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The World Bank

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Report No: PGD331

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF EUR 709.9 MILLION (US$ 750 MILLION EQUIVALENT)

TO

REPUBLIC OF INDONESIA

FOR THE

INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN

MAY 20, 2022

Public Disclosure Authorized

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

Republic of Indonesia

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 30, 2022)

Currency Unit: Rupiah (IDR)

US$ 1.00 = IDR 14,497

US$ 1.00 = EUR 0.94652153

ABBREVIATIONS AND ACRONYMS

ABIP	Australia-World Bank Indonesia Partnership	KPI	Key Performance Indicator
ADB	Asian Development Bank	KPPN	Kantor Pelayanan Pembendaharaan Negara (Treasury Payment Office)
AFD	Agence Française de Développement	LAR	Loans at Risk
APINDO	Asosiasi Pengusaha Indonesia (Indonesia Business Association)	LGST	Luxury Goods Sales Tax
APPSI	Asosiasi Pedagang Pasar Seluruh Indonesia (Indonesian Market Reseller Association)	LHS	Left-hand side
ASA	Advisory Services and Analytics	LKPP	Laporan Keuangan Pemerintah Pusat (Central Government Financial Statement)
Bappenas	Badan Perencanaan Pembangunan Nasional (Ministry of Planning)	MoF	Ministry of Finance
BAU	Business-as-usual	MoU	Memorandum of Understanding
BBNKB	Bea Balik Nama Kendaraan Bermotor (Transfer Fee for Vehicles)	MSME	Micro, Small, and Medium Enterpises
BI	Bank Indonesia (Central Bank of Indonesia)	MTEF	Medium Term Expenditure Framework
BoP	Balance of Payment	Mton	Metric Ton
BPK	Badan Pemeriksa Keuangan (Audit Board)	NDC	Nationally Determined Contribution
BPS	Badan Pusat Statistik (Statistics Agency)	NGO	Non-Governmental Organization
BRIC	Brazil, Russia, India, China	NIK	Nomor Induk Kependudukan (National ID)
CAD	Current Account Deficit	NPL	Non-Performing Loan
CBT	Climate Budget Tagging	NPWP	Nomor Pokok Wajib Pajak (Tax Identification Number)
CEQ	Commitment to Equity	OECD	Organisation for Economic Co-operation and Development
CGE	Computable General Equilibrium	OJK	Otoritas Jasa Keuangan (Financial Services Authority)
CIT	Corporate Income Tax	OSR	Owned-source Revenue
CO2eq	Carbon dioxide equivalent	PASA	Programmatic ASA
CPAT	Carbon Pricing Assessment Tool	PBB	Performance-based Bonus

CPF	Country Partnership Framework
DAK	Dana Alokasi Khusus (Special Allocation Grant)
DAU	Dana Alokasi Umum (General Allocation Grant)
DBH	Dana Bagi Hasil (Revenue Sharing)
DG	Directorate General
DGT	Directorate General of Tax
DIPA	Daftar Isian Pelaksanaan Anggaran (Budget Implementation List)
DPL	Development Policy Loan
DPO	Development Policy Operations
DPR	Dewan Perwakilan Rakyat (People's Representative Council, lower house of Indonesian legislature)
DPR	Development Policy Review
DSA	Debt Sustainability Analysis
DTKS	Data Terpadu Kesejahteraan Sosial (Integrated Social Welfare Data)
EMDE	Emerging Market Development Economies
ETS	Emission Trading Scheme
FDI	Foreign Direct Investment
FMIS	Financial Management Information System
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GoI	Government of Indonesia
GRS	Grievance Redress Service
HCI	Human Capital Index
HDI	Human Development Index
UHNWI	Ultra-high-net-worth individual
IBRD	International Bank for Reconstruction and Development

PBJT	Pajak atas Jasa dan Barang Tertentu (Combined Sales-based Tax)
PEFA	Public Expenditure and Financial Accountability
PFM	Public Finance Management
MDTF	Multi Donor Trust Fund
PIT	Personal Income Tax
PKB	Pajak Kendaraan Bermotor (Vehicle Tax)
PLN	Perusahaan Listrik Negara (National Electricity Company)
PMK	Peraturan Menteri Keuangan (MoF regulation)
PPP	Public-private partnership
PROSPERA	Australia Indonesia Partnership for Economic Development
PSIA	Poverty Social Impact Analysis
REER	Real Effective Exchange Rate
Renja	Rencana Kerja (Workplan)
Renstra	Rencana Strategis (Strategic Plan)
RHS	Right-hand side
RKA	Rencana Kerja dan Anggaran (National Workplan and Budget)
RKA-KL	Rencana Kerja dan Anggaran Kementerian Negara/Lembaga (Workplan and Budget of Ministries/Agencies)
RKP	Rencana Kerja Pemerintah (Government Workplan)
ROA	Return on Assets
ROC	Regional Operations Committee
ROE	Return on Equity
RPJMN	Rencana Pemerintah Jangka Menengah Nasional (National Medium-Term Development Plan)
RSPP	Redesain Sistem Perencanaan dan Penganggaran (Joint Decree on Redesigning of the Planning and Budgeting Systems)
RUU HKPD	Rancangan Undang-undang Hubungan Keuangan Pusat dan Daerah (Bill on Financial Relations between Central and Regional Government)
SAKTI	Sistem Aplikasi Keuangan Tingkat Instansi (Spending Unit-level Financial Application System)
SEMAR	Subnational Finance and Management for Results
SEMEFPA	Support for Enhanced Macroeconomic and Fiscal Policy Analysis

ICT	Information, Communications, and Technology
IGGF	Indonesia Infrastructure Guarantee Fund
IHPS	Ikhtisar Hasil Pemeriksaan Semester (Summary of Semester Examination Results)
IKK	Indeks Kemahalan Konstruksi (Construction Cost Index)
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
KADIN	Kamar Dagang dan Industri (Indonesia Chamber of Commerce)
KEM PPKF	Kerangka Ekonomi Makro dan Pokok-pokok Kebijakan Fiskal (Macro Framework and the Fiscal Policy Direction)
KPI	Key Performance Indicator
KPPN	Kantor Pelayanan Pembendaharaan Negara (Treasury Payment Office)
SME	Small-medium enterprise
SNG	Subnational Government
SOE	State-Owned Enterprise
SPAN	Sistem Perbendaharaan dan Anggaran Negara
Susenas	Survei Sosial Ekonomi Indonesia (Indonesian Socio-economic Survey)
THL	Tax Harmonization Law 7 of 2021
VAT	Value-Added Tax

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REPUBLIC OF INDONESIA

INDONESIA FISCAL REFORM DEVELOPMENT POLICY LOAN

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic
P177726	No

Proposed Development Objective(s)

The objectives of this operation are to increase tax revenue and improve equity of the tax system, and to strengthen institutions for planning and budgeting, and fiscal transfers.

Organizations

Borrower:	REPUBLIC OF INDONESIA
Implementing Agency:	Ministry of Finance, Ministry of Finance

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**750.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	750.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

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

Overall Risk Rating

Results

Indicator Name	Baseline	Target
Value-Added Tax and Luxury Goods Sales Tax revenue (percent of GDP)	3.2 percent (2021)	At least 3.4 percent (2023)
Personal Income Tax revenue collected from individuals with income over five billion Indonesian Rupiah as a share of total PIT revenue	15.9 percent (2020)	18.0 percent (2023)
Percent of total emissions from grid-connected coal powerplants that is accounted for by powerplants that are subject to a carbon tax	0 percent (2021)	75 percent (2023)
Ratio of national median revenues per capita over the most populous district quintile	2.07 (2020)	2.02 (2023)
Number of programs in the budget	More than 600 (2020)	Fewer than 120 (2023)
Number of spending units in districts and cities (percent share of 2021)	100 percent (2021)	54 percent (2023) [1]

[1] The dates are based on the year when the budget implementation document (DPIA) with the number of spending units is issued (e.g., late 2023) and will apply to the following fiscal year (e.g., 2024).

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

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document proposes a stand-alone Development Policy Loan (DPL) in the amount of US$ 750 million equivalent.** The Development Objectives and Pillars of the operation are: 1) increase tax revenue and improve equity of the tax system; and 2) strengthen institutions for planning and budgeting, and fiscal transfers. These reforms will support the post-pandemic recovery and help expand fiscal space to address Indonesia's human capital and infrastructure gaps.

