiveness of spending by avoiding substantial reallocations of spending to disaster relief and reconstruction. Past experience in Indonesia has demonstrated that the current contingency budget is insufficient. In addition, good practice from other countries has shown more efficient ways to insure against these shocks by combining different financial instruments. Until recently, it was not possible to insure central government assets due to the lack of regulations, which prevented a culture of insurance from developing.

---

pose risk to crowding out of spending in priority areas. However, the level of energy subsidy spending is currently significantly lower than pre-2015 reform (16.2 percent of total expenditure in 2014 to a budgeted 6.4 percent in 2019). The government has also taken measures to reduce the consumption of subsidized fuels through the introduction of unsubsidized higher-quality fuel. Sustaining higher public spending on these priority sectors remains critical to support growth, reduce poverty and share prosperity in the medium term and remains a policy action through the three proposed DPL operations in this series.

[49] The coverage was 92.3 million in October 2018. Coverage of the poor and near-poor expanded rapidly in the first years after the energy subsidy reform (2015-17) but the annual rate of increase slowed down in 2018. The government has set a coverage target of 100 million by 2020.

[50] The Prior Action #1 results indicators for DPLs 1 and 2 compared the baseline budget allocations for social assistance, health and infrastructure in 2012-14 against target budget allocations in 2017 and 2019, respectively. In order to focus more on medium-term outputs of the increased spending, rather than inputs (budget allocations), and to streamline the results matrix, this DPL adopts as the health result indicator the number of poor and near-poor covered by the JKN health insurance scheme. For social assistance the key result is an increase in the number of beneficiaries of the JKN conditional cash transfers, which is aligned with a Disbursement-Linked Indicator in the ongoing World Bank Indonesia Social Assistance Program-for-Results operation, P160665 (World Bank, 2017b) and is therefore not repeated as a result indicator for this DPL. The expected result of increased infrastructure spending cannot be captured in a single indicator, since the spending is spread across a number of ministries, subnational governments and SOEs, and this DPL therefore does not include a result indicator for infrastructure.

[51] OECD and World Bank. 2019.

52. **Prior Action #2: The Borrower has enabled the purchase of disaster risk insurance for the Borrower's assets, as evidenced through the Minister of Finance Regulations 247/2016 and 142/2018.**

53. **Description:** The Government is implementing a public asset indemnity insurance program to transfer risks for rare, but severe events to financial markets, and to protect all central government assets, the state budget, and ultimately communities. This insurance program will benefit poor households, living in disaster-prone areas, which are often more reliant on public services (Box 1). The insurance program is one priority area under implementation as part of the Government's DRFI strategy. The first step will cover buildings owned by the Ministry of Finance including offices, education facilities, and health centers. The insurance is to be placed with a consortium of domestic insurers organized under the General Insurance Association of Indonesia (AAUI) during the second quarter of 2019.

54. **This program was enabled by recent regulatory reforms in public financial management.** The Government completed a program of reforms to establish the required regulatory framework, which removed key obstacles. The G.R. 45/2013 (Article 111) allowed the purchase of risk management contracts and the payment of insurance premiums in general through the budget. The Ministry of Finance Regulation 247/2016 sets the legal basis for insurance of state assets, including the objectives, plans, implementation mechanisms, reporting and the management of the insurance policy contracts. Finally, the Ministry of Finance Regulation 142/2018, includes public asset insurance in the guidelines for budget and workplan formulations, enabling the use of the national budget for the purchase of insurance. The insurance program will cover all perils, which supports cost-efficient insurance coverage for climate related risks.

55. **The public sector's financial resilience to climate-related natural disasters will improve with the purchase of disaster risk insurance under this prior action.** Insurance payments can provide timely post-crisis liquidity that enables the Government to deploy speedy disaster recovery response operations.

56. **Results:** The result indicator captures the gradual expansion of the program to cover all ministries and agencies and all asset categories. The first step will be the placement of an insurance program protecting 1,577 buildings owned by Ministry of Finance (with an estimated asset value of IDR 11 trillion) to build the system and capacity for a government insurance program. This will be followed by a gradual expansion to include more central government ministries and agencies, and more assets (bridges, other infrastructure and vehicles), as the disaster exposure of those assets is assessed, which will be tracked by the result indicator as the share of ministries and agencies covered by disaster insurance. In the medium term, the plan is to cover all central government assets, with a value estimated at IDR 4,206 trillion.[52] This will enhance budget spending on priority sectors by increasing the predictability of available funds for rehabilitation of public assets, reducing the need for unplanned budget reallocation, and possibly speed up the rehabilitation of assets.

Tagging climate change mitigation and adaptation activities in the budget

57. **Rationale:** Achieving Indonesia's climate policy objectives calls for the integration of climate change considerations with fiscal policy actions. To achieve this, the Government needs to mainstream

[52] Government of Indonesia (2018b).

budget tagging across line ministries to better understand the level and composition of expenditures that are associated with climate change mitigation and adaptation. The climate budget tagging initiative has enabled the planning and budgeting of climate-related expenditures and will enable the Government to strategize its climate policy actions to achieve both greenhouse gas emission reduction and climate-resilient development goals by 2030, as outlined in the Nationally Determined Contribution document. In addition, the budget tagging initiative enabled the Government to issue the world's first sovereign Green Sukuk amounting to US$ 1.25 billion in 2018, the proceeds of which will be spent on climate change adaptation and mitigation projects, opening up an addition channel for Indonesia to tap global finance.

58. **Prior Action #3: The Borrower has expanded the climate finance budget tagging initiative from tagging only for climate change mitigation to climate change mitigation and adaptation, as evidenced through the Climate Budget Tagging Manual.**

59. **Description:** The National Action Plan on Climate Change Adaptation (RAN-API) 2014 put in place a policy framework to promote climate change adaptation actions in Indonesia. In line with the Ministry of Finance Regulation 94/2017, line ministries were directed to conduct budget tagging for adaptation. Climate budget tagging for mitigation has been performed by 6 ministries since 2016.[53] In 2018, the Ministry of Finance expanded the budget tagging initiative to include budget tagging for expenditures linked to climate change adaptation for 17 ministries, of which 8 ministries[54] already began tagging in 2018. These 8 ministries represent 9 percent of 87 ministries and 10.8 percent of the total central government approved budget in 2018.[55] The Government will roll out this initiative to 17 more ministries and agencies in the medium-term, whose budgets in aggregate represent 24.3 percent of the total central government approved budget in 2018. In addition, 4 out of the 17 ministries are among in the top 11 ministries with the largest allocated budgets in 2018.

60. **Results:** The prior action will contribute to the mainstreaming of the monitoring, planning and budgeting of climate associated expenditures. The immediate result is that the 8 ministries that underwent budget tagging in 2018 will gain a better understanding of the level and composition of expenditures that are associated with climate change adaptation. As the initiative is rolled out to more ministries in the medium term, the Government will gather this information for monitoring, planning and budgeting and to implement policies that will further enhance climate change mitigation and adaptation efforts. The target in 2020 is 12 ministries, equivalent to 14 percent of total ministries and agencies. Specifically, the gathered information from climate budget tagging will facilitate analysis of budgetary changes in certain areas over time, serve as a feedback mechanism into reform processes, and create a platform for dialog among decision makers for substantive discussions on further aligning Indonesia's national priorities with international commitments. The policy will also facilitate convergence of different programs and initiatives across sectors and between national and local levels to achieve climate results.

---

[53] The 6 ministries are: Ministry of Agriculture, Ministry of Environment and Forestry, Ministry of Energy and Mineral Resources, Ministry of Public Works and Public Housing, Ministry of Industry, Ministry of Transportation.

[54] The 8 ministries and agencies are: Ministry of Agriculture, Ministry of Environment and Forestry, Ministry of Maritime Affairs and Fisheries, Ministry of Energy and Mineral Resources, Ministry of Public Works and Public Housing, Geospatial Information Agency, Agency for the Assessment and Application of Technology, Meteorological, Climatological and Geophysical Agency.

[55] Total central government approved budget excluding interest payments and transfers to sub-national governments.

Implementing a standardized and harmonized subnational budget chart of accounts

61. **Rationale:** Indonesia's more than 500 subnational governments manage and implement nearly half of public spending (excluding interest payments and subsidies) and play a critical role in delivering public services in key areas such as education, health, and local infrastructure. However, Indonesia lacks detailed information on the substantial spending of subnational governments which is needed to (i) support expenditure analysis that would inform the design of incentives for improved subnational spending; and (ii) compile a consolidated picture of government spending to support robust fiscal policy decision-making. This is partly because the current subnational government budget chart of accounts, as stipulated by the G.R. 58/2005, is not fully consistent with the central government's budget chart of accounts, which conforms with the Classification of the Functions of Government (COFOG), and because of variations of charts of accounts adopted across local governments. This lack of information has made monitoring and evaluating of local government spending challenging, severely constraining meaningful analysis to improve the quality of subnational spending.

62. One example is the challenge to monitor the level of spending across the central and subnational governments on preventing stunting in children, which is a national priority. Without a single chart of accounts for central and subnational government with the same codes for the same programs, it is very difficult to assess aggregate spending on stunting prevention and improve the impact of spending programs on stunting prevention.

63. **Prior Action #4: The Borrower has adopted the framework for standardizing and harmonizing the subnational budget chart of accounts, as evidenced through the Government Regulation 12/2019.**

64. **Description:** The new G.R. 12/2019 on Subnational Public Financial Management (replacing the G.R. 58/2005) contains a number of important reforms, including mandating the implementation of an integrated electronic system for subnational financial management (e-government), mandating the publication of subnational budgets, execution and financial statements to the public in an easily accessible format, and reporting the fiscal balance every semester. The reform supported in this operation is the setting up of the parameters of the new subnational government chart of accounts that (i) is harmonized with the chart of accounts that is in use at the national level; (ii) is standardized across economic and functional classifications used in the preparation of budgets and financial statements; and (iii) expands the number of segments in the chart of accounts to include functional and program classifications. The G.R. is based on a consensus between the two key players in national and subnational public financial management—the Ministry of Finance and the Ministry of Home Affairs—and it gives a key role in determining the subnational chart of accounts to the former for the first time. It is expected that the chart of accounts will be adopted through a subsequent regulation in 2019 or 2020. The Ministry of Finance will pilot the new standard classification system and anticipates implementation during the preparation of the 2021 budget. Lastly, the issuance of the standard chart of accounts will facilitate climate finance budget tagging among sub-national governments and will therefore contribute to greater mainstreaming and monitoring of climate finance at the sub-national level.

65. **In addition to these reforms, G.R. 12/2019 also provides clearer guidance[56] on subnational expenditure on post-disaster recovery** by explicitly recognizing central government transfers as subnational revenue and providing flexibility for disaster emergency expenditures without advance formulation in the subnational ministries' programs and budget plans.[57] This increased clarity and flexibility is expected to allow subnational governments to respond more rapidly to natural disasters.

66. **Results:** Work on the development of the actual standardized and harmonized subnational chart of accounts to implement G.R. 12/2019 started in early 2019 and will be piloted in a number of districts and provinces for the 2021 budget preparation. This will be followed by the issuance of the new chart of accounts, requiring all sub national governments to follow the new chart of accounts.[58] This will lay the basis for subnational budgets for 2021 to be presented using a consistent classification system for the first time, which will facilitate the production of much more detailed data and support more effective analysis of spending mix both by subnational governments themselves, and by national government authorities designing incentives to stimulate better subnational spending. A standardized classification of spending by function and sub-function will support the production of a complete consolidated statistical report for the first time. This is expected to contribute to more effective expenditures at both central and subnational government level to support national priorities such as stunting prevention.

Pillar B - Strengthening Revenue Administration

The prior actions under this pillar seek to contribute to Pillar B objectives by: (i) reducing the cost of paying taxes, by broadening the number of businesses entitled to a streamlined VAT refund process (Prior Action #5); and (ii) enhancing compliance management and audit capability, by enabling the operation of an improved data management and tax analysis unit (Prior Action #6).

Streamlined VAT refunds

67. **Rationale:** Under current policies and practices, the Directorate General of Tax (DGT) takes up to one year to issue a resolution on taxpayers' VAT refund claims. With a few exceptions, those claims trigger preemptive full-fledged audits under harsh penalties in case inconsistencies are detected. Large withholding of VAT refunds not only levy hefty cash flow constraints on businesses with large VAT credit stances – mostly as a result of VAT zero rating of exports –, but also distorts the consumption nature of the VAT by shifting the burden back to producers for long periods of time.

