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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 central 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, tsunamis, 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 in 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