2. **Despite impressive development achievements over recent decades, Indonesia still faces large human capital and infrastructure gaps that impede its competitiveness and its ability to create jobs and reduce poverty.** Poverty fell from 19.1 percent in 2000 to 9.4 percent in 2019, life expectancy increased from 66 to 69 years, and households' access to improved drinking water and sanitation services nearly doubled over the same time. However, the speed of poverty reduction has slowed significantly since 2010. Human capital levels are far below that of peer countries. A child born in Indonesia today will be only 53 percent as productive when they grow up, as they could have been if they had enjoyed complete education and full health.[2] On the other hand, public capital per person is only a third of other emerging market economies, suggesting a gap in infrastructure assets of around US$ 1.6 trillion (134 percent of GDP). There are also large geographic and income-related disparities in service delivery and outcomes.

3. **The COVID-19 pandemic has made it more difficult to close the human capital and infrastructure gaps.** The pandemic has led to a sharp increase in poverty, peaking at 10.2 percent in September 2020 and remaining high at 10.1 percent in March 2021. Cuts to infrastructure spending to accommodate the pandemic response have delayed infrastructure development, while school closures have reduced learning outcomes. The widening fiscal deficit and elevated below-the-line spending have increased the debt-to-GDP ratio, although it remains sustainable and below the authorities' debt ceiling. Rising interest payments risk crowding out priority spending on health, social assistance, and infrastructure.

4. **Low and volatile fiscal revenues constrain the fiscal space available for development priorities.** Taxes amounted to just 9.1 percent of GDP in 2021, which is well below estimated tax potential. General government revenue was 12 percent of GDP in 2020, less than half the emerging market average of 27 percent of GDP. The tax system is characterized by high tax-free thresholds, wasteful exemptions, uneven treatment across sectors, and low health, wealth, and environmental taxes. Altogether, these result in a narrow tax base. Indonesia could potentially collect 6 percent of GDP more in revenue given its economic and other conditions.

5. **There are spending misallocations and systemic constraints to the quality of spending.** General government spending was 18 percent of GDP in 2020, just over half the emerging market average of 35 percent of GDP. Spending on health and social protection is also low, only one third of spending in peer countries. Although the cost of energy subsidies was brought down over the past two decades from over 3 percent of GDP to less than 1 percent of GDP, they have re-emerged and remain significant and not well

[2] See World Bank Human Capital Index.

targeted. The government is planning to better target the liquified petroleum gas (LPG) and electricity subsidies in 2022.[3] At the same time, the government lacks tools to adequately support and incentivize fiscal performance of local governments. Public financial management suffers from inadequate budget planning, poor links to results, misallocation of resources, and a lack of good data.

6. **The proposed operation will help address some key revenue and expenditure challenges.** Pillar 1 supports increasing value-added tax (VAT) revenue through increasing the rate and rationalizing exemptions, increasing personal income tax revenue from high-income earning individuals, and introducing a carbon tax. Increased revenue will improve the resilience of the fiscal system. Pillar 2 supports reforming the intergovernmental fiscal transfer system, strengthening the link between planning and budgeting, and improving capital budget execution. These reforms will increase funding for the more populous regions and increase the orientation of spending on results and national priorities. The operation is consistent with the Green, Resilient and Inclusive Development (GRID) approach.

7. **These reforms are taking place at the mid-point of the current administration's term.** The authorities have pursued ambitious reforms: the Job Creation Law 11 of 2020, the Tax Harmonization Law 7 of 2021 (THL), the Law on Intergovernmental Finance 1 of 2022, and a Financial Sector Reform Law that is currently under preparation. The THL supported by this DPL was approved well ahead of the 2024 presidential and parliamentary elections, while its provisions will be introduced gradually over the course of 2022 and later to reduce any potential negative impact the reforms may have on the recovery from the pandemic. There is still space for further reforms, including through government and ministry-level regulations that clarify design and implementation details of provisions that are only broadly outlined in the recently issued Laws. However, the window is expected to narrow in 2023 as the 2024 presidential elections approach and political conditions continue to change rapidly.

8. **The operation is expected to promote climate change mitigation and adaptation.** Besides taxing emissions through the introduction of a carbon tax, the operation also reduces a price distortion that favored fossil fuels, by phasing out VAT exemptions on mining and drilling products, including oil and gas. This is important given Indonesia has substantial financing needs to meet its Nationally Determined Contributions (NDCs). Further reforms to improve the efficiency and implementation of climate-related spending will improve climate mitigation and adaptation efforts.

9. **The macroeconomic policy framework is adequate for the purposes of the proposed operation.** Indonesia's direct exposure to Russia and Ukraine is limited, although increasing energy and food prices may lead to higher inflation and explicit or implicit food and fuel subsidies. It has policy space to respond to limited shocks from global financial and commodity markets. Indonesia has a strong track record of prudent macroeconomic and fiscal management. Fiscal and monetary expansion were appropriate in the current exceptional economic circumstances. The authorities are committed to keeping the central bank's financing of the fiscal deficit time-bound (ending in 2022) and targeted to maintain monetary and exchange rate policy credibility. While the banking sector remains stable, it will be important to closely monitor the application of loan forbearance measures, maintain adequate loan provisioning, support

[3] The government included provisions in the 2022 budget to allow them to better target the LPG and electricity subsidies to the bottom 40 percent using the unified poverty database and to directly channel the LPG subsidy to recipients as a quasi-cash transfer. These reforms are contingent on improving the accuracy of the poverty database, the economic outlook and global commodity prices.

credit to viable firms and prepare for potential stress. Implementation of the recently approved THL and other structural reforms is important to improve growth, fiscal space, and debt sustainability.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

10. **Indonesia's economy is recovering from the pandemic.** GDP growth rebounded from -2.1 percent in 2020 to 3.7 percent in 2021, supported by public consumption and exports. This came on the back of a counter-cyclical fiscal and monetary response to the pandemic, a positive terms-of-trade shock led by higher commodity prices, and a pick-up in external demand. On the supply side, more than 60 percent of the contribution to growth came from the manufacturing, wholesale and trade, construction, and telecom sectors reflecting growing demand especially in sectors less affected by COVID-19 restrictions. The recovery continues in 2022, where GDP stood at 5.0 percent in Q1, as private consumption and investment growth accelerated, offsetting the moderations in exports and imports growth.

11. **The recovery is coming amid uncertain global conditions including from ongoing tensions in Europe.** On February 24, Russian forces invaded Ukraine, sending commodity prices soaring and increasing volatility in the global financial markets**.** Natural gas prices rose more than 30 percent while Brent crude oil surpassed US$ 100 per barrel. Other commodity prices such as wheat and aluminum followed suit, impacting food security and supply chains. Moreover, global financial volatility shot up with the CBOE Volatility Index (VIX) recording its highest level since 2020 and the spread of medium-term Emerging Markets and Developing Economies (EMDE)s' government bonds widening by 27 basis points during the early days of the conflict.

12. **While Indonesia's direct links to Ukraine and Russia are limited, the country is impacted by global commodity and financial markets.** Indonesia's economy has very limited direct trade, financial and foreign investment exposure to Russia and Ukraine. But it is exposed to global financial and commodity markets; sovereign credit risk has increased slightly, in line with other major emerging markets. Equity inflows have remained stable, while coal and palm oil prices (Indonesia's top 2 exports) have soared. However, Indonesia is exposed to the indirect impact as the main trading and economic partners, mainly China and other regional countries, are affected by the crisis. Government policy to contain consumer prices for electricity and transport fuel, mainly through maintaining price controls at the consumer and business level, is increasing contingent liabilities to energy SOEs. Sustaining the subsidies for a protracted period risks increasing fiscal pressures if the contingent liabilities materialize. The government has also imposed a short-lived export ban of palm oil and its derivatives (during the first three weeks of May) with the objective of making cooking oil available for domestic markets, which increased domestic cooking oil supply, although it has had a limited impact on lowering cooking oil prices. Separately, there has also been domestic passthrough of global food price inflation, which could increase poverty. Indonesia has some policy space to respond to limited shocks transmitted through global financial and commodity markets. For instance, external financing needs are moderate, foreign exchange reserves are strong, government debt levels are low and mostly domestic, and the policy rate is positive in real terms while inflation is low.

13. **The response to COVID-19 improved with the vaccine rollout reaching a critical mass, and booster vaccinations starting in January 2022**. By April 2022, 60.4 percent of the population had been

fully vaccinated, but there is variation at the provincial level. Among provinces with the highest inoculation rates (i.e., the top quartile of provinces), around 62.4 percent of the population is vaccinated. By contrast, provinces with the lowest inoculation rates (i.e., the bottom quartile) exhibit vaccination rates of only 43 percent. These latter provinces tend to be in more remote and less densely populated, making access to vaccines difficult. The government has started the rollout of booster vaccines and reached 13.4 percent of the population by mid-April. The inoculation rate lags that of peer countries.[4] The Omicron wave has started to subside, and the government is gradually loosening restrictions on international travel.