68. **Prior Action #5: The Borrower has broadened the coverage of taxpayers subject to a streamlined procedure for VAT refunds by: (a) increasing the refund value threshold; (b) expanding the criteria to be considered a low risk VAT taxpayer; and (c) allowing partial refunds, as evidenced through the Minister of Finance Regulation 39/2018.**

[56] Compared to G.R. 58/2005, and Ministry of Home Affairs Regulation No. 13/2006.
[57] RKA SKPD – *Rencana Kerja dan Anggaran Satuan Kerja Perangkat Daerah* or Program and budget plan for the SNG offices/agencies, equivalent to ministries at the central government level.
[58] The implementation of similar ambitious reforms in Mexico, Brazil and South Africa took 7 to 8 years, according to World Bank analysis. See also South Africa National Treasury, "Municipal Regulations on a Standard Chart of Accounts", November 2017.

69. **Description:** DGT has defined new categories of taxpayers to be eligible for preliminary refunds, namely low risk VAT taxpayers involved in export business and that are customs priority partners. For eligible taxpayers, DGT undertakes a material examination of the taxpayer's request instead of a full audit, and taxpayers will receive notice of preliminary tax refund assessment from DGT within a month. The next step is the issuance of a tax overpayment instruction letter to the Treasury Office within a month. Based on this letter, the Treasury Office will issue a disbursement letter transferring the refund amount to the taxpayer's account within 2 days.

70. **Results.** The immediate result of this reform is an increase in the number of VAT refunds requests subject to the streamlined refund procedure. By streamlining VAT refund procedures for more taxpayers, DGT will allow a critical mass of businesses that pay more tax on purchases than is collected on their sales, in particular zero-rated exporters entitled to a full refund of VAT paid on purchases, to improve their cash flow profile. More timely resolution of refund requests will also improve the overall administration of the VAT, while enhancing DGT's transparency and efficiency.

Strengthening Compliance Risk Management

71. **Rationale:** Despite recent modernization actions, the overall tax compliance rate remains low. Recent estimations indicate that only half of taxpayers comply with their tax obligations. There has been progress in the area of risk management as part of the ongoing reform, but DGT still needs to take bold actions towards adopting a systematic and comprehensive risk management framework. In addition, the quality of internal and external data is not up to par for proper risk management. To overcome this institutional challenge, functional and operative changes need to be implemented to combine data governance with data analytics, traditionally undertaken by different units within DGT, and establish a risk management unit tasked with designing compliance improvement actions from adequate identification, measurement, and assessment of the main non-compliance gaps across types of taxes, segments of taxpayers and tax administration functions.

72. **Prior Action #6: The Borrower has created a risk management unit (Data Management Team) within the Directorate General of Taxes, as evidenced through the Minister of Finance Decree 67/2019.**

73. **Description:** By merging data governance with data analysis functions into a new risk management unit, DGT strengthens its institutional capacity to improve overall voluntary compliance levels across the taxpayer population through a systematic risk assessment framework. The new unit will be endowed with the needed technical staff and IT management systems to undertake intelligence gathering and research initiatives to build knowledge of tax compliance levels with respect to core taxes, taxpayer segments and key tax obligations (registration, filling, payments and accurate reporting in declarations).

74. **Results:** The immediate result is that the new Data Management Team will be operational. Among other key functions, the Team will identify the most critical compliance risks in the tax system, segmented by groups of taxpayers and tax types, and will propose the needed mitigation actions to address underlying causes of non-compliance behavior, all of which are expected to lead to improved tax compliance which has been a key constraint on collecting more tax revenue.

Pillar C: Enhancing Tax Policy

75. The prior actions under this pillar seek to contribute to Pillar C objectives by increasing revenue potential and the economic efficiency of tax policy. Reform of the presumptive tax on micro, small and medium enterprises (MSMEs) (Prior Action #7) broadens the base of the general standard corporate income tax regime by encouraging graduation of MSMEs into this regime. Publishing regular tax expenditure statements (Prior Action #8) increases fiscal transparency and enables a cost/benefit analysis of tax incentives with a view to future efficiency-enhancing reforms. Upgrading Indonesia's tax treaties helps fight base erosion through treaty abuse, which will enhance tax collections from multi-national enterprises (MNEs), and support a stable and predictable tax environment for foreign investment in Indonesia (Prior Action #9).

Reforming taxes on MSMEs to broaden the income tax base

76. **Rationale:** The special final tax regime for MSMEs introduced in 2013 (under G.R. 46) eroded the tax base for the general income tax regime because of its non-voluntary nature,[59] an extremely high threshold of IDR 4.8 billion, and a low rate of 1 percent of gross turnover. As a result, G.R. 46 inadvertently created disincentives for business growth and for taxpayers to migrate to the standard income tax regime, encouraging strategic behavior.[60]

77. **Prior Action #7: The Borrower has enabled the expansion of the general income tax base, including by: (a) introducing sunset clauses for the MSME final tax; and (b) allowing MSME taxpayers to opt for taxation under the general regime, as evidenced through the Government Regulation 23/2018.**

78. **Description:** G.R. 23 introduces sunset-clauses for different legal types of companies, namely three years for limited liability companies, and four years for other companies such as cooperatives. For individuals, the sunset clause is set at seven years. These clauses apply from the time of the enactment of G.R. 23 for taxpayers already registered (July 1, 2018), or from the date of registration for future taxpayers. Consistent with standard practice in most presumptive regimes, G.R. 23 also excludes professional services such as doctors, lawyers and accountants, who typically have high profit margins and the capacity to calculate their net income.[61] Making the regime voluntary is a good system-improvement, but with limited revenue impact in practice.[62]

---

[59] Taxpayers were not given the option to opt in the general standard income tax regime instead of G.R. 46.

[60] In contrast, the general standard corporate income tax rate is 25 percent, though a discount is applied for companies with revenues lower than IDR 50 billion (Article 31E). The personal income tax regime is progressive, with four tiers: starting with 5 percent on taxable income up to IDR 50 million, going gradually up to a maximum of 30 percent on taxable income above IDR 500 million. G.R. 46 covered both 'corporate' and 'individual' MSMEs, thus providing an alternative to the standard income tax treatment of both corporates and individuals. Businesses whose sales approached the MSME threshold thus had strong incentives either not to grow their business further, or to act strategically – for example, by splitting their business into 2 or 3 – so as to avoid migration into the general regime.

[61] Given this, including professional services in the presumptive regime, even for a short period of time, results in unjustified revenue losses.

[62] Due to the low tax burden and reduced compliance costs afforded under G.R. 23, there are no incentives for businesses to select taxation under the general regime. Thus, in reality, the option to select the general tax regime will only be interesting for loss-making businesses who have the capacity to keep books and properly document their losses. Such businesses under the general regime would have zero tax liability, and the additional right to carry forward losses for future years.

79. **Results:** G.R. 23 supports the broadening of the general income tax regime, enabling enhanced revenue potential over the medium term. This is mainly achieved through the sunset clauses, that also serve to partly mitigate the distortive impact of a high threshold combined with low rates in the final regime.[63] Making the system voluntary is a good additional measure that will mean some businesses and individuals can elect to move to the general income tax regime prior to the sunset clauses coming into effect. Given the short timeframe of the DPL, the results indicator included in this Program Document focuses on these voluntary migrations, as those that will move due to the sunset clauses taking effect will only do so from 2021 onwards.[64] Strengthening compliance is a critical component for making this reform a success. DGT's Data Management Team (Prior Action #6) will play an important role in matching different datasets and using these to analyze compliance behavior as part of a risk management strategy.

Publishing tax expenditure statements to increase fiscal transparency

80. **Rationale:** Tax expenditures (TEs) are special provisions (incentives) that operate as exceptions to the standard prevailing tax rules. While TEs may bring some economic benefits, they result in foregone tax revenue, create economic distortions (both intended and unintended), and undermine the equity of the tax system. TE Statements (TES) help address concerns with TEs by quantifying the costs of these incentives, and by making them public, increasing transparency and controls, with the end goal of supporting fiscal sustainability.

81. **Prior Action #8: The Borrower has increased fiscal transparency by: (a) identifying all the tax expenditure across its major taxes; (b) publishing its first tax expenditure statement; and (c) adopting its sustainability strategy, as evidenced through the Financial Note for 2019 Budget, Minister of Finance Official Note ND-315/KF/2018 and Indonesia tax expenditure report.**

82. **Description:** The Financial Note for the 2019 Budget included a discussion of TEs and estimates of revenue foregone in 2016 (IDR 143.6 trillion or 1.16 percent of GDP) and in 2017 (IDR 154.7 trillion or 1.14 percent of GDP). The Ministry of Finance published a more comprehensive TES, entitled "Tax Expenditure Report 2016-2017"[65] on its website, identifying a full inventory of TEs of major taxes collected by the central government, namely VAT, income taxes, import duties and excises. The report sets out the Ministry's commitment to issue a similar report annually. Work has started on preparing the 2019 TES, aiming to provide a more comprehensive quantification of tax expenditures in the 2020 Budget Financial Note.

83. **Results:** This policy action strengthens fiscal transparency and is facilitating a debate at the Government and public levels on the effectiveness of existing fiscal incentives. While only one TE item was included in the 2018 Financial Note, the TES issued in 2018 included an inventory of all tax expenditures in existing regulations (numbering 89 in total) and costed 34 of them, a summary of which was included in the 2019 Financial Note. The Ministry of Finance is now working on its second annual

[63] In G.R. 23, the rate is set at 0.5 percent, and the threshold is maintained as in G.R. 46 at IDR 4.8 billion, though the impact of annual inflation and recent depreciation of the Rupiah, means this threshold is lower in real terms, and lower compared to the U.S. Dollar.
[64] Taxpayers that were filing under the presumptive tax regime in 2017 will be tracked over 2018 and 2019 to see which tax regime they elect to use. Those that elect to use the general income tax regime will be counted as part of this results indicator.
[65] Government of Indonesia (2018d). The TEs inventory only excludes property taxes and stamp duty, which represent less than 2 percent of central government taxes.

TES, in which it aims to conduct a more comprehensive analysis of the key tax expenditures. Over the medium-term, annual TES reports will strengthen policy dialog around the effectiveness of fiscal incentives, supporting reform efforts of those incentives that are least effective and most costly.

Developing model tax treaty to strengthen measures against base erosion and profit shifting (BEPS)

84. **Rationale:** Supported by Fiscal DPL 1 and 2, Indonesia has undergone reforms to strengthen anti-base erosion and profit shifting (BEPS) regulations. The effectiveness of these reforms, however, is severely limited by the fact that Indonesia has a wide network of taxation treaties negotiated long before issues relating to BEPS had emerged. Upgrading existing treaties is a pressing issue and will serve as a critical complement for the anti-BEPS regulations that the Government has been developing. Renegotiations are best conducted when they start from a sound basis against which existing treaties are evaluated.

85. **Prior Action #9: The Borrower has strengthened measures against base erosion and profit shifting by developing a model tax treaty for use in double tax agreements, as evidenced through the Minister of Finance Official Note ND-471/KF/2018.**

86. **Description:** Indonesia's model tax treaty has been built drawing among others, on the UN Model [66] and on provisions Indonesia has adopted as part of signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "MLI"). The model tax treaty's primary objective is to avoid double taxation and double non-taxation, while protecting the taxation rights of the source country in a more balanced way.

87. **Results:** Indonesia's model tax treaty articulates a coherent tax treaty policy that, amongst other things, seeks to limit risks associated with BEPS. Since being developed, the model tax treaty has been used to identify priority treaties in need of re-negotiation and served as a basis for the commencement of tax treaty negotiations with 4 countries (1 new, 3 re-negotiations). While there is scope to further improve, expand and clarify the model, effective implementation of the model tax treaty, along with the necessary amendments to the corresponding domestic tax law provisions, has the potential to enhance revenue, and to support a stable and predictable tax environment for foreign investment in Indonesia.