14. **The external position strengthened due to a positive terms-of-trade shock, maintaining an adequate level of foreign exchange reserves.** The current account recorded a surplus in 2021 (0.3 percent of GDP) on the back of robust commodities exports and improvements in the secondary income balance as foreign grants for COVID-19 support increased (Table 2). External buffers have been adequate to manage external financial pressures. Foreign reserves averaged around 9-10 months of imports throughout 2021. The real effective exchange rate (REER) has been stable since May 2020.

15. **The government temporarily relaxed the fiscal deficit ceiling (3 percent of GDP) for 2020-2022 to create space for a countercyclical fiscal response.** After peaking at 6.1 percent of GDP in 2020, the fiscal deficit narrowed to 4.6 percent of GDP in 2021. Spending increased strongly with the implementation of a COVID fiscal package focusing on health, social assistance and firm support, amounting to 3.7 and 4.0 percent of GDP in 2020 and 2021, respectively. The wider deficit in 2020 was also driven significantly by falling tax revenues, due to economic contraction, lower commodity prices and temporary tax relief.

16. **The fiscal deficit narrowed in 2021 due to a broad-based rebound in public revenues, despite increased COVID fiscal outlays.** Total revenues increased from 10.7 percent of GDP in 2020 to 11.8 percent in 2021 driven by value-added tax (VAT), tobacco excises, trade taxes and non-tax revenue. Revenues remain below pre-crisis levels of 12.4 percent of GDP in 2019 due to lower corporate and personal income tax revenue. Spending declined from 16.8 percent of GDP in 2020 to 16.4 percent of GDP in 2021. This was underpinned by weakness in social assistance, personnel spending, and transfers to subnational governments, and partially offset by strength in material and capital spending, and energy subsidies. Central government debt reached 40.7 percent of GDP in 2021, still well below the 60 percent ceiling imposed by Law Number 17 of 2003 on State Finance.

[4] The group of peer countries used in this section consists of Brazil, China, India, Malaysia, Philippines, Thailand and Vietnam, except when data is not available.

Table 1. Key Macroeconomic Indicators 2019-2024

	2019	2020	2021	2022	2023	2024	2025
	Actual		Est.	WB projection			
Real economy							
Real GDP (% change)	5.0	-2.1	3.7	5.1	5.3	5.3	5.3
Consumer Price Inflation (CPI) (year-average, %)	2.8	2.0	1.6	2.7	3.1	3.3	3.3
Demand side (contribution to growth, in percentage points)							
Private Consumption	2.9	-1.5	1.1	2.6	2.7	2.8	2.9
Government Consumption	0.3	0.2	0.3	0.1	0.1	0.3	0.3
Gross Fixed Investment	1.5	-1.6	1.2	1.8	2.0	2.1	2.2
Exports	-0.2	-1.7	4.7	3.4	2.6	2.2	2.2
Imports	1.5	3.1	-3.7	-2.8	-2.3	-2.2	-2.3
Supply side (contribution to growth, in percentage points)							
Agriculture	0.5	0.2	0.5	0.2	0.5	0.5	0.5
Industry	1.5	-1.1	1.3	1.7	1.7	1.7	1.7
Services	2.8	-0.6	1.6	3.0	2.9	3.0	2.9
Net Taxes on Production	0.2	-0.5	-0.1	0.1	0.2	0.1	0.2
Fiscal accounts, central government, percent of GDP							
Revenues	12.4	10.7	11.8	12.4	12.1	12.1	12.5
of which Tax Revenue	9.8	8.3	9.1	9.9	9.8	10.0	10.5
Expenditures	14.6	16.8	16.4	16.1	15.1	15.1	15.5
Primary Balance	-0.5	-4.1	-2.6	-1.5	-0.6	-0.5	-0.4
Fiscal Balance	-2.2	-6.1	-4.6	-3.7	-3.0	-3.0	-3.0
Central Government Debt	30.2	39.3	40.7	42.9	43.2	43.4	43.8
Balance of Payments, percent of GDP unless indicated otherwise							
Current Account Balance	-2.7	-0.4	0.3	-0.9	-1.4	-1.9	-2.3
Exports, Goods and Services	17.9	16.8	20.8	22.1	21.7	21.7	21.6
Imports, Goods and Services	-18.3	-15.1	-18.4	-20.5	-20.8	-21.2	-21.7
Net Foreign Direct Investment	1.8	1.3	1.4	1.6	1.8	1.9	1.9
Gross Reserves (months of imports of goods and services)	9.7	7.5	7.1	7.5	7.6	7.6	7.2
Memorandum items							
Nominal GDP (IDR trillion)	15,832	15,434	16,971	17,843	19,186	20,557	21,878
Per Capita GDP (US$)	3,877	3,757	3,856	…	…	…	…
Nominal GDP (US$ billion)	1,119	1,058	1,186	…	…	…	…

Note: the fiscal numbers for 2021 are World Bank projections as of December 2021 and are different from preliminary estimates released by the MoF in January 2022 (see Table 4).
Source: Ministry of Finance, BI, World Bank staff projections.

17. **Bank Indonesia (BI) has maintained an accommodative monetary stance while financing the fiscal deficit during the pandemic.** BI has cut its policy rate by 150 basis points since the beginning of the pandemic and injected liquidity into the financial system by relaxing reserve requirements. Nonetheless, given modest inflation outcomes, the real policy interest rate remains high relative to peers. With fiscal financing needs estimated to have increased, BI's share of local currency government debt rose to 26.1 percent at end-2021, up from 9.9 percent at end-2019. Likewise, commercial bank holdings have increased from 22.6 to 34.0 percent over the same period, while the share of non-resident holdings declined from 38.6 to 16.6 percent. BI's primary market purchases of government bonds fell from 3.0 percent of GDP in 2020 to 2.2 percent of GDP in 2021. The authorities are committed to phasing out monetary financing by end-2022.

18. **Bank balance sheets are healthy, corporate vulnerabilities are moderate, but loans-at-risk are elevated.** The Non-Performing Loan (NPL) ratio declined at the end of 2021 to 3.0 percent, slightly lower than peers. The capital adequacy ratio edged up to 25.6 percent in December 2021 and remained well above the Basel regulatory minimum of 10 percent. Provisioning levels relative to NPLs increased markedly to 190 percent in November 2021, which is high by international standards and should be sufficient to absorb a shock to large banks' NPLs. Notwithstanding, the loans at risk (LAR) ratio, defined as the sum of NPLs, restructured loans and special mention loans, increased from 11.6 to 21.6 percent in March 2020-October 2021, although LAR for top ten banks have stabilized since March 2021. This warrants close monitoring since loan forbearance measures have been extended until March 2023 and may temporarily mask the true extent of bank balance-sheet vulnerabilities. Liquid assets stood at 27.1 percent of deposits and short-term funding in November 2021, up from 24.2 percent half a year ago. This remains lower though than East Asia and the Pacific (EAP) average and peers. Return on assets (ROA), return on equity (ROE) and interest margin to gross income declined from high pre-pandemic levels to 1.9 percent, 10.7 percent, and 4.5 percent in November 2021. Data from listed firms also shows that corporate vulnerability has stabilized after increasing in 2020.

19. **Credit to the private sector has increased slightly in early 2021 but remains weak overall.** Credit to the private sector expanded by 5.2 percent in December 2021 after contracting in October 2020-May 2021. Despite monetary policy relaxation, credit growth remained well below its pre-crisis level of 8 percent in September 2019 and tracked lower than most peers. Possible causes of continued lackluster credit growth include demand side factors, such as weak economic conditions, as well as supply side factors, such as uncertainty and high borrower risks. However, survey data from the Financial Services Authority (OJK) point to stable household demand for credit.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

20. **Growth is expected to recover over the medium-term despite the deteriorating global environment.** As pent-up demand is released, and structural reforms move forward, private consumption and investment are expected to anchor the recovery and gradually boost growth to 5.3 percent over the medium term. This compensates for the drag on growth imposed by fiscal consolidation as the deficit returns to 3 percent in 2022-2023 (Table 2). On the supply side, assuming the pandemic is under control, mobility restrictions are gradually lifted, and vaccine rollout coverage improves, contact-intensive services sectors such as trade and hospitality are expected to rebound. Rising commodity prices will also support growth and investment especially in commodity related sectors such as coal and palm oil where Indonesia

is a net-exporter. However, those gains will be partially offset by rising oil and food prices from the war in Ukraine, which put a drag on sectors like transport and manufacturing.

21. **Inflationary pressures are expected to increase in 2022 with inflation projected to remain slightly below the upper bound of the official target** (2-4 percent) (Table 2). The rise in global energy prices is already being partially passed on to consumers. Rising global oil prices also feed into food prices in Indonesia through input costs. The authorities have also indicated plans to raise electricity tariffs over the course of 2022 (and target subsidies better to the poor). Inflation expectations for 2022 have risen from 2.9 percent in January to 3.4 percent in March.[5]

Table 2. Balance of Payment (BoP) Financing Requirements and Sources (US$, billions)

	2019	2020	2021	2022	2023	2024	2025
	Actual		Est.	WB projection			
Current account deficit	30.3	4.5	-3.3	11.6	18.9	26.5	35.0
Scheduled government debt amortization	10.5	12.3	11.1	11.6	12.4	12.5	12.9
Private sector debt repayment	27.5	23.4	24.4	25.4	27.2	29.1	31.0
Total financing needs	**68.3**	**40.2**	**32.2**	**48.6**	**58.5**	**68.2**	**78.9**
Total financing sources	**68.3**	**40.2**	**32.2**	**48.6**	**58.5**	**68.2**	**78.9**
FDI inflows (net)	20.5	14.1	16.5	19.8	23.5	26.8	29.0
Portfolio inflows (net)	16.0	-0.8	-2.4	16.6	16.7	16.9	17.0
Other investment (net)[(a)]	23.7	11.8	15.3	15.9	17.0	18.3	19.4
Government borrowing (gross)[(b)]	15.7	20.6	20.4	18.8	19.9	22.6	25.3
Securities	10.5	10.9	13.2	10.5	12.9	14.6	16.4
Loans	5.2	9.7	7.2	8.3	7.0	7.9	8.9
Of which WB DPLs	1.0	0.6	1.2	1.7	..	..	..
Other items (net)[©]	-3.0	-2.9	-4.0	-0.1	0.0	0.1	0.2
Use of reserves[(d)]	-4.7	-2.6	-13.6	-22.4	-18.7	-16.5	-12.0

Source: BI, World Bank staff projections. Note: (a) Including other equity, trade credits, loans etc. but excludes government and private borrowing and currency swaps. (b) The government estimates funding from donors other than the World Bank (including from the Asian Development Bank, Japan International Cooperation Agency, Australia, Agence Francaise de Développement, KfW etc.) in 2021 at US$ 5.2 billion. (c) Comprising capital account, derivatives, and errors and omissions components; for historical data also includes discrepancy between balance of payments and fiscal data on government borrowing. (d) Use of reserves: '–'denotes an accumulation; '+' denotes a reduction.

22. **Indonesia is vulnerable to tightening external financing conditions.** The outlook assumes that global financing conditions will tighten in 2022 given US monetary tightening and global risk aversion towards emerging markets. There could diverging performance across asset classes. First, pressures are likely to be strong on portfolio debt as inflation erodes yields. Second, portfolio equity is expected to remain strong on the back commodity earnings. Third, FDI commitments have been announced in the energy, mining, manufacturing, and pharmaceutical sectors, and more are expected in services, such as tourism, as COVID restrictions abate. External financing needs are expected to increase but remain contained as the current account deficit is projected to remain low (Table 3). A stable Rupiah, adequate official reserves, a positive interest rate differential with the US, and relatively low inflation to date provide Indonesia with some policy space to manage tighter global financial conditions while supporting

[5] Asia Pacific Consensus Forecast, April 2022.

the economic recovery. An increase in loan financing, including development policy loans, could manage the risk of tightening financial conditions in 2022.

23. **The fiscal deficit is expected to narrow to 3.0 percent of GDP by 2023-2024, in line with government commitments, although pressures will remain in light of the effects of global developments (Table 4).** A fiscal adjustment of around 1.6 percent of GDP will be needed to reach the government's target deficit. The macro framework assumes this fiscal consolidation will be achieved through a fairly even split of expenditure cuts and revenue-generating reforms. As a result, gross fiscal financing needs are expected to gradually decline but remain sizeable at an average of 7.0 percent of GDP in 2022-2024 especially given spending pressures arising from the effects of global developments. With FX-denominated debt issuances and loans expected to finance a larger share of the deficit, monetary financing is expected to subside. The eventual withdrawal of monetary financing will be a welcome development owing to the need to limit moral hazard and the risks of financial repression, but it also has risks given the uncertainty surrounding the current recovery. Moreover, if economic conditions continue to be weak, financing needs could remain elevated longer than expected. While the consolidation will withdraw some domestic demand, this will be compensated through the release of pent-up demand, thus boosting private consumption, as COVID restrictions are eliminated and contact services reopen. It also comes amid planned structural reforms that are expected to boost domestic and foreign investment.

24. **Public spending is projected to gradually decline with the phasing out of the COVID-19 support package, but remain above pre-pandemic levels, due in part to subsidy and social assistance pressures.** Elements of the COVID-19 fiscal package, such as health, social assistance, and firm support, are expected to be phased out as the pandemic comes under control and the economic recovery strengthens.[6] COVID-19 fiscal support has already shrunk to 2.6 percent of GDP in 2022, down from 4.0 percent of GDP in 2021. Overall, fiscal consolidation efforts will also markedly reduce capital spending in the outlook, returning to pre-COVID levels. Social assistance spending will be maintained above pre-COVID levels to protect the poor and vulnerable, including from the impacts of rising food prices, and to accommodate the planned roll out of unemployment insurance and social insurance. Spending on fuel and electricity subsidies is expected to rise temporarily in 2022, as the government limits pass-through of higher global energy prices through fixed administered retail prices, although small retail price adjustments in April 2022 will decrease fuel subsidy spending somewhat.[7] Interest payments will also increase due to the build-up in public debt (+0.7 percent of GDP in 2023 compared to 2019).

[6] Health and social protection spending under the fiscal package in 2022 are expected to decline by around 40 percent and 10 percent, respectively, compared to their outlays under the package in 2021.
[7] The government has been considering reforms to fuel and electricity subsidies that would better target spending on intended beneficiaries via the use of an integrated poverty database. The fiscal impact of subsidy reforms has not been included in the baseline forecasts as reform progress is currently on hold.

Table 3. Baseline Medium-Term Fiscal Framework (Central Government), percentage of GDP

	2019	2020	2021	2022	2023	2024	2025
	Actual		Est.	WB projection			
Revenue	**12.4**	**10.7**	**11.8**	**12.4**	**12.1**	**12.1**	**12.5**
Tax revenue	**9.8**	**8.3**	**9.1**	**9.9**	**9.8**	**10.0**	**10.5**
Income tax	4.9	3.8	4.1	4.5	4.3	4.5	4.5
Sales tax	3.4	2.9	3.2	3.6	3.8	3.8	4.2
Excises	1.1	1.1	1.2	1.3	1.3	1.3	1.4
International trade tax	0.3	0.2	0.4	0.4	0.3	0.3	0.3
Other taxes	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Non-tax receipts	**2.6**	**2.2**	**2.7**	**2.5**	**2.3**	**2.1**	**2.0**
Grants	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Total expenditure	**14.6**	**16.8**	**16.4**	**16.1**	**15.1**	**15.1**	**15.5**
Primary expenditure	**12.8**	**14.8**	**14.4**	**13.9**	**12.7**	**12.7**	**12.9**
Central government	**7.7**	**9.8**	**9.8**	**8.7**	**7.7**	**7.7**	**7.8**
Personnel	2.4	2.5	2.3	2.3	2.3	2.3	2.3
Material	2.1	2.7	3.1	2.5	2.0	2.1	2.1
Capital	1.1	1.2	1.4	1.2	1.1	1.1	1.2
Subsidy	1.3	1.3	1.4	1.5	1.3	1.2	1.2
Energy	0.9	0.7	0.8	1.0	0.9	0.8	0.8
Non-energy	0.4	0.6	0.6	0.5	0.4	0.4	0.4
Social assistance	0.7	1.3	1.0	1.0	1.0	1.0	1.0
Others	0.1	0.8	0.5	0.1	0.6	0.1	0.1
Transfers to subnational	**5.1**	**4.9**	**4.6**	**5.2**	**5.0**	**5.0**	**5.1**
Interest	**1.7**	**2.0**	**2.0**	**2.2**	**2.4**	**2.5**	**2.6**
Overall fiscal balance	**-2.2**	**-6.1**	**-4.6**	**-3.7**	**-3.0**	**-3.0**	**-3.0**
Primary fiscal balance	-0.5	-4.1	-2.6	-1.5	-0.6	-0.5	-0.4
Net financing	**2.2**	**6.1**	**4.6**	**3.7**	**3.0**	**3.0**	**3.0**
Investment in financial assets	-0.6	-1.8	-0.5	-0.6	-0.2	-0.2	-0.2
Net borrowing	2.8	8.0	5.1	4.3	3.2	3.1	3.1
Net local currency	2.3	6.9	4.4	3.7	2.6	2.4	2.3
o/w BI fiscal financing[(a)]	0.0	3.0	2.2	1.3	0.0	0.0	0.0
Net foreign currency	0.5	1.1	0.7	0.6	0.6	0.7	0.8
Central government debt	30.2	39.3	40.7	42.9	43.2	43.4	43.8
Gross fiscal financing needs	5.9	9.8	8.1	7.2	6.7	7.1	7.5