Table 7. DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar A – Improving Quality of Spending ***Objectives: Improving (i) composition of spending; (ii) budget execution; and (iii) efficiency of spending***	
#1. Composition of Spending. The Borrower has increased the shares of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-energy subsidy reform years (2012-2014), as evidenced through the 2019 Budget Law and Presidential Regulation 129/2018.	• Ongoing Programmatic Public Expenditure Review (PER), including sectoral chapters on health, social assistance, and infrastructure • WB (2016) Health Financing Study • WB (2017) Social Assistance PER Update

[66] The 2011 United Nations Model Taxation Convention between Developed and Developing Countries. For more analysis of the role of model tax treaties in fighting tax abuse in Indonesia, see: "Note on Treaty Abuse Legislation and Tax Treaties: GAAR enacted by Indonesia", The World Bank (October 2016)

Prior Actions	Analytical Underpinnings
#2. Disaster risk insurance. The Borrower has enabled the purchase of disaster risk insurance for the Borrower's assets, as evidenced through the Minister of Finance Regulations 247/2016 and 142/2018.	• Improving Public Assets and Insurance Data for Disaster Risk Financing and Insurance Solutions, Technical Contribution to the APEC Finance Ministers' Process, 2019 • Managing Disaster-Related Contingent Liabilities in Public Finance Frameworks, Technical Contribution to the APEC Finance Ministers' Process, World Bank and OECD, 2019. • Supporting the Development of the Disaster Risk Financing Strategy of the Government of Indonesia, 2018-2019. • World Bank, Financial Protection Against Natural Disasters: An Operational Framework for Disaster Risk Financing and Insurance, 2014.
#3. Climate finance budget tagging. The Borrower has expanded the climate finance budget tagging initiative from tagging only for climate change mitigation to climate change mitigation and adaptation, as evidenced through the Climate Budget Tagging Manual.	• Government of Indonesia (2016) "First Nationally Determined Contribution: Republic of Indonesia", November 2016 • World Bank (2018): Review of Indonesia Climate Budget Methodology • World Bank (2019): Indonesia Climate Budget Report
#4. Standardization of subnational budget chart of accounts. The Borrower has adopted the framework for standardizing and harmonizing the subnational budget chart of accounts, as evidenced through the Government Regulation 12/2019.	• Decentralization that Delivers PASA • Ongoing TA on improving subnational PFM, supported by PFM-MDTF • Aide Memoire: Technical Support Mission on Subnational Financial Management Information Systems (SN-FMIS) Integration, September 24-October 5, 2018 • Review of SIKD (Regional Financial Information System), World Bank and DG Fiscal Balance, June 2018
Pillar B – Strengthening Revenue Administration ***Objectives: Increasing (i) tax administration efficiency; (ii) compliance management and audit capability; and (iii) reducing the cost of paying taxes***	
#5. VAT refunds. The Borrower has broadened the coverage of taxpayers subject to a streamlined procedure for VAT refunds by: (a) increasing the refund value threshold; (b) expanding the criteria to be considered a low risk VAT taxpayer; and (c) allowing partial refunds, as evidenced through the Minister of Finance Regulation 39/2018.	• WB PFM-MDTF Tax administration support pillar. • WB PEFA Assessment (2017) • IMF VAT Refunds: a review of country experience (2018) • IMF Modern VAT (2001) • Tax Administration Diagnostic Tool (TADAT): Field Guide (2015)
#6. Compliance risk management. The Borrower has created a risk management unit (Data Management Team) within the Directorate General of Taxes, as evidenced through the Minister of Finance Decree 67/2019.	• WB PFM-MDTF Tax administration support pillar. • WB PEFA Assessment (2017) • WB Lessons on DRM (2016) • IMF Developing a Taxpayer Compliance Plan (2010) • OECD Compliance Risk Management: Managing and Improving Tax Compliance (2004) • Tax Administration Diagnostic Tool (TADAT): Field Guide (2015)
Pillar C – Enhancing Tax Policy ***Objectives: Increasing (i) revenue potential; and (ii) economic efficiency of tax policy***	
#7. MSME presumptive tax regime. The Borrower has enabled the expansion of the general income	• Technical Notes (2017, 2018) • WB technical assistance missions (2016, 2017, 2018)

Prior Actions	Analytical Underpinnings
tax base, including by: (a) introducing sunset clauses for the MSME final tax; and (b) allowing MSME taxpayers to opt for taxation under the general regime, as evidenced through the Government Regulation 23/2018.	• WB support to BKF provided by SEMEFPA and by DRM's Global Tax Team • AIPEG technical assistance (2016-2017)
#8. Tax expenditure. The Borrower has increased fiscal transparency by: (a) identifying all the tax expenditure across its major taxes; (b) publishing its first tax expenditure statement; and (c) adopting its sustainability strategy, as evidenced through the Financial Note for 2019 Budget, Minister of Finance Official Note ND-315/KF/2018 and Indonesia tax expenditure report.	• WB VAT MSM Study (2019) • WB CIT MSM Study (2018) • WB support to BKF provided by SEMEFPA • Support provided by Australian Treasury, AIPEG, and PROSPERA (2017-2019)
#9. Model Tax Treaty. The Borrower has strengthened measures against base erosion and profit shifting by developing a model tax treaty for use in double tax agreements, as evidenced through the Minister of Finance Official Note ND-471/KF/2018.	• WB Technical Note on Indonesia's Tax Treaty Model (2017) • WB support to BKF provided by SEMEFPA and by DRM's Global Tax Team • Support provided by AIPEG (2017)

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

88. **This DPL series is aligned with the Indonesia FY 16-20 Country Partnership Framework (CPF), discussed by the Board in December 5, 2015, Report No. 99172.**[67] It contributes mainly to the "Collecting more and spending better" Engagement Area, which supports the Government in addressing key policy and institutional bottlenecks to improve the quality of spending (Pillar A), strengthen revenue administration (Pillar B) and enhance tax policy (Pillar C). The operation also contributes to other Engagement Areas, such as "Sustainable landscape management" through Pillar A, which will help to improve climate change and natural disaster resilience. Prior Acton #1 on increasing the spending shares on infrastructure, health and social assistance contributes to the Supporting Beams of "Shared prosperity, equality and inclusion". Prior Action #4 on improving the quality of subnational expenditure and service delivery, will support "Infrastructure platforms at the national level" and "Delivery of local services and infrastructure". Prior Action #5 on reducing the cost of paying taxes and Prior Action #7 on the formalization of businesses contributes to "Leveraging the private sector: investment, business climate and functioning of markets".

89. **World Bank-financed projects in close collaboration with the MoF provided much of the underlying analytical work underpinning the DPL series.** This includes analytical work on revenue collection enhancement and improvement on the quality of spending provided through the Program for Support for Enhanced Macroeconomic and Fiscal Policy Analysis (SEMEFPA), funded by the Government of Australia. The DPL series also draws upon analytical work delivered for improving tax administration and budget efficiency through the Public Financial Management Multi-Donor Trust Fund, funded by the Governments of Canada, Switzerland and the European Union. The analytical work

[67] World Bank (2015b).

surrounding the review of climate finance budget tagging was possible through the trust fund provided by the NDC Partnership Support Facility.

90. **The World Bank Group is supporting Indonesia to address challenges from climate change through an active portfolio of climate-relevant activities.** With climate change as a thematic focus across all engagement areas of the current CPF, the World Bank has set a target of at least 31 percent of lending commitments with climate co-benefits for Indonesia. This DPL supports this target through advancing implementation of the Government's Disaster Risk Financing and Insurance Strategy, strengthening resilience to climate and disaster risks, including setting up the necessary institutions and risk insurance instruments. These reforms help the Government in becoming a proactive risk manager rather than just being an emergency responder to natural disaster shocks. Such shocks, which are associated with disasters such as floods, landslides, droughts, are projected to increase with climate change. Building financial and physical resilience to such shocks will protect the national fiscal balance, support local governments, and protect the most vulnerable against falling back into poverty, in line with the Government's objective of more inclusive growth.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

91. **The Government has conducted consultations with internal and external stakeholders, as required by its own regulations (G.R. 87/2014, G.R. 7/2017, Ministerial Regulation of Ministry of Law 23/2018).** For example, the standardization of the subnational chart of accounts (Prior Action #4) required extensive consultations between the Ministry of Finance, Ministry of Home Affairs and the Coordinating Ministry of Economic Affairs.

92. **The World Bank has maintained regular consultations with other development partners**, including the International Monetary Fund (IMF), Asian Development Bank (ADB), Japan International Cooperation Agency (JICA) and Agence Française de Développement (AFD).

93. **The Government of France, represented through AFD, is also providing policy loans to support the Government's program, under this DPL series.** AFD signed a EUR 100 million credit facility agreement with the Ministry of Finance in November 2016 following the World Bank Board's approval of the first operation in May 2016. Following the World Bank Board's approval of the second operation in October 2017, AFD's board approved a second, parallel co-financing operation in June 2018 for a EUR 150 million loan, which was signed and disbursed in December 2018. AFD is also mobilizing technical assistance support to the Ministry of Finance closely coordinated with the technical assistance support provided by the Bank. Strong collaboration in preparation for the current operation continues.

94. **Discussions with representatives from the Australia-Indonesia Partnership for Economic Development (PROSPERA) have also been regular and ongoing.** There were regular consultations between the World Bank and PROSPERA on fiscal policy reforms including the implementation progress of the Medium-Term Expenditure Framework (MTEF), and input was jointly delivered on reforms such as the publication of Indonesia's first tax expenditure statement.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

95. **The overall poverty and social impact of the DPL is positive.** While most of the prior actions are broadly neutral, some will likely have a direct impact on poverty in the short and medium run. The most important ones from the perspective of poverty and social impact are discussed below.

96. **Prior Action #1 on increasing the share of the central government budget allocated to the infrastructure, social assistance and health sectors has the strongest potential for poverty and inequality reduction.** As mentioned, budgets sustaining a higher allocation for priority spending on infrastructure, health, and social assistance, relative to the 2012-14 period, have led to the creation of new public assets, including housing, transport and rural electrification. In addition, the coverage of the health insurance premium (PBI) waiver for the poor has been expanded, while continuing the transformation of the rice for the poor program through implementation of non-cash food assistance (BPNT). The benefit level for the conditional cash transfer program (PKH) has also doubled, following the rapid expansion of its coverage from 6 million in 2017 to 10 million beneficiary families in 2018. Higher local spending on infrastructure has the potential to address spatial disparities by helping poor districts close their infrastructure gap and help link the poor to economic opportunities through greater connectivity and market access.[68] Improved infrastructure also facilitates school children traveling to school, thereby reducing the cost of attaining education, which should entail further productivity increases in the medium term. Increased health expenditures have contributed to an expansion of the population coverage under the JKN, the Indonesian national health insurance, from 52 percent (2014) to 78 percent (2018), and improved supply-side readiness of subnational health centers, benefitting mainly the poor. Indonesia's increased spending on social assistance has had a positive impact on the reduction in poverty and inequality. In 2017, without direct assistance through programs such as the PKH, Rastra (rice subsidy program) and KIP (cash transfers to poor student), the poverty rate would have been 1.5 percentage points higher. Similarly, inequality would have been higher without expanded social assistance.[69] Further expanding the budgetary allocation and spending through these programs would enhance these impacts, especially if accompanied by continued efforts to strengthen and improve targeting.[70] Higher social assistance spending, apart from being pro-poor, also tends to be pro-women. The PKH program directly targets mothers within families via two channels – mothers as recipients of cash benefit and as recipients of coaching/counseling support. The non-cash food assistance program (BPNT) also targets women and hence favors female members of beneficiary families.[71]

97. **Prior Action #2 on improving financial resilience to natural disasters through the purchase of disaster risk insurance for state assets will not have immediate poverty and social impacts, but will in the medium term as the availability of disaster risk insurance is expanded across the government.** Natural disasters typically have a disproportionately adverse effect on the poor and vulnerable groups.

[68] World Bank (2018e).
[69] World Bank (2019a).
[70] ibid.
[71] World Bank Social Protection and Labor Global Practice internal progress report.

This is often due to higher exposure, since the poor tend to live closer to disaster prone areas, as well as a lower ability to cope due to lack of savings and insurance.[72] All things equal, disaster risk insurance will help mitigate the economic impact of shocks, so that the livelihoods and economic activities of the insured are not jeopardized by the occurrence of extreme natural events. The program starts with a pilot to purchase disaster risk insurance of MoF buildings for this year and is expected not to have immediate poverty and social impacts. However, once the pilot achieves the desired demonstration effect and coverage is rolled-out to all line ministries, it is likely that there will be positive benefits for the poor in the medium run. The poor and the vulnerable tend to be the most intensive users of basic public services, such as education and health.[73] To the extent that financial resilience through disaster insurance can enable the government to more rapidly restore critical services, such as education, maternal and child health, and drinking water, which are likely to be disrupted with disasters, this action will bring benefits to the poor, vulnerable, women and children, in the event of a disaster.

98. **Prior Action #3 on budget tagging for climate change adaptation is expected to be pro-poor and pro-women, as climate change disproportionately affects the poor and women.** Climate change could slow down or possibly reverse progress on poverty reduction in Indonesia.[74] This is due to its potential negative impacts on agriculture, from which over 60 percent of the poor derive their income and wellbeing, and on human health. In addition, natural disasters, which have become more frequent with global warming,[75] also tend to disproportionately affect the poor.[76] Estimates show that climate change will impose a total cost of IDR 132 trillion, currently equivalent to 0.9 percent of GDP, on the Indonesian economy by 2050.[77] About 53 percent of this cost will be due to decreased agricultural output, 34 percent will be due to its negative impacts on health (in the form of dengue fever and malaria); and the remaining 13 percent will be due to flood-induced damage to homes, offices, industrial areas, fields and aquaculture facilities resulting from rising sea levels. The cumulative negative effect of climate change on agriculture, human health, and assets will weigh on economic growth, which is a key driver of poverty reduction.[78] Females in the developing countries in general are disproportionally vulnerable, and have less adaptive capacity, to the effects of natural disasters and climate change.[79,80] There are gender differentials in many of the health risks, such as undernutrition and malaria, which are likely to increase due to ongoing climate change. Globally, natural disasters such as droughts, floods and storms kill more women than men.[81] Natural disasters in Asia in general, and in particularly in Indonesia, disproportionally affect females more than males. For instance, 67 percent of the tsunami victims in

[72] For example, women represented 67 percent of total deaths Indonesia experienced during the 2004 Indian Ocean tsunami in Banda Aceh (Rush, 2013). Likewise, Myanmar's 2008 Cyclone Nargis, forced up to half of the country's poor farmers to sell off assets, including land, to cope with the losses experienced.
[73] World Bank (2019b). Forthcoming. About 73 percent of the poor in 2016 used public hospitals and government primary health facilities (*puskesmas*) for inpatient care. Likewise, a significant majority of the poor sent their kids to public schools at the primary (86 percent), lower secondary (71 percent) and upper secondary (74 percent) levels.
[74] Skoufias et al. (2011).
[75] Hydrological (such as floods and landslides), meteorological (such as storms), and climatological (such as droughts) hazards are projected to intensify with climate change.
[76] See previous paragraph
[77] USAID (2016).
[78] It has been estimated that the impact of reduced agricultural output will trim global economic growth by 3 percentage points annually by 2080. See Asafu-Adjaye (2014).
[79] World Bank (2011).
[80] UNDP (2013).
[81] WHO (2009).