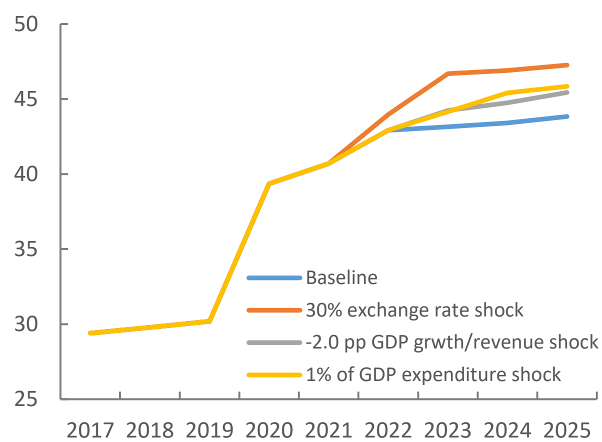
Note: Estimated data for 2021 based on unaudited data published by MoF. (a) 2022 is based on an August 2021 government announcement.
Source: Ministry of Finance and World Bank staff projections.

25. **Government revenues are projected to increase due to tax reforms supported in this DPL and stronger commodity prices.** In addition, the government has approved tax law and excise reforms that will be implemented over 2022 to 2025. These reforms are expected to boost government revenues by 0.9 percentage point of GDP, on average, over 2022-2025, with the VAT reform supported by this proposed operation accounting for 0.3 percent of GDP in 2022.[8] This will be complemented by near-term temporary revenue gains from a tax amnesty measure, and a modest permanent uptick in 2024 as tax administration reforms already underway begin to bear fruit. In addition, ongoing strength in global commodity prices, combined with the recent conflict-driven surge, is expected to boost income taxes and non-tax receipts from the resource sector in 2022-2023.[9] The combination of these factors will result in the tax ratio rising above its pre-pandemic (2019) share of GDP of 9.8 percent, throughout most of 2022-2024. Parliament approved a revision of the 2022 budget in May increasing the allocation for the energy subsidies from 0.7 to 1.2 percent of GDP, which is funded largely by increased commodity-related revenue, narrowing its projected fiscal deficit from 4.9 percent to 4.3-4.5 percent of GDP.

26. **The World Bank's Debt Sustainability Analysis (DSA) shows that central government debt would remain overall low and manageable under plausible adverse shocks.** Under the baseline, central government debt is projected to rise over the medium term and stabilize at around 44 percent of GDP in 2025, well below the government debt ceiling (60 percent of GDP). The DSA results show that debt is more vulnerable to a large exchange rate shock but would remain sustainable under plausible scenarios. More specifically, a permanent 30 percent exchange rate depreciation shock in 2023 would increase the debt-to-GDP ratio by 3.4 percentage points relative to the baseline by 2025 (Figure 1). An expenditure shock of 1 percent of GDP lasting through 2023 and 2024, to respond to a protracted crisis or a natural disaster for instance, would increase the debt-to-GDP ratio by 2.0 percentage points relative to the baseline. A negative growth shock, subduing GDP growth in 2023 to 3.3 percent from 5.3 percent in the baseline, combined with a proportional revenue decline, would increase the debt-to-GDP ratio by 1.6 percentage point relative to the baseline. The interest-to-revenue ratio is projected to increase from 14.1 to around 21-22 percent over 2019-2025, under all scenarios considered. After rising sharply in 2020 due to exchange rate and GDP shocks, external debt is expected to return to pre-COVID levels as the economy rebounds, gross financing needs fall, and equity inflows gradually rise (Figure 2 and Table 4).

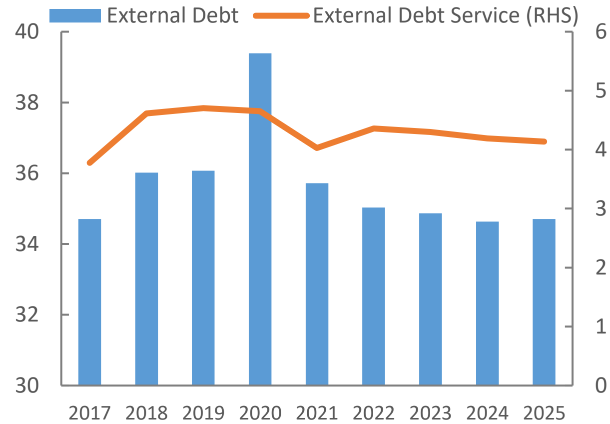
[8] The majority of this impact is driven by higher VAT revenues due to a higher standard VAT rate, and higher income taxes due to the reversal of the government's prior decision to cut the standard corporate income tax rate from 22 percent to 20 percent.
[9] Nonetheless, non-tax receipts will fall over 2021-2022 due to a moderation in once-off ad hoc strength in other non-tax items, such as revenues from public service delivery units.

Figure 1. Central government debt is projected to remain overall manageable....
(Percentage of GDP)



Note: DSA last updated in March 2022
Source: Ministry of Finance, World Bank staff projections

Figure 2. .... while external debt is expected to decline
(Percentage of GDP)



Note: DSA last updated in March 2022
Source: Bank Indonesia, World Bank staff projections

Table 4. External Debt Composition, end-2021

	USD (billions)	Share of total debt	% of GDP
Monetary authorities	9.0	2.2	0.8
Central government	200.1	48.2	17.6
Banks	33.0	7.9	2.8
Other private	172.9	41.7	14.6

Source: Bank Indonesia

27. **Fiscal risks and contingent liabilities are generally manageable, although they warrant closer monitoring as the pandemic has increased risks.** Exposure to explicit contingent liabilities in the form of loan guarantees to state-owned enterprises (SOEs) amounted to 1.85 percent of GDP as at end-Q4:2021, well below the guarantee ceiling of 6.0 percent of GDP. Non-financial SOE debt (guaranteed and non-guaranteed) increased from 6.3 to 7.1 percent of GDP over 2019-Q1:2021-Q4. These trends warrant monitoring[10] especially as the COVID-19 response package has expanded the level of loan guarantees to private businesses and SOEs. Central government capital injections into SOEs have increased from an average of 0.4 percent of GDP in 2016-2019[11] to an expected 0.9 percent in 2020-2022, partially reflecting a materialization of implicit contingent liabilities. Such capital injections will decline after 2022 as the recovery strengthens. Rising global energy prices could lead to increased energy subsidies, both explicitly through the budget and implicitly as economic prices exceed the administered retail energy prices and the energy SOEs will have to absorb losses. This will increase continent liabilities in the form of future compensation payments to settle these implicit subsidies. Risks from guarantees to public-private partnership (PPP) projects on the other hand are mitigated by the Indonesia Infrastructure Guarantee

[10] The government publishes a guarantee analysis each quarter and includes a fiscal risk statement in its budget report.
[11] Pre-COVID SOE injections supported SOE borrowing capacity for infrastructure investments.

Fund (IGGF) for guarantee risks. Indonesia is also exposed to fiscal risks from natural disasters. However, the risk is being mitigated through its National Disaster Risk Insurance Strategy.

28. **Risks to the outlook are skewed to the downside, given tightened global financial conditions, fiscal shocks, and spillover impacts from the war in Ukraine.** Indonesia's direct exposure to Russia and Ukraine is limited, although increasing energy and food commodity may lead to increased inflation and explicit or implicit food and energy subsidies. The country has policy space to respond to limited shocks transmitted through global financial and commodity markets. For instance, some of the commodity-driven revenue windfalls will go towards subsidizing food products (e.g., cooking oil) and energy products (e.g., electricity and fuels) to weather the impact of the crisis on the poor. Faster-than-expected global monetary tightening and contagion effects from other EMs which could increase the cost of financing, trigger capital outflows and rupiah depreciation and fuel inflation. The recovery of domestic lending to private sector and the phasing out of monetary financing will lead to more competition for domestic financing between the government and the private sector. A fiscal shock could lead to an increase in short-term financing needs. Moreover, as COVID-19 may become endemic this will make maintaining adequate vaccination and other health measures for a protracted period necessary. If downside risks materialize, notably a terms of trade shock and a deceleration in regional growth, Indonesia's growth could slow to 4.6 percent in 2022 compared to 5.1 percent in the baseline. Moreover, if revenue growth also falls by an equal magnitude, the combined effects would see the fiscal deficit rise slightly to 3.8 percent of GDP in 2022.

29. **Exit strategies for macroprudential easing, particularly loan forbearance measures, will need to be carefully designed and the insolvency strengthened to facilitate private sector debt restructuring.** Exit from macroprudential easing faces difficult tradeoffs between exiting too early which could increase bankruptcies and exiting too late which could fuel zombification (i.e., unviable firms kept alive by policy support). The Financial Sector Omnibus Law provides an opportunity to address gaps in financial sector depth and stability. The law can help promote legal certainty, clarity, and confidence in the legal frameworks on financial innovation, macro prudential mandates, and supervision. Moreover, completing the revision of the Bankruptcy Law, developing industry-funded resolution mechanisms are important to strengthen the insolvency framework and the crisis preparedness and resolution framework.

30. **The macroeconomic policy framework is adequate for the purposes of the proposed operation.** Indonesia built a strong track record of prudent macroeconomic and fiscal management over the past decade. The authorities' strategy of monetary policy is appropriate in the current exceptional economic circumstances. A lower policy interest rate is fitting, contingent on the inflation outlook. The policy on financing of the fiscal deficit as a last resort and using market mechanism was necessary and will be phased out gradually. The recent tax reforms, supported by the DPL, show that the authorities are committed to returning to the 3 percent of GDP fiscal deficit ceiling by 2023 and to keeping monetary financing of deficit time-bound (until end of 2022). While the banking sector remains overall stable, it is important to closely monitor the application of loan forbearance measures, maintain adequate loan provisioning, support credit to viable firms and prepare for potential stress. Implementation of the recently approved Tax Harmonization Law and other structural reforms is important to improve growth, fiscal space, and debt sustainability.

3. GOVERNMENT PROGRAM

31. **The government of Indonesia (GoI) is aiming to improve fiscal space by increasing fiscal revenue and improving the efficiency and effectiveness of government spending.** The Ministry of Finance (MoF) Strategic Plan 2020-2024 supports the development agendas of the National Medium-Term Development Plan 2020-2024. It comprises five Policy Directions: 1) sound and sustainable fiscal management; 2) optimum state revenues; 3) management of quality state expenditures; 4) management of treasury, state assets, and accountable and productive financing with controllable risks; and 5) an agile, effective and efficient bureaucracy and public services.

32. **In support of sound and sustainable fiscal management, the GoI has embarked on reforms to increase tax revenue and improve the quality of revenue collection**. The Tax Harmonization Law (THL) expands the tax base, increases tax rates, and improves the equity of the tax system:

- **It expands the tax base** through the introduction of a carbon tax, rationalizing value-added tax (VAT) exemptions, strengthening the legal basis for e-commerce taxation, simplification of the approval process for excise reforms, and an asset declaration program ('tax amnesty').
- **It increases tax rates in 3 different areas:** The VAT rate is set to be increased by 1 percentage point in 2022 and an additional 1 percentage point will be added by 2025. A new personal income tax (PIT) bracket with a 35 percent tax rate is imposed on taxable income over IDR 500 million (approximately US$ 33,000). The previously legislated corporate income tax rate cut from 22 to 20 percent in 2022 has been abandoned.
- **It makes the tax system more equitable** through: (i) rationalizing VAT exemptions, which improves the horizontal equity of the VAT (i.e., fewer distortions from more limited exemptions, resulting in more equal treatment of different business sectors); (ii) shifting the PIT burden towards high-income earning individuals; (iii) lowering the VAT threshold combined with introducing a new tax-free threshold for the income of small firms, which ensures medium-sized firms are part of the tax net while micro and small firms are given more support; and (iv) imposing stricter rules on fringe benefits to increase PIT revenue.

33. **The MoF has also set out a 5-year public financial management (PFM) roadmap of key institutional reforms to modernize public finance institutions, through the introduction of technology and by making them more performance oriented.** This roadmap from 2019 includes the following strategic reform themes:

(i) *Core tax information technology (IT) system:* implementing this system is a prerequisite for further structural tax administration reforms to optimize public revenues and maintaining aggregate fiscal discipline.

(ii) *Integration of planning and budgeting:* the recent initiatives through the Redesign of Planning and Budgeting (RSPP) aim to introduce reforms for more strategic planning and a performance orientation in budgeting.

(iii) *Timely and efficient budget execution and accountability:* through the consolidation of a large number of spending units at the regional level and the roll-out of web-based spending unit level financial management system (called SAKTI) to all spending units of central government ministries and agencies to execute budgetary transactions.

(iv) *Intergovernmental fiscal relations and subnational finance*: improving the intergovernmental transfer system through the Law on Intergovernmental Finance 1 of 2022. The law's provisions aim to (i) ensure a better horizontal equalization of fiscal capacity across subnational governments; (ii) improve the quality of transfer-financed spending; (iii) better integrate national and subnational spending; and (iv) increase subnational own-source revenue (OSR).

34. **These reforms are aligned with the government's climate commitments in its Nationally Determined Contributions (NDCs).** In terms of mitigation, Indonesia has committed to reduce its emissions by 29 and up to 41 percent against business-as-usual projections by 2030, primarily through land use and energy transitions towards a low-carbon development pathway. For adaptation, Indonesia aims to achieve resilience across four areas (economic, social and livelihoods, ecosystems and landscape, as well as enabling conditions) through adaptation actions across six sectors (disasters, ecosystems, food, water, energy, and health) to avoid losses from climate change. Achieving both requires the central government to introduce fiscal policies to help close a significant financing gap and incentivize the private sector to invest in low-carbon and resilience-enhancing options.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

35. **The proposed DPL is aligned with the government's priorities.** DPL Pillar 1 to increase tax revenue and improve equity of the tax system is aligned with MoF Policy Directions (1), sound and sustainable fiscal management, and (2), optimum state revenues. DPL Pillar 2 to strengthen institutions for planning and budgeting, and fiscal transfers is aligned with MoF Policy Direction (3), management of quality state expenditures. These reforms will support the post-pandemic recovery and longer-term growth.

36. **The proposed prior actions will contribute to Indonesia's climate change mitigation and adaptation efforts**. Prior actions in both pillars support Indonesia's efforts to mobilize resources more effectively towards mitigation and adaptation actions in line with its 2030 climate commitments under the Nationally Determined Contributions submitted under the Paris Agreement.

37. **The proposed operation is designed as a stand-alone DPL for three reasons.** First, the experience with recent DPLs in Indonesia is that this instrument works best as a tool to validate policy reforms aligned with the World Bank Group's Country Partnership Framework (CPF) for Indonesia, discussed by the Board on May 11, 2021, Report No. 157221-ID, after extensive engagement with the government on these reforms. A programmatic DPL series is not an appropriate tool to incentivize politically sensitive reforms in a pre-determined sequence. Second, the window of opportunity for reforms is gradually closing in the run-up to the elections of 2024. While the government is still planning reforms in the next year, processing a second DPL based on those reforms may be too close to the election. Third, to incorporate the lessons learnt from the previous DPL on fiscal reforms as explained below.