Banda Aceh in 2014 were females. Women are often more vulnerable to natural disasters because they have lower access to, and control over, key survival and recovery resources, such as food, shelter and transport.[82]

99. **Prior Action #7 on the MSME presumptive tax regime will not negatively affect poverty.** The proposed policy will lower the tax burden on existing MSMEs and introduce a sunset clause to graduate individuals and companies operating under the current MSME tax regime into the general income tax regime. This may entail a higher tax burden in the future, but the prevailing exemption thresholds on corporate as well as personal income tax implies that the policy is unlikely to have any effect on the poorest entrepreneurs. For example, under the current personal income tax threshold, 94 percent of the middle class and the entire aspiring middle class are exempt from paying income tax.[83] Likewise, the IDR 4.8 billion turnover threshold for firms leaves ample room for small and medium enterprises potentially owned and operated by those at the lower end of the income distribution to grow without being affected by the general tax regime.

100. **The portfolio of reforms geared towards enhancing revenue collection and better budgetary planning, management and execution has the potential to be pro-poor.** The standardized and subnational budget chart of accounts could benefit the poor, if they eventually lead to meaningful improvements in the quantity and quality of spending. Similarly, improving tax administration and policy, through improved taxpayer compliance, better management of VAT refunds, a broader tax base, more fiscal transparency and less tax base erosion, could be pro-poor to the extent that the improved revenue collection could lead to more resources targeted at the poor and the bottom 40 percent.

5.2. ENVIRONMENTAL ASPECTS

101. **The environmental impacts of the fiscal reform actions supported by the DPL series continue to be overall positive.** The prior actions for the first pillar on the quality of spending aim to increase the level and improve the quality of public spending and improve the budgeting process, to achieve efficiency of spending. For Prior Action #1 on the composition of spending, public infrastructure development can bring significant environmental, economic and social benefits. However, it can also have significant costs on the environment, both in its construction and use. While some infrastructure spending relating to mitigation against floods or rehabilitation of dams for irrigation purposes can have positive effects, increased public investment in general could have positive and negative effects on the environment. For example, construction work can disturb habitats and wildlife or contaminate surface and ground water. Materials used can also be from unsustainable sources. On the other hand, infrastructure, such as solar fields, can be part of the transformation to a low-carbon economy. Infrastructure can also benefit communities by connecting them to markets but also disadvantage other communities because of environment degradation. In addition, there is a risk that some individual investments may have negative impacts because of uneven implementation of Indonesian safeguards systems. Prior Action #2 on disaster risk insurance is unlikely to have any direct environmental impact as it helps to increase risk protection of state assets against natural disasters and reduces the financial

[82] Asian Development Bank (2013). The Rise of Natural Disasters in Asia and the Pacific.
https://www.adb.org/sites/default/files/evaluation-document/36114/files/rise-natural-disasters-asia-pacific.pdf
[83] World Bank (2019). "Aspiring Indonesia: Expanding the Middle Class". Forthcoming.

burden of reconstruction and rehabilitation after a natural disaster. For Prior Action #3 on climate budget tagging, the benefits are positive, especially in the more efficient utilization of scarce natural resources and adapting to future climate conditions and extreme weather events. These actions are unlikely to have any adverse impact, but will have positive impact in improving resilience to disaster events or preparing for climate change events, thus better safeguarding human lives, livelihood, and public health. Other prior actions under the revenue administration and tax policy pillars are expected to yield more tax revenues and could therefore expand resources for the mitigation of negative effects from environmental, climatic and disaster events.

102. **Indonesia has a comprehensive legal and institutional framework for environmental impact assessment and licensing of infrastructure development, including for management of direct, induced or cumulative impacts that in general embodies international standards.** There are, nonetheless, institutional gaps, particularly regarding enforcement of existing legal frameworks, among government agencies and government levels, which may hinder the adequate implementation and management of environmental risks. More specifically, these gaps result from the fact that human capacity to prepare, review, monitor and enforce Environmental Impact Assessments[84] varies from one local or provincial government to another. Other issues include insufficient budgets in local agencies for enforcement and supervision of environmental and social management plans, and the lack of trained staff. On the social side, besides community health and safety risks associated with infrastructure projects, other primary risks are associated with land acquisition.

103. **Continuous efforts and support from development partners, including the World Bank, have been instrumental in the Government's efforts to strengthen its environmental risk mitigation capacity through various analytical and advisory services.** The effect of World Bank assistance to build the human capacity of the Government towards better awareness, better budgeting and attention to managing environmental and social impacts is overall positive. Efforts from the Government for improving environment monitoring includes implementation of the PROPER audit system to track performance and compliance of Indonesian corporation.[85] The ADB has been supporting the Government through its technical assistance activities, including its assessment of the country safeguards system and filing of gaps as addressed in the paragraph above. The follow-up includes a partnership with the World Bank in formulating Business Plans for the establishment of the Indonesia Environmental and Social Safeguard Learning Center. This partnership is part of the World Bank's commitment to promote sustainable development and sets out the principles and guidelines for Borrowers in mitigating risks and impacts associated with public infrastructure projects.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

104. **The Public Financial Management system in Indonesia has shown significant improvements over time.** The latest Public Expenditure and Financial Accountability (PEFA) report (2017)[86] concludes that Indonesia has established a strong legal and regulatory framework that aligns with most international standards on Public Financial Management (PFM). Overall, the average PEFA performance

[84] *Analisis Mengenai Dampak Lingkungan* or AMDALs.
[85] The PROPER Audit system is under the Ministry of Environment and Forestry and they monitor compliance on water quality standards, wastewater, air quality, and hazardous waste management annually.
[86] World Bank (2018c).

score is slightly below "B", which is above the basic level of performance broadly consistent with good international practices. 9 out of 31 PEFA performance indicators received "A" score, which is the highest performance according to PEFA standards, although the effectiveness of the PFM systems in place and the monitoring of performance can still be strengthened.

105. **PFM in Indonesia has important strengths, primarily associated with the development of instruments that have allowed prudent fiscal management and control of budget execution.** The recent introduction of fiscal rules to support major development initiatives has been effectively followed. The roll-out of the financial management information system (FMIS), together with the implementation of strict cash consolidation management rules, a well-defined treasury management system at the central government level, consistency between the accounting and budgetary classifications, and the convergence of national accounting with international accounting standards for the public sector, have created a solid platform for automation and integration of PFM processes for the improved quality of financial reporting and oversight.

106. **However, there are still some weaknesses related to the strategic allocation of resources, the accountability of budget implementation and the efficient delivery of public services.** These are areas where reform efforts are taking place, but where these efforts have yet to realize full performance. Among the most important of these ongoing efforts are: (i) improving budget credibility by strengthening the budget forecast, establishing consistent budgeting framework, and increasing revenue mobilization and compliance of tax and non-tax collection; (ii) improving the system capacity to deliver infrastructure outcomes by harmonizing the selection, implementation and monitoring of capital expenditure with formal guidelines and oversight, efficient management of public assets, as well as consolidation and monitoring of public procurement operations; (iii) the inclusion in the budget of performance information, linking resource planning in the most appropriate manner for better service delivery; (iv) promoting effective reporting of subnational budget execution; and (iv) strengthening internal audit and external audit, and control measures.

107. **The PEFA assessment also notes that the Aggregate Fiscal Discipline in Indonesia is supported by a number of strong points:** a clearly defined fiscal strategy; the capability to prepare robust projections of macroeconomic and fiscal performance; the proper reporting of revenue and expenditure operations outside the budget; and sufficient control over fiscal risks and commitments to maintain expenditures during budget execution. However, this generally positive aggregate fiscal discipline outcome is partially limited by weaknesses in budget reliability; insufficient linkages between investment expenditures and recurrent expenditures; and inconsistent implementation of the MTEF.

108. **The Strategic Allocation of Resources is supported by the existence of budget rules and circulars that assign predictable budgeting ceilings as well as the timely approval of the annual budget law.** However, the difficulty of aligning planning and budgeting and weaknesses in the management of public investment leaves an adverse impact. Robust foundations have been laid for the efficient service delivery, but requires better consolidation and integration of performance information to achieve the goal of delivering the right level of services at the right cost.

109. **The *Badan Pemeriksa Keuangan* (BPK), as Indonesia's Supreme Audit Institution (SAI), has a mandate to conduct financial audits of all central government entities, as well as local government agencies.** BPK expressed an unqualified opinion in the last two years to central government financial reports. The audit reports include audit reviews on: (i) the internal control system; (ii) compliance with laws and regulations; and (iii) the status of follow-up audit findings and recommendations. Besides

government entities, BPK conducts audits on Bank Indonesia (Central Bank), State Own Enterprises (SOE) and other entities that manage state finances. BPK audits include financial audits, performance audits and audits for special purposes.

110. **BPK audit reports on the central government's financial statements are submitted to parliament within two months after the issuance of the unaudited financial statements.** Audit reports on line ministries are submitted semi-annually, three months after the end of the semester, together with a summary (IHPS). Article 21 in Law No. 15/2004 on State Financial Oversight requires parliament to review the follow-up of BPK's audit reports through hearings with the relevant ministries. The role of reviewing the follow-up of BPK's audit reports is distributed among the relevant parliamentary commissions, which conduct scrutiny and discussions on the audit reports as part of their regular hearings scheduled with the counterpart ministries. The depth of each hearing may differ depending on the urgency of the issues raised in the audit report and the capacity of each commission.

111. **The PEFA assessment also demonstrates that Indonesia shows good performance on indicators about comprehensiveness and transparency of PFM.** The "A" score for PI-9 on Public Access to Fiscal Information shows that the fiscal transparency is at the highest standard, as information on government fiscal plans, positions and performance is easily accessible to the public. However, one element of public access to fiscal information needs to improve: the fact that (non-confidential) other external audit reports on central government consolidated operations are not available to the public within six months of submission, as the individual line ministry's audit reports are not yet available in the BPK and the line ministries websites.

112. **BI's financial statements have received a clean audit opinion.** The IMF has not conducted a safeguards assessment covering Bank Indonesia's (BI) framework of reporting and controls since 2002. BPK has expressed an unqualified (clean) opinion on the latest financial statements of BI for FY 2017. Several DPLs, including the First and Second Fiscal Reform DPLs, were disbursed successfully in 2016 and 2017.

113. **The loan disbursement will follow the standard Bank procedures for DPLs.** The Borrower is the Republic of Indonesia and this operation is a single-tranche IBRD loan of US$ 1 billion equivalent. 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 loan amount will be disbursed in JPY as Sub-Loan Numbers 8956-001 and 8956-002 in the amounts of JPY 55,397.5 million each (total amount JPY 110,795 million or US$ 1 billion equivalent) 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 U.S. 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 the General Conditions for IBRD Financing: Development Policy Financing (2018) ("General Conditions"). If any portion of the loan is used to finance excluded expenditures as so defined in the General Conditions, 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

114. **The Borrower will implement the development policy financing of this operation under the same arrangement framework used for the previous two operations of the DPL programmatic series.** The Fiscal Policy Agency (BKF) of the Ministry of Finance will coordinate the monitoring of progress on result indicators on a quarterly basis. The main counterpart is the MoF, with engagement with DGT on tax administration reforms, DG Fiscal Balance and the Ministry of Home Affairs on the subnational budget chart of accounts reform, and BKF on expenditure and revenue reforms. Policy dialog and regular coordination meetings with Government are already ongoing.

115. **Grievance Redress.** Communities and individuals 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 mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that 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 http://www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

116. **The overall risk rating of this operation is substantial.** While macroeconomic risks have subsided significantly since the first DPL in the series, others remain 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 (Table 8). These risks, if materialized, could negatively impact the implementation of prior actions and the achievement of the intended positive results, which would in turn affect meeting the development objectives for this operation.