38. **The operation incorporates the lessons from the previous Fiscal Reform DPL series from 2016 to 2019.** The Implementation Completion and Results (ICR) report[12] noted that there were several

[12] Implementation Completion and Results Report on a Series of Loans in the amount of USD 1.7 billion to the Republic of Indonesia for the Fiscal Reform Development Policy Loan Series. Report No: ICR00005478. World Bank. May 2021.

substantial changes in the policy matrix between the 3 individual DPLs in the series. It also noted that several politically sensitive prior actions (related to the Income Tax Law, Value-Added Tax Law, and the Fiscal Decentralization Law) had to be dropped ahead of the 2019 presidential elections. A key lesson learned from the DPL series is that the preparation of DPLs should start after key legislation has been approved by parliament, so that the operations can focus on supporting the implementation. Consistent with this advice, the preparation of this proposed operation therefore started after parliament had approved the THL and the Law on Intergovernmental Finance 1 of 2022 in late 2021.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1- Increase Tax Revenue and Improve Equity of the Tax System

1. Increasing the Rate and Broadening the Base of the Value-Added Tax (VAT)

39. **VAT is responsible for around a third of total tax revenues, but it has significant scope for improvement.** It is the second largest source of tax revenues behind corporate income tax. Nonetheless, collections are low compared to peers and have been declining for several years, falling from 4.0 percent of GDP in 2013 to 3.4 percent in 2019. This is caused by a low statutory rate and low efficiency of collection, or c-efficiency.[13] Low efficiency is driven by generous exemptions, a high eligibility threshold (for VAT registration), and weak administration. Wide-ranging VAT exemptions create an uneven playing field between different sectors and undermine tax neutrality, result in costly revenue losses, and deliver benefits primarily to richer households. Exemptions also break the VAT filing chain (businesses selling exclusively exempt goods do not file), creating opportunities for tax evasion and increasing the administrative costs of managing the VAT.

Prior Action #1. To increase VAT revenue and improve its efficiency, the Borrower has (a) increased the statutory VAT rate (effective from April 1, 2022) to 11 percent, and (b) adopted a legal framework to remove the statutory VAT exemption status of several goods and services, including those for mining and drilling products taken directly from their sources, as evidenced by the Tax Harmonization Law 7/2021.

40. **The government has legislated to increase the standard VAT rate and remove several statutory exemptions.** The standard VAT rate has been increased from 10 percent to 11 percent effective April 1, 2022 and will be increased further to 12 percent no later than January 1, 2025. Statutory VAT exemptions have been removed from the VAT law for several goods and services, including mining or drilling products extracted directly from the source, basic necessities (e.g., rice, grain, eggs, and salt), medical, social, education and public transportation services. Within this list of good and services , many of them, including basic necessities, have been explicitly reclassified as 'VAT payable, but not collected'. The new classification continues to offer exemption status, until a future regulation will determine the exact VAT status. This means the legal basis of the exemptions has shifted as they will now be granted through a regulation by the executive branch instead of fixed in the law. Moreover, the law enables MoF to define

[13] C-efficiency is the ratio of VAT collections to the expected revenue from applying the standard rate to all consumption.

these exemptions as temporary or partial, which provides the opportunity for MoF to unwind these exemptions in the future taking into account macro-fiscal conditions and its costs and benefits.

41. **Standard VAT treatment of the products of mining and drilling[14] (i.e., assuming no temporary or partial exemptions) will partially correct distortions of the tax system on energy prices, supporting a transition away from fossil fuel production.** Prior to this reform, products from mining and drilling, including oil, gas, geothermal mining, and gas and oil drilling were treated as 'non-taxable' for VAT purposes. This meant that businesses selling goods and services under this category were not liable for or required to charge VAT, or even to register for VAT.[15] As a result, a large share of the VAT related to this sector was lost and the tax effort from this sector (VAT liability as a share of sales) was much lower than in other sectors that were subject to standard treatment.[16] This reform will change this preferential tax treatment. First, businesses selling these goods now must be registered for VAT, which is expected to increase tax compliance of this and related sectors. Second, imposing VAT on the sector will result in higher prices not only within the mining and quarrying sector, but also, to higher prices being charged by other businesses that rely on this sector for inputs into their production processes. Thus, a previous distortion of the tax system for a sector that is polluting will be removed. While VAT exemptions for the geothermal subsector are also phased out, this subsector is small relative to the oil and gas sector (the former accounts for 4 percent of electricity supply and the latter 49 percent). So the main expected net positive impact on emissions reduction and revenue gain will fall on the oil and gas and mining sector. Moreover, recent reforms through the Job Creation Law 11 of 2020 and expected renewable energy pricing reforms will increase geothermal energy's attractiveness relative to fossil fuel energy, while other investment incentives in the geothermal subsector remain in place.

42. **The VAT reform is expected to result in an increase in VAT and Luxury Goods Sales Tax (LGST) revenue from 3.2 percent of GDP in 2021 to at least 3.4 percent of GDP in 2023.** Bank simulation estimates indicate that the VAT rate increase could boost VAT and LGST revenue by approximately 0.3 percent of GDP in 2022 after accounting for a small negative revenue impact from reduced consumption.[17] By contrast, phasing out VAT exemptions will have an almost negligible positive impact on revenues in the short-term.

2. Increasing the Personal Income Tax Revenue from High-Income Earning Individuals

43. **As countries develop, and the middle-class segment of their populations expand, they tend to rely more on direct forms of taxation such as personal income tax (PIT).** PIT has the potential to be a significant source of tax revenue in the future. Research shows that realizing this potential usually requires countries to implement holistic PIT policy and administration reforms, including increasing the top

[14] This is defined as mining and drilling products which are directly taken from their sources and includes:
(a) crude oil; (b) natural gas (excluding LPG); (c) geothermal; (d) selected rocks and minerals, including asbestos, feldspar, granite, marble, sand and gravel, quartz sand, phosphate, and basalt; and (e) iron ore, gold ore, lead ore, copper ore, nickel ore, silver ore, and bauxite ore. VAT exemptions on products from coal mining were already removed in 2020.
[15] Previously, only businesses that sold a 'mix' of taxable and non-taxable goods and services were required to register, as well as businesses that were selling goods to the government.
[16] WBG analysis shows that the tax effort, defined as total VAT liability (from 'import VAT' and 'domestic VAT') over total sales, from sectors such as manufacturing, real estate, and construction was much higher on average than for mining and quarrying.
[17] Estimated using a sample of data received from the Directorate General of Taxes, and using an estimated short run elasticity of -1.11 percent, which was derived from the academic literature (Alm & El-Ganainy, 2012; Miki, 2011; and Adegbite, 2018).

marginal tax rates, moving from family-based taxation to individual-based taxation, and better integrating third-party data.

44. **PIT collection in Indonesia is low but is progressive compared to peers**. The PIT system in Indonesia is fairly progressive, measured by the concentration coefficient, and is close to the top of a group of other middle-income countries.[18] However, Indonesia's PIT collection in 2019 amounted to only 1.0 percent of GDP, or 10.2 percent of total tax revenues, which is low compared to peer countries.

45. **Despite the challenging context of high informality and low compliance with direct taxes there are opportunities for PIT reforms.** MoF recognizes that its level of revenue collection from direct taxes is too low and has set objectives to raise more revenue from its income taxes as part of its medium-term revenue strategy.[19] Yet, Indonesia's economy has a very large informal sector, with many businesses not registered for a tax ID and/or employing workers without formal contracts. Past reform efforts attempting to address this context have included the introduction of a simplified final tax regime for micro, small, and medium enterprises. Thresholds for the PIT and corporate income tax (CIT) were set at high levels, in part because of limitations in the revenue administration's capacity to enforce compliance on the large informal sector. Increasing digitalization of the economy combined with increasing automation of the revenue authority provides an opportunity to tackle the informality challenge.

46. **MoF is enacting a series of complementary reforms**, including: (i) replacement of the Tax Identification Number with the National ID to broaden the tax base and enable better integration with third-party data; (ii) reform of fringe benefits taxation to strengthen the revenue impact and progressiveness of the PIT reform; (iii) introduction of a new core tax IT system at the Directorate General of Tax in the medium term to enable better tax enforcement, including management of much larger taxpayer datasets; and (iv) expansion of Medium Taxpayer Offices for tax base expansion via better and more targeted enforcement.

Prior Action #2. To increase personal income tax revenue from high-income earning individuals, the Borrower has added a new personal income tax bracket for individuals with annual incomes higher than five billion Indonesian Rupiah, as evidenced by the Tax Harmonization Law 7/ 2021.

47. **The THL has introduced a new top marginal personal income tax rate of 35 percent for taxpayers with annual taxable incomes above IDR 5 billion (about US$ 330,000).**[20] Previously, the highest marginal bracket was 30 percent and applied to taxpayers with taxable income above IDR 500 million (approximately US$ 33,000). In addition, the income range for the lowest marginal individual income tax rate has been broadened from IDR 0 – 50 million (US$ 0 – 3,300) to IDR 0 – 60 million (US$ 0 – 4,000).