117. **Political and governance risks are substantial**. While collecting more and spending better is a recognized priority for the government, there is not a government-wide consensus on how to achieve these objectives and how to balance them with other priorities, such as increasing private sector investment. This trade-off, exacerbated on the eve of presidential elections in 2019, is likely to impact progress on needed changes on laws and government-level regulations encompassing fiscal structural policy reforms, especially on tax legislation. The political environment associated with the election cycle has already contributed to delays and uncertainty over major legislative reforms on tax policy and subnational transfers. On tax administration, Indonesia has been facing enduring challenges to address

overall low levels of tax compliance and improve the performance of core functions supported by an outdated business processes and IT tax platform.

118. **Sector strategies and policies risks are substantial.** While budget shares to priority sectors have increased, expenditure has not always been allocated efficiently and implementation bottlenecks often lead to underspent budgets. Broader government tax initiatives (outside of the DPL) may have a negative impact on achieving the PDOs of the revenue administration and tax policy pillars. The pressure to meet revenue targets may lead to the adoption of short-term measures which 1) detract the focus from reforms that lead to sustained improvements, but which 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 private investment. To partially address some of these risks, the World Bank is providing ongoing technical assistance to the Government on initiatives outside the DPL series.

119. **Institutional capacity for implementation and sustainability risks are substantial.** The pace of implementation of tax reforms at DGT is challenged by weak capacity to procure a large core tax IT system, and, generally, to execute an ambitious reform action plan in coordination with donor partners and advisory firms. The World Bank has been providing technical support on the implementation of key initiatives of the DGT reform program to mitigate those risks, with special emphasis on the design of the technical and procurement specifications of the new core tax IT system.

120. **Intensive and sustained World Bank policy engagements offer some mitigation against the above risks.** Through an array of technical assistance projects and capacity enhancement programs, the World Bank remains strongly engaged in policy dialog with the Ministry of Finance and other central ministries, supporting continued reform momentum in Indonesia. At the same time, in an effort to mitigate political risk, the World Bank is finalizing a Development Policy Review that outlines a comprehensive structural reform agenda, which senior management will use to engage the administration to encourage continued reforms after the election. The political risk is partially mitigated by the fact that major institutional decisions for the reforms supported by this operation have already been taken, meaning that implementation relies on technical, non-political MoF staff, whose duties are typically unaffected by the political environment. Lastly, several prior actions pertain to the improvement of data availability and management, which will enhance monitoring and evaluation capabilities, and facilitate monitoring, which, in turn, provide some mitigation of the above risks.

Table 8. Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Low
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Moderate
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Other	Low
Overall	Substantial

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
Pillar A-- Improving Quality of Spending: Improving (i) composition of spending; (ii) budget execution; and (iii) efficiency of spending					
#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.	**#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.	**#1. Composition of spending.** The Borrower has increased the shares of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-energy subsidy reform years (2012-2014), as evidenced through the 2019 Budget Law and Presidential Regulation 129/2018.	Number of PBI-JKN subsidized health insurance premium recipients	86.4 million (2014)	93 million (2020)
	#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		Deviation between indicative line ministry expenditure ceiling in a new budget and the forward estimate in the earlier planned budget	22 percent (2016)	Less than 22 percent in 2020 **Current status:** 2.9 percent (September 2019)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
	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.				
#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.			Time taken for central government monthly budget realization data to be publicly available	On average 2 months after the end of the month (2014)	On average 15 days after the end of the month (from mid-2016 to end-2018) **Current status** 15 days
#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.			Availability of enabling regulatory framework for Availability Payment Contracts for infrastructure projects with the private sector	No (2014)	Yes (2016) **Current status** Yes (2016)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	Prior Actions under DPL 2	Prior Actions for DPL 3	Indicator Name	Baseline	Target (June 2020)
#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.			Proportion of Ministry of Public Works and Housing budget (total) delivered through multi-year contracts.	7 percent (2014)	More than 17 percent (2016 & 2017) **Current status** 41.7 percent (2018)
		#2. Disaster risk insurance. The Borrower has enabled the purchase of disaster risk insurance for the Borrower's assets, as evidenced through the Minister of Finance Regulations 247/2016 and 142/2018.	Share of ministries and agencies covered by disaster risk insurance (out of 87)	0 percent (2018)	6 percent (2020)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
		#3. Climate finance budget tagging. The Borrower has expanded the climate finance budget tagging initiative from tagging only for climate change mitigation to climate change mitigation and adaptation, as evidenced through the Climate Budget Tagging Manual.	Share of ministries and agencies undertaking budget tagging for climate change adaptation (out of 87)	9 percent (2018)	14 percent (2020)
#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.	**#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.		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.	70 percent (2014)	More than 90 percent (2018) **Current status** 80 percent by first semester (2018)
	#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;		Proportion of districts meeting the requirement to spend 25% of DAU and revenue sharing allocations on infrastructure.	42 percent of districts (2016) Note: In 2016, 42 percent 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	60 percent of districts (2019) **Current status** 46 percent of districts (2018)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
				Physical).	
	(b) disbursing DAK based on reports on achievements; and		Percentage of DAK physical realization in infrastructure sectors at the end of fiscal year.	60.5 percent (2016)	More than 70 percent (2019) **Current status** 74 percent (2017)
	(c) improving DID allocation criteria, as evidenced through the 2017 Budget Law and the Minister of Finance Regulation 112/2017.		Average improvement in NER for Junior Secondary School for Districts that received DID (compared to the year before)	0.06 percentage point (2016)	0.08 percentage point (2019) **Current status** 0.17 percentage point (2018)
		#4. Standardization of subnational budget chart of accounts. The Borrower has adopted the framework for standardizing and harmonizing the subnational budget chart of accounts, as evidenced through the Government Regulation 12/2019.	Number of districts and provinces piloting the new chart of accounts during the 2021 budget preparation (out of 542)	0 (2018)	10 (2020)
	#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.		Proportion of contracted value of DAK by July of each year	67 percent (2014)	80 percent (2019) **Current status** 93.5 percent (2017)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
Pillar B--Strengthening Revenue Administration: Increasing (i) tax administration efficiency; (ii) compliance management and audit capability; and (iii) reducing the cost of paying taxes					
#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.	**#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.		Share of monthly VAT returns filed electronically	0 percent (2014)	90 percent (from end 2016 to end 2018. **Current status** 2018: 100 percent
		#5. VAT refunds. The Borrower has broadened the coverage of taxpayers subject to a streamlined procedure for VAT refunds by: (a) increasing the refund value threshold; (b) expanding the criteria to be considered a low risk VAT taxpayer; and (c) allowing partial refunds, as evidenced through the Minister of Finance Regulation 39/2018.	Share of VAT refund requests subject to the streamlined refund procedure, from total VAT refund requests.	14.17 percent (2017)	30.6 percent (2020)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
#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.	**#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.		Share of annual individual income tax income tax returns filed electronically. Share of annual corporate income tax returns filed electronically.	27 percent (2015) 2 percent (2015)	48 percent (2017) **Current status** 77.10 percent (2017) 57 percent (2017) **Current status** 64.39 percent (2017)
#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.			Number of taxpayers with multiple/duplicate IDs that can be used to file returns	500,000 duplicate IDs (2014)	<3,000 duplicate IDs (2018): **Current status** 47,754 duplicate IDs (2018)[87]

[87] In anticipation of the new core tax IT system, DGT has started the preparation for data migration and data cleansing. DGT reduced the number of multiple ID cases to 42,067, which is the best result DGT can achieve using IT parameters by cross-checking multiple taxpayer ID against the status of taxpayer (active or inactive) based on several criteria such as: last tax payment and return filing, status of tax payable, etc. Further reducing the number of multiple IDs to below 3,000 requires manual intervention by tax offices. The DGT Head Office is planning to notify tax offices as the authorized units to reach out to taxpayers for clarification. DGT expects to continue reducing the multiple ID cases before core tax IT system vendor is on board.

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
#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.	**#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.		Average time taken to receive land asset and access financial information requested by DGT for audit use	Land asset data • 5 days, limited to local land agency data (2014) Financial information: • no data (2015)	Land asset data • 1 day, nation-wide land agency data (from beginning 2017 to end-2018). Financial information • all financial institutions to submit financial data for audit purposes automatically (year) **Current status** Land asset data: 1 day Financial information: once a year (2018)
		#6. Compliance risk management. The Borrower has created a risk management unit (Data Management Team) within the Directorate General of Taxes, as evidenced through the Minister of Finance Decree 67/2019.	Status of creation of the new risk management unit (Data Management Team, Directorate level)	Non-existent (2017)	New risk management unit created (Data Management Team) (2020)
Pillar C--Enhancing Tax Policy: Increasing (i) revenue potential; and (ii) economic efficiency of tax policy					
#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 VAT regime is revised to reduce the share of final consumption exempt from standard VAT. Replacement of the vehicle LGST with a vehicle excise tax	16.3% in the current VAT regime (2015) Vehicle LGST in place (2015)	Not tracking as reform has been postponed Not tracking as reform has been postponed

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
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.					
		#7. MSME presumptive tax regime. The Borrower has enabled the expansion of the general income tax base, including by: (a) introducing sunset clauses for the MSME final tax; and (b) allowing MSME taxpayers to opt for taxation under the general regime, as evidenced through the Government Regulation 23/2018.	Share of 2017 MSME taxpayers who are filing as part of the general income tax regime	1 percent (2017)	3 percent (2020)
		#8. Tax expenditure. The Borrower has increased fiscal transparency by: (a) identifying all the tax expenditure across its major taxes; (b) publishing its first tax expenditure statement; and (c) adopting its sustainability strategy, as evidenced through the Financial Note for 2019 Budget, Minister of Finance Official Note ND-315/KF/2018 and Indonesia tax expenditure report.	Share of tax expenditures by regulation whose revenues foregone are estimated in the Budget Financial Notes out of the identified total number	0 percent (2017)	30 percent (2020)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
#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.					Not tracking as reform has been postponed
	#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		The Income Tax regime is revised to reduce tax base erosion and broaden the tax base.	Few anti-tax base erosion measures in place: only controlled foreign company (CFC) rule (2017)	Increase in anti-tax base erosion measures in place, including LoB clause in treaties and requirements for standardized documentation (2019) **Current status** Increase in anti-tax base erosion measures in place, including LoB clause in treaties and requirements for standardized documentation (2017)

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
	signatories and the DGT Regulation 10/2017.				
	#10. The Ministry of Finance has: (a) enabled the implementation of APA and MAP[88] 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.		Number of new APA and MAPs concluded under new rules.	a) Number new APAs concluded under new rules: 3 b) Number of new MAP cases before new rules: 33 (2016)	(a) Number new APAs concluded under new rules (2018): 7 (b) Number of new MAP cases after new rules (2018): 70 **Current status** a) Number new APAs concluded under new rules: 18 b) Number of new MAP cases after new rules: 37 (February 2019)
	#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.		Access to information on passive income improved	Baseline (2016): Average rate of growth of nominal NO&G Income Tax revenues (excluding Tax Amnesty) 2012-2016: 8.3%	Target: Average rate of growth of nominal NO&G Income Tax revenues 2017-2019: 14.2% **Current status** 14.2 percent (2017-18 average)

[88] APA stands for Advanced Pricing Agreements and MAP stands for Mutual Agreement Procedure. For more background on this, see OECD BEPS Action 14 and Program Document, Fiscal DPL2, The World Bank

Prior actions and Triggers			Results		
Prior Actions under DPL 1	**Prior Actions under DPL 2**	**Prior Actions for DPL 3**	**Indicator Name**	**Baseline**	**Target (June 2020)**
		#9. Model Tax Treaty. The Borrower has strengthened measures against base erosion and profit shifting by developing a model tax treaty for use in double tax agreements, as evidenced through the Minister of Finance Official Note ND-471/KF/2018.	Number of treaties negotiated based on model tax treaty	0 (2017)	4 (2020)

Note:

- Social assistance is defined as spending on the major social assistance programs: subsidized rice/Raskin, Bantuan Pangan Non Tunai/BPNT and cash transfer for poor students/BSM/KIP and other Ministry of Social Affairs programs but excluding Health insurance for the poor/JAMKESMAS/SJSN/KIS and compensation for fuel price increase in 2013, as a share of total central government spending excluding transfers to subnational governments.
- Health spending is defined as central government health spending (Ministry of Health, Drugs and food monitoring agency (POM), Family Planning (BKKBN), Health insurance for civil servant & military and Other contingency budget) and earmarked transfers to subnational governments (DAK health and family planning) and including health insurance for the poor (JKN), as a share of total central government spending excluding transfers to subnational governments
- Infrastructure spending is defined as central government infrastructure spending (Ministries of Public Works, Transport, Agriculture (only capital -intensive programs) and Energy and Mineral Resources (only capital-intensive programs, VGF and grants), transfers to subnational governments and the Village Fund (infra DAK and rural electrification DAK, General Transfer Fund for Infrastructure, Village Funds for infrastructure, Special Autonomy Fund for Infrastructure), as a share of total central government spending including Specific allocation fund - DAK (starting 2016 only Physical DAK), Village fund , General Transfer Fund (DBH + DAU), Special autonomy fund , including special fund for Yogyakarta, Financing - Government investment only.

ANNEX 2: FUND RELATIONS ANNEX

Indonesia—Assessment Letter for the World Bank
February 1, 2019

Recent Developments and Outlook

Macroeconomic developments and outlook. The Indonesian economy continued to perform well in 2018, despite facing some external headwinds. A pickup in international crude oil prices and tighter global financial conditions led to capital outflows from emerging markets, including Indonesia. Consequently, the rupiah depreciated against the U.S. dollar by 8.5 percent for the year, the 10-year government bond yields rose by 175 basis points and the current account deficit is estimated to have widened to 3.0 percent of GDP, mainly due to the demand-driven expansion of import and lower palm-oil exports. Real GDP growth is estimated to have stabilized at 5.1 percent in 2018, as domestic demand growth offset the decline in net exports. International reserves declined, as the authorities intervened against the depreciation of the rupiah. Inflation retreated slightly to 3.1 percent at the end of the year (3.6 percent in 2017), as electricity and some fuels prices were frozen, and Bank Indonesia (BI) raised interest rates. GDP growth is expected to remain stable at 5.1 percent in 2019 and inflation to pick up to 3.6 percent, notwithstanding the decline of oil prices, as the authorities are expected to relax some administered prices to contain rising subsidies.

Risks to the outlook. The balance of risks remains tilted to the downside. The main risks are external, including a significant further strengthening of the U.S. dollar and/or higher rates, a retreat from cross-border integration, higher oil prices, and geopolitical uncertainties. Domestic risks include political uncertainties related to the April 2019 elections, that could slow capital inflows, and higher-than-expected interest rates stemming from inflation surprise. On the upside, global growth and non-oil commodity prices could be higher than expected.

Policy Framework and Settings

Fiscal policy. The 2018 fiscal deficit is estimated to have declined to 1.8 percent of GDP from 2.4 percent of GDP in 2017, driven by strong revenue performance, as oil receipts, income tax, VAT and nontax revenues improved. Total expenditures slightly increased as lower capital and local government spending partially offset increase in other areas, in particular subsidies. Fuel subsidies more than doubled relative to their 2017 level, while electricity subsidies rose by 12 percent and other subsidies declined by 8 percent. The budget for 2019 envisages stabilizing the deficit at 1.8 percent of GDP. Oil prices are projected to decline in 2019 and would therefore lower fiscal revenue. At the same time, the authorities should seize the opportunity of lower oil prices to move away from untargeted fuel and electricity subsidies toward targeted social safety nets.

Monetary policy. The current monetary policy stance is broadly appropriate. Indonesia faced depreciation pressures in 2018, and the authorities have responded by raising interest rates and allowing the exchange rate to adjust, while intervening in the FX market to avoid excessive exchange rate volatility. Bank Indonesia raised its policy rate by a total of 175 basis points to 6 percent in 2018. At its latest Board meeting in December 2018, BI held its policy rate unchanged, as external pressure subsided. At end-2018, reserves remained adequate, notwithstanding their decline following BI's FX interventions. Going forward, BI should continue to allow the exchange rate to move in line with market forces and limit FX intervention to addressing disorderly market conditions. BI should also continue to tighten monetary policy if depreciation poses risks to inflation. Clear and focused communication will remain critical, especially during bumpy periods.

Financial sector. The banking system is well capitalized, profitability is high, and system-wide liquidity remains ample, although pockets of vulnerabilities remain among medium- and small-sized banks. Loan growth has recovered (13.1 percent (y/y) in October 2018) and NPL ratios have stabilized to 2.6 percent compared to 3.2 percent in early 2017. Nonetheless, bank asset quality needs to be closely monitored because of sizable problem loans: the sum of special-mention loans, restructured loans, and NPLs amount to about 10 percent of total loans. The authorities should continue to strengthen the supervisory framework, including financial oversight and crisis management. The authorities should also watch corporate vulnerabilities carefully. Corporate external debts, which had increased substantially after the global financial crisis, remain elevated and vulnerable to volatile market conditions. The corporate prudential FX regulation has helped moderate risks from corporate external debt but can be further improved by extending its coverage to all corporate FX liabilities.

Macrostructural issues. Further efforts in structural reforms would help achieve higher potential growth. The policy priority should be a self-reinforcing fiscal-structural reform package that mobilizes revenues to finance development spending. An early priority is to implement a medium-term revenue strategy that centers on tax policy reforms and improved tax administration to strengthen the business environment. Other structural reforms include promoting female labor force participation, including by expanding the availability of childcare facilities, to reduce persistent gender gaps; reforming product markets to encourage higher private investment; further streamlining and harmonizing complex regulations; improving coordination with local governments; and fostering financial deepening.

IMF Relations

The 2017 Article IV consultation was concluded by the IMF's Executive Board on January 10, 2018.

3

Table 1. Indonesia: Selected Economic Indicators, 2014–19

Nominal GDP (2017): Rp 13,589 trillion or US$ 1015 billion
Population (2017): 261.9 million
Main exports (percent of total, 2017): Coal (12.1), palm oil (11), oil and gas (9.3), textile & textile products (7.5)
GDP per capita (2017): US$3,878
Unemployment rate (2017): 5.3 percent
Poverty headcount ratio at national poverty line (2017): 10.6 percent of population

	2014	2015	2016	2017	2018 Est.	2019 Proj.
Real GDP (percent change)	5.0	4.9	5.0	5.1	5.1	5.1
Domestic demand	5.0	4.2	4.6	4.9	5.7	5.2
Of which:						
Private consumption 1/	5.3	4.8	5.0	5.0	5.2	5.1
Government consumption	1.2	5.3	-0.1	2.1	6.0	4.0
Gross fixed investment	4.4	5.0	4.5	6.2	6.7	5.8
Change in stocks 2/	0.5	-0.6	0.2	-0.2	0.0	0.0
Net exports 2/	-0.2	0.9	0.2	0.3	-0.4	0.1
Saving and investment (in percent of GDP)						
Gross investment 3/	34.6	34.1	33.8	33.4	33.5	33.6
Gross national saving	31.5	32.0	32.0	31.7	30.2	30.7
Prices (12-month percent change)						
Consumer prices (end period)	8.4	3.4	3.0	3.6	3.1	3.6
Consumer prices (period average)	6.4	6.4	3.5	3.8	3.2	3.4
Public finances (in percent of GDP)						
Central government revenue	14.7	13.1	12.5	12.2	13.1	13.1
Central government expenditure	16.8	15.7	15.0	14.6	14.9	14.9
Of which : Energy subsidies	3.2	1.0	0.9	0.7	1.0	1.0
Central government balance	-2.1	-2.6	-2.5	-2.4	-1.8	-1.8
Primary balance	-0.9	-1.2	-1.0	-0.8	0.0	-0.2
Central government debt	24.7	27.5	28.3	28.8	29.8	29.9
Money and credit (12-month percent change; end of period)						
Rupiah M2	13.5	9.0	11.7	12.0	...	...
Base money	11.6	3.0	4.6	9.8	...	...
Private Sector Credit	11.8	10.3	7.7	8.7	12.0	12.3
One-month interbank rate (period average)	7.5	7.2	6.9	6.1	...	...
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)						
Current account balance	-27.5	-17.5	-17.0	-17.3	-33.0	-32.4
In percent of GDP	-3.1	-2.0	-1.8	-1.7	-3.2	-2.9
Trade balance	7.0	14.0	15.3	18.8	5.0	6.4
Of which : Oil and gas (net)	-11.8	-5.7	-4.8	-7.3	-11.0	-9.5
Inward direct investment	21.8	16.6	3.9	21.9	18.6	19.4
Overall balance	15.2	-1.1	12.1	11.6	-12.3	-0.7
Terms of trade, percent change (excluding oil)	1.4	-1.8	0.5	1.9	1.1	-3.2
Gross reserves						
In billions of U.S. dollars (end period)	111.9	105.9	116.4	130.2	117.9	117.2
In months of prospective imports of goods and services	8.1	8.0	7.6	7.3	6.4	5.9
As a percent of short-term debt 4/	189	191	213	238	202	188
Total external debt 5/						
In billions of U.S. dollars	293.3	310.7	320.0	352.9	373.7	400.0
In percent of GDP	32.9	36.1	34.3	34.8	36.6	36.4
Exchange rate						
Rupiah per U.S. dollar (period average)	11,862	13,391	13,306	13,383	...	...
Rupiah per U.S. dollar (end of period)	12,435	13,788	13,473	13,568	...	...
Memorandum items:						
Jakarta Stock Exchange (12-month percentage change, composite index)	22.3	-12.1	15.3	20.0	...	...
Oil production (thousands of barrels per day)	794	800	820	815	800	740
Nominal GDP (in trillions of rupiah)	10,570	11,526	12,407	13,589	14,806	16,073

Sources: Data provided by the Indonesian authorities; and IMF staff estimates and projections.

1/ Includes NPISH consumption.
2/ Contribution to GDP growth (percentage points).
3/ Includes changes in stocks.
4/ Short-term debt on a remaining maturity basis.
5/ Public and private external debt.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA

LETTER OF DEVELOPMENT POLICY

Jakarta, 4 April 2019

No.: S-..268.../.MK.08.../2019

Ms. Kristalina I. Georgieva
Interim President
The World Bank

Dear Madam President,

Since taking office, the Government of Indonesia has embarked on a substantive reform program to achieve the development and poverty reduction goals envisioned in the National Medium-Term Development Plan (RPJMN) for 2015-2019, in which fiscal reforms have played a center role. In support of these reforms, we are writing this Development Policy Letter to request the International Bank for Reconstruction / World Bank for a third operation of the Indonesia Fiscal Reform Development Policy Loan.

Towards this end, we are outlining below the Government's medium-term reform agenda to enhance the quality of public spending and to improve revenue collection through a more efficient revenue administration and enhanced revenue potential.

On behalf of the Government of Indonesia, we would like to express our appreciation for the technical assistance rendered by the World Bank on fiscal reform over the span of the ongoing development policy series, alongside partners from the governments of Australia and France.

Economic and social context

Overall, macroeconomic fundamentals in Indonesia remain strong. Economic growth improved in 2018 to 5.2 percent, the highest in 5 years, supported by strong domestic demand. Underpinned by prudent and coordinated monetary, fiscal, exchange rate policy framework, inflation has remained stable, fiscal deficits narrow and debt low. Labor market conditions also remained strong in 2018 with the employment rate reaching a two-decade high, matched by the unemployment rate falling to a 20-year low of 5.3 percent. Underpinned by the sound macro-fiscal performance, poverty rates have steadily declined, reaching lowest on record at 9.7 percent in 2018, while the Gini index has been also easing, at 31.9 in 2018, slightly lower than the 32.0 in 2017.

Notwithstanding sound macroeconomic stance, there is room to improve fiscal policies to generate and sustain growth, create jobs, improve service delivery and opportunities for all, and also to enhance natural resource management to address country's exposure to climate change and natural disasters.

In particular, revenue performance continues to be a major fiscal challenge, despite the turnaround in 2018. As a result of early dividends from tax reforms, Indonesia's tax-to-GDP ratio rose from 9.9 percent of GDP in 2017 to 10.3 percent after five years of year-on-year declines. Largely due to ongoing revenue reforms and better compliance, revenues surged 18.8 percent in 2018, the largest increase since 2011.

On the other hand, increasing the quality of spending also remains a priority, not only to achieve medium-term development goals, but also to build resilience to natural disasters and climate change. Considering the fiscal rule to keep the deficit below 3 percent of GDP and limitations of the tax system to improve revenue collection, a significant increase of public expenditure is not foreseen in the short-term. Hence, the Government has targeted the improvement of the quality of public expenditure as a policy target, and some progress has been made through a sustained higher allocation of priority spending on infrastructure, health, and social assistance in the 2018 and 2019 approved budgets. Furthermore, 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.

This DPL will also support government reconstruction efforts due to the series of natural disasters that take place in the later part of 2018, the economic impact of which are large. Resources from this operation will support government reconstruction efforts.

Fiscal Reform Agenda for the Medium-Term

In response to fiscal challenges ahead and in support the national development goals of the RPJMN, the program of fiscal reforms is outlined below.

Improving the quality of spending

Improving central government budget allocation. The Government has maintained higher budget allocation in the proposed 2019 Budget for priority areas to support human and physical capital investment for growth, jobs, and poverty reduction, such as infrastructure, health, and social assistance, in relation to the pre-2015 fuel subsidy reform period. This has contributed to a sustained improvement in availability and quality of infrastructure, an expansion of a well-targeted social assistance program and improved basic health services coverage, committed to addressing specific intervention malnutrition and stunting.

Aligning planning and budgeting. Better alignment between planning and budgeting is considered critical to align strategic plans with the limited resource envelope. For this purpose, the Government has adopted actions to allow better coordination among agencies (BAPPENAS, MoF, and line ministries) at every stage of planning and budgeting process, and the use of common IT applications for planning and budgeting purposes through the KRISNA system deployed for the first time on the 2019 budget process.

Ensuring fiscal resilience against natural disasters. The Government has reformed the disaster risk financing policy by issuing the National Strategy on Disaster Risk Financing and insurance to improve the resilience of the budget to shocks, in particular, natural disaster shocks such as earthquakes, tsunami, floods and landslides. The strategy combines various financing instruments, including insurance for public assets as part of risk transfer mechanism to address financing needs for disaster rehabilitation and reconstruction.

Tagging climate change mitigation and adaptation activities in the budget. The Government has mainstreamed budget tagging across line ministries to better understand the level and composition of expenditures associated with climate change mitigation and adaptation. Such information will help the Government strategize its climate policy for meeting the National Determined Contribution to greenhouse gas emission reductions by 2030. The 8 line ministries that undertook budget tagging climate change adaptation in 2018 will gain a better understanding of the level and composition of expenditures that are associated with climate change adaptation. As the initiative is rolled out to more ministries in the medium term, the Government will gather critical information to implement policies that will further enhance climate change mitigation and adaption efforts.

Implementing a standardized subnational budget chart of accounts. In an effort to better understand and track subnational public spending, which accounts for half of total public spending, the Government has also implemented reforms to adopt a framework that would standardize the subnational budget chart of accounts. The reform would enhance the quality of spending as it would allow the Government to eventually perform expenditure analysis and consolidate financial report between central and local government. Without such a harmonized system, meaningful analysis to improve the quality of subnational spending remains unattainable.

Strengthening revenue administration

Streamlining VAT refunds. Under standard practices and regulations, the tax administration could take up to one year to issue a resolution on taxpayer's VAT refund claim, triggering preemptive full-fledged audits under harsh penalties in case inconsistencies are detected. To ease large withholding of VAT refunds resulted by such policy, the Government has broadened the coverage of taxpayers subject to a streamlined procedure to request VAT refund, previously available only to a subset of relatively low-risk taxpayers. By doing so, more taxpayers with VAT credit stance will receive timely resolution of refund request, easing their financial cashflow and improving the overall functioning of the VAT system.

Procurement and deployment of a new IT tax system. Core to its modernization agenda for many years, the tax administration has embarked on actions to deploy a new and more integrated IT tax system to support revamped business processes, enabling overall improved performance of key operations in future along with reforms to HR management, legal and regulatory framework and organization structure. To overcome budget rigidities for similar type of procurement of goods and services, the Government has put in place the legal framework to allow the multi-year contract and deployment of a commercial-off-the-shelf (COTS) IT tax system.

Compliance risk management unit. Albeit progress has been made on risk management of tax administration processes, the overall tax compliance rate in Indonesia remains a binding constraint to enhancing revenue collection as only around 71% of taxpayers comply with their tax obligations. To enhance risk management processes, the Government has taken actions to build capacity on this area at the tax administration by enhancing the institutional capacity of the Data Management Unit, allowing a better data management process to improve the identification of non-compliance taxpayers and allow better targeted enforcement actions.

Enhancing revenue policy

Reforming Taxes on MSMEs. In an effort to broaden the standard income tax base and to encourage the formalization of MSME taxpayers, the Government recently issued a new Government Regulation (PP 23/2018) to allow MSME taxpayers to opt for taxation under the general regime, and to limit the time period under which entities can remain the presumptive tax regime for Micro, Small and Medium Enterprises. This reform will push firms after a certain number of years into the standard income tax regime which would expand the standard income tax base, thereby enhancing revenue potential in the medium-term as well as to give choice to MSME taxpayer for reporting their tax under the standard tax regime or the presumptive tax regime.

Publishing of tax expenditure. While tax incentives and other exceptions to the standard tax framework may bring some economic benefits, they result in foregone tax revenue, create economic distortions, and undermine the equity of the tax system. The issuance of tax expenditure statements helps to address these concerns by quantifying the costs of these incentives, and by making them public with the end goal of supporting fiscal sustainability and transparency. Towards that end, the Government has published the Tax Expenditure Report (TER) 2016-2017 in August 2018 which is the first document of its kind in Indonesia. It provides information related to the amount of tax that was not obtained due to different policies that aims to improve tax system's efficiency, to support investment climate and other development goals. Government committed to publish Tax Expenditure report annually.

Development of a tax treaty model. The Government has developed a tax treaty model to be used as a guidance for the negotiator in the negotiation of the new treaties or existing treaties, as information for the executives for decision making purpose and to be used for early warning system to assess whether particular treaties need to be reviewed or terminated. This action follows up the reforms undertaken in the recent past and supported by previous operations of the development policy series to address base erosion and profit sharing from international transactions.

Conclusions

In summary, the Government is firmly committed to the program of fiscal reforms set out above with the main objective to improve fiscal policies and attain medium-term development goals, including addressing country's exposure to climate change and natural disasters, through policy actions geared to improve the quality of spending, to strengthen revenue administration and to enhance revenue policy.

The Government greatly values the assistance rendered by the World Bank over the years that supports 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 the Bank's continued engagement and support.

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 Budget, Ministry of Finance
5. Director General of Taxes, Ministry of Finance
6. Director General of Fiscal Balance, Ministry of Finance

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effect
Pillar A – Improving Quality of Spending ***PDO A: Improving (i) composition of spending; (ii) budget execution; and (iii) efficiency of spending***		
#1. Composition of Spending. The Borrower has increased the shares of the central government budget allocated to infrastructure, social assistance and health sectors, compared to pre-energy subsidy reform years (2012-2014), as evidenced through the 2019 Budget Law and Presidential Regulation 129/2018.	Potentially significant positive and negative effects	Yes, positive
#2. Disaster risk insurance. The Borrower has enabled the purchase of disaster risk insurance for the Borrower's assets, as evidenced through the Minister of Finance Regulations 247/2016 and 142/2018.	Yes, positive, not significant.	No
#3. Climate finance budget tagging. The Borrower has expanded the climate finance budget tagging initiative from tagging only for climate change mitigation to climate change mitigation and adaptation, as evidenced through the Climate Budget Tagging Manual.	Yes, positive and significant	No
#4. Standardization of subnational budget chart of accounts. The Borrower has adopted the framework for standardizing and harmonizing the subnational budget chart of accounts, as evidenced through the Government Regulation 12/2019.	No	No
Pillar B – Strengthening Revenue Administration ***PDO B: Increasing (i) tax administration efficiency; (ii) compliance management and audit capability; and (iii) reducing the cost of paying taxes***		
#5. VAT refunds. The Borrower has broadened the coverage of taxpayers subject to a streamlined procedure for VAT refunds by: (a) increasing the refund value threshold; (b) expanding the criteria to be considered a low risk VAT taxpayer; and (c) allowing partial refunds, as evidenced through the Minister of Finance Regulation 39/2018.	No	No
#6. Compliance risk management. The Borrower has created a risk management unit (Data Management Team) within the Directorate General of Taxes, as evidenced through the Minister of Finance Decree 67/2019.	No	No
Pillar C – Enhancing Tax Policy ***PDO C: Increasing (i) revenue potential; and (ii) economic efficiency of tax policy***		
#7. MSME presumptive tax regime. The Borrower has enabled the expansion of the general income tax base, including by: (a) introducing sunset clauses for the MSME final tax; and (b) allowing MSME taxpayers to opt for taxation under the general regime, as evidenced through the Government Regulation 23/2018.	No	No
#8. Tax expenditure. The Borrower has increased fiscal transparency by: (a) identifying all the tax expenditure across its major taxes; (b) publishing its first tax expenditure statement; and (c) adopting its sustainability	No	No

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effect
strategy, as evidenced through the Financial Note for 2019 Budget, Minister of Finance Official Note ND-315/KF/2018 and Indonesia tax expenditure report.		
#9. Model Tax Treaty. The Borrower has strengthened measures against base erosion and profit shifting by developing a model tax treaty for use in double tax agreements, as evidenced through the Minister of Finance Official Note ND-471/KF/2018.	No	No

ANNEX 5: CLIMATE AND DISASTER RISK

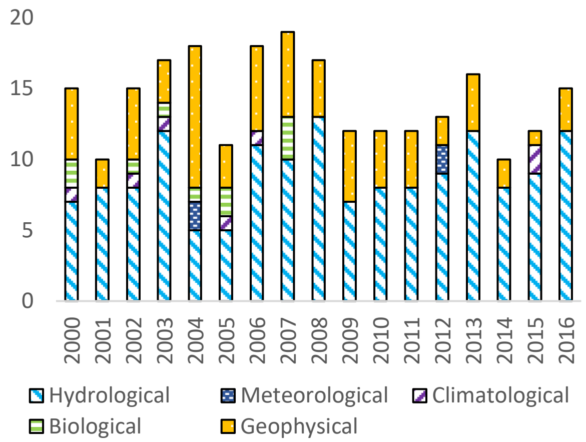
1. **Indonesia's hazard risk profile, high population exposure to disasters, and relatively low public investment in resilience makes the country more vulnerable to the negative impact of natural disasters and extreme climatic events.** Indonesia is one of the most disaster-prone countries in the world. On average, Indonesia faces 289 significant natural disasters each year between 2000 and 2014 and an annual average death toll of 852 between 1989 and 2018 excluding the impact of the 2004 Aceh Tsunami disaster (Box 1), with an annual economic impact estimated at US$ 1.6 billion.[89,90] Across the country, over 200 million people live in disaster-prone areas, while almost all regions are exposed to high risk of major disasters.

2. **Indonesia is exposed to various types of natural disasters that are projected to intensify with climate change.** Hydrological disasters such as floods and landslides, as well as meteorological disasters such as storms make up almost 70 percent of major disaster events since 2000 (Figure 7). Floods and landslides are also responsible for 65 percent of total lives lost and 76 percent of total number of displaced people during the same period. Indonesia is particularly vulnerable to flood disasters, because it has high rainfall events throughout the year, coupled with high concentration of population in flood-prone areas and limited investment to strengthen resilience against flood risks. The 2007 and 2013 flood episodes in Jakarta, for example, resulted in US$ 4 billion loss from direct damages and affected over 465,000 people. Furthermore, climatological hazards, such as droughts and involuntary spread of manmade fires for land clearing exacerbated by droughts, also contributed to significant economic loss to Indonesia. The 2015 haze crisis, for example, resulted in an approximately US$ 16 billion loss. These hydrological, meteorological, and climatological hazards are projected to intensify with climate change.

3. **Despite being lower in frequency, geophysical natural disasters such as earthquakes, tsunamis, and volcanic eruptions together cause approximately the same amount of level of total economic damage** (Figure 8). Major events include the 2004 Aceh tsunami, which led to US$ 4.5 billion in direct damages and 165,000 lost lives, as well as the 2018 West Nusa Tenggara and Sulawesi earthquakes and which resulted in US$ 2.2 billion in direct damages (Box 1) and at least 2,500 fatalities. Indonesia's location on the Pacific Ring of Fire makes the country vulnerable due to high degree of tectonic activities[91] and high number of active volcanoes. At the same time, urban residential construction in Indonesia often comprises low-rise, non-engineered structures unable to withstand earthquakes and tsunamis.

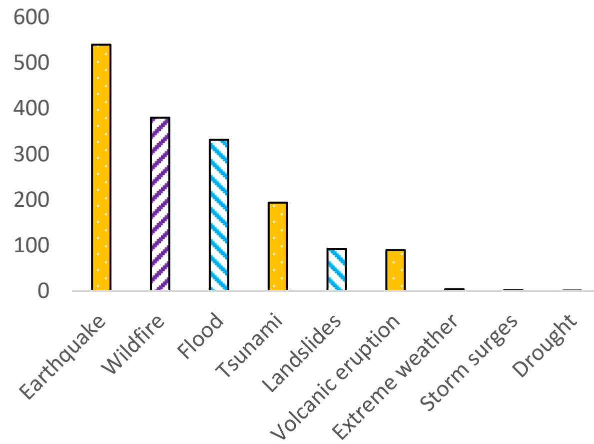
[89] Hydrometeorological disasters, such as floods and droughts, currently make up 80 percent of disaster occurrences in Indonesia, and are projected to increase with climate change (Government of Indonesia, 2016. Indonesia's First Nationally Determined Contributions submitted to the UNFCCC.
[90] GFDRR (2016).
[91] Cummins (2017).

Figure 7. Annual frequency of major disasters in Indonesia, by type (average 2000-2016)



Source: Emergency Events Database (EM-DAT) 2018

Figure 8. Economic impact from disasters in Indonesia, by type, Average 2000-16)
(US$ million)



Source: Ministry of Finance, 2018

4. **The government currently spends between US$ 300-500 million annually on post-disaster reconstruction, with spending during major disaster years reaching 0.3 percent of the GDP; and as high as 45 percent of the provincial Gross Regional Product.**[92] The national government budget bears a significant part of the economic cost of natural disasters, due to the need for reconstruction of destroyed core assets, including public infrastructure, which often have no or inadequate insurance coverage. These costs are likely to increase with global warming, thus placing a significant burden on public expenditures.

5. **Natural disasters impact poverty directly and directly.** The direct impact is through reducing income and wealth levels of households and government revenue, and the indirect impact is through negatively impacting savings, investment, education, health, savings and investment and economic growth. Estimates show that, at the district level, a one standard deviation increase in disaster harm can increase the poverty rate by 0.8 percentage point and the poverty gap by 2.3 percentage points.[93] Other estimates show for 2014 that 55 percent of poor people were not poor the year before, and that frequent natural disasters had been a major contributor.[94]

6. **Recently, the government launched new initiatives to improve resilience to natural disasters, supporting a fundamental shift to become a proactive risk manager rather than emergency responder to natural disaster shocks.** This includes an equal focus on building financial and physical resilience to shocks. As part of this agenda, the Government integrated early plans to strengthen the Disaster Risk Financing and Insurance (DRFI) Framework in its annual Macroeconomic Framework and Fiscal Policy Principles (KEM-PPKF) submission to the Parliament in March 2018. Subsequently, it successfully

[92] GFDRR (2016).
[93] Rush (2013).
[94] Aji (2015).

prepared and launched its DRFI strategy during the WB-IMF Annual Meetings in October 2018. This strategy contains priority areas on three levels, to protect the national fiscal balance, support local governments, and protect the most vulnerable against falling back into poverty. The World Bank has partnered with the government on this agenda, including the ongoing World Bank technical assistance funded by the Government of Switzerland, which supported the preparation and drafting of the DRFI Strategy. The Government requested sustained WB support to implement the strategy.

7. **Continuous efforts and support from the development partners including World Bank have been instrumental in the GoI's efforts to strengthen its environmental risk mitigation capacity through various analytical and advisory services.** The effect of World Bank assistance to build the human capacity of the GoI towards better awareness, better budgeting and attention to capacity gaps in managing environmental and social impacts is overall positive. The World Bank had been supporting GoI through its technical assistance activities including on urban flood risk management.[95] The report helped to provide baseline inventory prepared for 30 cities selected by GoI focusing on flood risk challenges and investment needs to reduce flood risks in cities. Following the disaster events in West Nusa Tenggara and Central Sulawesi Provinces, the World Bank offered assistance to GoI in carrying out resilient reconstruction of social and economic infrastructure in disaster-affected areas. This includes developing public education and awareness programs, and enhancing the capacity of local governments to implement improved construction standards and building code compliance, which will contribute to long-term disaster preparedness and emergency response capacity across Indonesia.

Climate change impact and mitigation and adaptation measures

8. **Climate change is recognized as a key threat to Indonesia's development.**[96] Besides the projected increase in extreme weather events leading to increased frequency of hydrological, meteorological, and climatological disasters in the short to medium term, Indonesia, with the second-longest coastline in the world, is also anticipating long-run impacts from slow-onset events, namely sea-level rise and coastal inundation that may affect up to 42 million people living in low-lying coastal zones.[97] Almost 50 percent of these high-risk areas have rapidly urbanized by 2010, putting urban infrastructure and non-infrastructure assets at risk.

9. **The above manifestations of negative consequences from climate change will affect almost all regions in Indonesia and will disproportionately affect the poor.** All regions are exposed to high climate change risks, including the spread of diseases. More frequent hydrometeorological disasters such as floods are likely to cause more damage to public infrastructure of provinces, cities and villages. Changes in rainfall patterns could increase the risk of food insecurity linked to more frequent crop failures and water insecurity linked to reduced water availability. Changes in the rainfall and temperature patterns is also associated with potentially higher public health risks from climate-sensitive diseases such as diarrhea, dengue and malaria.[98]

[95] The technical assistance report received financial support from the Swiss State Secretariat for Economic Affairs (SECO) through the Indonesia Sustainable Urbanization Multi-Donor Trust Fund (IDSUN MDTF).
[96] Government of Indonesia (2016), Indonesia's First Nationally Determined Contributions submitted to the UNFCCC
[97] *Ibid.*
[98] Government of Indonesia (2016), Submission to the Subsidiary Body for Scientific and Technological Advice of the UNFCCC on recent work on climate impacts on human health.

10. **In addition to Indonesia's high vulnerability to the negative impacts of climate change, the country is also one of the world's largest contributors of greenhouse gas (GHG) emissions and therefore has recognized climate change as a key policy issue.** Roughly two-thirds of the country's emissions come from land use change, particularly conversion of peatlands into agricultural plantations, while the energy sector makes up another quarter of the country's growing emissions. In the country's first Nationally Determined Contributions (NDC), Indonesia committed to achieving an unconditional emission reduction target of 29 percent and a conditional target of 41 percent by 2030 against the business-as-usual scenario.[99]

11. **Apart from improved disaster risk financing, the Government also aims to enhance capacity of Indonesia to adapt to a changing climate.** For climate change adaptation, the country's medium-term strategy is to reduce risks from climate change for all development sectors—agriculture, water, energy security, forestry, maritime and fisheries, health, public service, infrastructure, and urban system—by 2030, through strengthening local capacity, improving knowledge management, converging policies on climate change adaptation and disaster risks reduction, and applying adaptive technology.[100] The strategy also includes expansion of budget tagging from mitigation-related activities to cover adaptation-related activities, development of a Disaster Risk Financing and Insurance Strategy, and a Bappenas-led disaster risk management master plan, which includes management of climate-related disaster risks. The National Action Plan for Reducing GHG Emissions (2010) and the National Action Plan for Climate Change Adaptation (2013) provide the basis for development planning and budgeting to achieve the climate change adaptation policy objectives through 2020.

[99] Government of Indonesia (2016), Indonesia's First Nationally Determined Contributions submitted to the UNFCCC
[100] Ibid.

REFERENCES

Aji, P. 2015. "Summary of Indonesia's Poverty Analysis." ADB Papers on Indonesia No. 4, Asian Development Bank, Manila. *https://www.adb.org/sites/default/files/publication/177017/ino-paper-04-2015.pdf*.

Asafu-Adjaye, J. (2014). The Economic Impacts of Climate Change on Agriculture in Africa. Journal of African Economies, Vol. 23. AERC Supplement 2, pp. 1117-1149.

CNN Indonesia. *January 3,* 2019. *https://www.cnnindonesia.com/ekonomi/20190103192601-532-358333/pemerintah-siapkan-dana-bencana-rp15-triliun-pada-2019*.

Cummins, P. R. 2017. "Geohazard in Indonesia: Earth science for disaster risk reduction – introduction." Geological Society London Special Publications 441 (1): 1. *https://doi.org/10.1144/SP441.11*.

Fenochietto, R. and C. Pessino. 2013. "Understanding Countries' Tax Effort" IMF Working Paper 13/244, International Monetary Fund, Washington, DC.

Gaspar, V., L. Jaramillo, and P. Wingender. 2016. "Tax Capacity and Growth: Is There a Tipping Point?" IMF Working Paper 16/234, International Monetary Fund, Washington, DC.

GFDRR (Global Facility for Disaster Reduction and Recovery). 2016. *Country Profile: Indonesia*. Washington, DC: GFDRR. *https://www.gfdrr.org/indonesia*.

Google Temasek. 2018. e-Conomy SEA 2018: Southeast Asia's internet economy hits an inflection point. Singapore: Temasek.

Government of Indonesia. 2016a. *Submission to the Subsidiary Body for Scientific and Technological Advice of the UNFCCC on recent work on climate impacts on human health*. Jakarta: Ministry of Environment and Forestry.

_________. 2016b. *First Nationally Determined Contribution*. Jakarta: Ministry of Environment and Forestry.

_________. 2018a. *Indonesia Disaster Risk Financing Strategy: National Strategy to Build Fiscal Resilience*. Bali: Ministry of Finance.

_________. 2018b. *Persiapan Implementasi Asuransi BMN 2019*. Jakarta: Ministry of Finance.

_________. 2018c. *Gempa Nusa Tenggara Barat Rekapitulasi Kerusakan dan Kerugian*. (Recapitulation of Earthquake Damage and Losses, West Nusa Tenggara, October 12, 2018).

_________. 2018d. "*Laporan Belanja Perpajakan*/Tax Expenditure Report 2016-2017". Jakarta: Ministry of Finance. Available at: *http://www.fiskal.kemenkeu.go.id/dw-taxexpenditure.asp*.

_________. 2019. *Dampak Bencana Alam Gempa Bumi, Tsunami dan Likuifaksi di Wilayah Padagimo Provinsi Sulawesi Tengah*. (Impact of the Earthquake, Tsunami and Liquefaction in Central Sulawesi Province, January 30, 2019).

Mooij, R. D., S. Nazara, and J. Toro. 2018. "Implementing a Medium-Term Revenue Strategy." In *Realizing Indonesia's Economic Potential*, edited by L. Breuer, J. Guajardo, and T. Kinda, 109-139. Washington, DC: International Monetary Fund.

OECD and World Bank. 2019. *Boosting Fiscal Resilience: Managing Disaster related Contingent Liabilities in Public Finance Frameworks.* Paris: OECD.

Rush, J. V. 2013. "The Impact of Natural Disasters on Poverty in Indonesia." Available at *https://pdfs.semanticscholar.org/8888/ebd41d4d478caaebe5b762ede0e67eda9174.pdf.*

Skoufias, E., Rabassa, M., Olivieri, S., and Brahmbhatt, M. (2011). The Poverty Impacts of Climate Change. Economics Premise, The World Bank, March 2011, Number 51.

UNDP (2013). Gender and Climate Change, Asia and Pacific, Policy Brief 1.

USAID (2016). Indonesia: Costs of Climate Change 2050. United States Agency for International Development, Policy Note.

WHO (2009). Gender, Climate Change and Health. World Health Organization, Geneva, Switzerland.

World Bank (2011). Gender and Climate Change: Three Things You Should Know. The World Bank Group, Washington DC.

World Bank (2011). Indonesia: Advancing a National Disaster Risk Financing Strategy – Options for Consideration. Washington, DC. Available at: *https://openknowledge.worldbank.org/handle/10986/22421*.

World Bank. *2014. "Reducing Extreme Poverty in Indonesia." October 22, 2014. Available at http://www.worldbank.org/en/country/indonesia/brief/reducing-extreme-poverty-in-indonesia.*

_________. 2015a. *Indonesia Systematic Country Diagnostic: Connecting to the Bottom 40 Percent to the Prosperity.* September. Jakarta: World Bank. Available at *https://openknowledge.worldbank.org/handle/10986/23117.*

_________. 2015b. *Indonesia Country Partnership Framework for the period FY 16-20.* December 2015. Report No. 99172. World Bank. Available at *http://www.worldbank.org/en/country/indonesia/brief/indonesia-country-partnership-framework-for-2016-2020.*

_________*. 2016a. "Indonesia Fiscal Reform DPL."* May 2016. Report No. 104730. *Projects and Operations. Available at http://projects.worldbank.org/P156655?lang=en.*

_________. 2017a. "Indonesia Fiscal Reform DPL 2." October 2017. Report No. 120230. *Projects and Operations*. Available at *http://projects.worldbank.org/P161475?lang=en.*

_________. 2017b. "Indonesia Social Assistance Reform Program." April 2017. Report No. 112703. *Projects and Operations*. Available at *http://projects.worldbank.org/P160665?lang=en.*

_________*. 2018a. "*Second DPL to reform the Indonesian maritime logistics sector.*"* May 2018. Report No. 128183. *Projects and Operations. Available at http://projects.worldbank.org/P163973?lang=en.*

_________*. 2018b. "*Indonesia – Supporting Primary Health Care Reform.*"* May 2018. Report No. PAD2781. *Projects and Operations. Available at http://projects.worldbank.org/P164277?lang=en.*

_________*. 2018c. Indonesia – Public Expenditure and Financial Accountability (PEFA): Assessment Report 2017. Washington, DC: World Bank. Available at https://pefa.org/assessments/indonesia-2017.*

_________. 2018e. *Indonesia Economic Quarterly: Urbanization for All*. September. Jakarta: World Bank. Available at *https://openknowledge.worldbank.org/handle/10986/30448*.

_________. 2019a. *Revisiting the Distributional Impact of Fiscal Policy in Indonesia*. Mimeo. World Bank.

_________. 2019b. (forthcoming). *Aspiring Indonesia: Expanding the Middle Class*. Jakarta: World Bank.

World Economic Forum. 2017. *The Global Competitiveness Report 2017-2018*. Geneva: World Economic Forum. *https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018*.