48. **As a result, the PIT revenue collected from individuals with income over IDR 5 billion as a share of total PIT revenue is expected to increase from 15.9 percent in 2020 to 18.0 percent in 2023.** The reform is expected to be progressive and World Bank simulation results show that the reform is expected to be largely revenue neutral in the short term as the additional revenue raised from the top income bracket will be offset by the decrease in revenue from widening the lowest tax bracket. However, over

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[18] The sample of countries is limited by the availability of country studies using the Commitment to Equity methodology.
[19] 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.
[20] This is equal to 90 times GDP per capita and is higher than the 99th percentile of the income distribution

the next five years and beyond, Indonesia's class of ultra-high-net-worth individuals (UHNWIs) are projected to grow by 67 percent.[21] Hence, with good enforcement, this reform can be expected to generate higher revenue over the medium term.

3. Introduction of a Carbon Tax

49. **The largest sources of greenhouse gas (GHG) emissions in Indonesia are land use and energy, an unusual emissions profile among global top 10 emitters.** By 2030 though, rising emissions from coal-fired electricity generation are expected to comprise the majority share. Over 90 percent of Indonesia's energy is fossil-fuel-based. The government has signaled its intention to decarbonize including through specifying NDCs to climate change mitigation, discussing goals of shifting from coal to renewable sources, and initiating a moratorium on new coal-fired power plants after 2022.

50. **To deliver these significant emission reductions, the government has enacted legal instruments that set the stage for a domestic price on carbon-dioxide-equivalent[22] (CO2eq) emissions in Indonesia.** Indonesia introduced a framework for a carbon tax through the THL. With this, Indonesia will become the second country in Southeast Asia (after Singapore), to introduce a carbon tax. Alongside the carbon tax, Indonesia has also introduced the regulatory framework for two more ways to price carbon. This includes an Emissions Trading Scheme (ETS) and Results-Based Financing, through Presidential Regulation No. 98 of 2021 on the Economic Value of Carbon. The carbon tax will expand the tax base, while working in tandem with the ETS to mitigate CO2eq emissions.

Prior Action #3. To limit greenhouse gas emissions, the Borrower has introduced a carbon tax regime initially applicable to the coal-fired power plants sector, as evidenced by the Tax Harmonization Law 7/2021.

51. **The THL establishes a carbon tax on CO2eq emissions that is expected to become effective in July 2022.[23]** The coverage of the carbon tax will initially be limited to the power sector and apply to entities operating coal-fired power plants, including the national electricity company (PLN) and independent power producers. Small power plants with a generation capacity of less than 100 MW are expected to be subject to the carbon tax from 2023. Industrial entities that operate coal-fired power plants for their own consumption and not connected to the national electricity grid (such as in the metal processing and cement sectors) are expected to be included from at least 2023 and no later than 2024. The extension of the carbon tax to other sectors of the economy is expected to commence in 2025, but further details are not anticipated until the second half of 2022. The design and implementation of the carbon tax in other sectors may differ from that in the coal-fired power plant sector.

[21] According to the 2021 Wealth Report by Knight Frank, UHNWIs (with a net worth over US$ 30 million including primary residence) are expected to grow by 67 percent in Indonesia, the fastest rate for any Asian country (Asia has forecast average growth of UHNWIs of 39 percent). The Wealth Report, Knight Frank (2021: 15th Edition) pp. 16; accessed online at: *https://content.knightfrank.com/research/83/documents/en/the-wealth-report-2021-7865.pdf*

[22] This includes emissions of carbon dioxide (CO2), methane (CH4) and nitrous oxide (N2O) which are expressed in CO2-e units.

[23] The implementation has been postponed from April 1 to July 2022 to cushion the impact of rising global energy prices on consumers according to a senior MoF official at an MoF press conference. Reported by *https://www.todayonline.com/world/indonesia-delays-carbon-tax-around-july-finance-ministry-1857336*

52. **The carbon tax will work in tandem with an ETS to put a price on CO2eq emissions in the coal-fired power plant sector.** A pilot voluntary ETS has already been operating in this sector since 2021 with participants representing about 90 percent of total CO2eq emissions from Indonesian grid-connected power plants. Participation in this ETS will become mandatory in late 2022 with the temporary exception of small power plants and power plants that directly service industrial users, as discussed in the previous paragraph. These excluded emitters were also not part of the original voluntary ETS and account for around 15 percent of total coal-fired power plant CO2eq emissions. Participating entities will each have an initial allocation of emissions permits (an 'emissions cap') for every reporting period.[24] During each reporting period, entities that expect to emit less than their emissions cap will be able to sell their excess permits in the ETS marketplace. Entities that emit more than their emissions cap are able to account for their 'deficit emissions' by either: (i) purchasing additional emissions permits from the ETS marketplace; or (ii) acquiring certified carbon offset credits through their own, or third parties', offset activities. The interaction between the carbon tax and the ETS centers on the treatment of these deficit emissions. Entities may only purchase additional permits and carbon offsets to cover up to a maximum of 70 percent of deficit emissions. The remaining deficit emissions will be subject to the carbon tax; hence, for entities with deficit emissions, the carbon tax will apply to a minimum of 30 percent of their deficit emissions. The carbon tax will therefore disincentivize power plants from emitting beyond their emissions caps, by expanding Indonesia's tax base to include these excess emissions.

53. **The carbon tax will set a ceiling on the price of CO2eq emissions within the ETS and begin with a rate of US$ 2 per ton.** Whenever the price of additional permits or offset credits in the ETS is deemed to be too high, an entity with deficit emissions can pay the carbon tax rate on its deficit emissions by choosing not to purchase additional permits or credits. As such, the carbon tax rate will act as a ceiling on the ETS market price of emissions within the coal-fired power plant sector. The MoF has the authority to set and revise the carbon tax rate, subject to a floor of US$ 2 per ton. The government has signaled its intention to implement the floor rate in 2022 and, in subsequent years, set the rate as equal to 1.2 times the average ETS market price of emissions from the previous year.[25] As a price on CO2eq emissions, the carbon tax rate is very low by international standards. It is less than that in almost all other countries that place an explicit price on emissions, and below the global average emissions price of US$ 3 per ton.[26] The initial impact of the carbon tax will be limited due to this low rate, but should increase in the medium term as the rate rises. Alternative rate-setting approaches may be considered by the MoF after an initial period of implementation.

54. **The revenue generated by the tax is difficult to estimate.** Carbon tax revenues will depend on the tax rate, the price of emissions permits and offset credits within the ETS, and the extent to which the tax disincentivizes deficit emissions. Given the central role of the ETS in providing emitters with emissions caps and tradable permits, and the low tax rate, carbon tax revenues are expected to be modest.

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[24] It is expected that in the early years (perhaps, 2022-24), emissions caps will be offered to entities through a free allocation based on historical emissions ("grand fathering"). The government plans to undertake research (with help from development partners) to improve the allocation mechanism, for implementation in later years.

[25] For instance, in 2023, the tax rate per ton of CO2-e emissions would be set equal to 1.2x the average ETS market price in 2022.

[26] Which includes around four-fifths of global emissions that remain unpriced. See: IMF. 2021. Not Yet on Track to Net Zero: The Urgent Need for Greater Ambition and Policy Action to Achieve Paris Temperature Goals. IMF Staff Climate Note 2021/005.

55. **Three implementing regulations will further specify how the carbon tax and ETS will work in the coal-fired power plant sector, setting the stage for implementation.** Two MoF regulations outline relevant policy content (e.g., tax objects, tax rate setting mechanism, key timeframes) and administrative arrangements (e.g., taxpayer registration, payments, reporting, and how permits and offsets will reduce tax obligations). A Ministry of Energy and Mineral Resources regulation outlines revised implementation details of the ETS in the coal-fired power plant sector (e.g., participation requirements, emission caps, mechanism for assigning caps, emissions measurement).

56. **As a result, the share of total emissions from grid-connected coal-fired power plants that is accounted for by power plants that are subject to a carbon tax is expected to rise from 0 percent to 75 percent in 2023.** Despite a few temporary exemptions (such as industrial own-use powerplants), and even if there are early teething problems as emitters navigate the new system, the carbon tax will still bring the vast majority of CO2eq emissions from coal-fired power plants under the tax system by 2023.

Pillar 2- Strengthen Institutions for Planning and Budgeting, and Fiscal Transfers

4. Reform of the Intergovernmental Transfer System

57. **Indonesia's transfer system does not adequately target fiscal resources to the subnational governments (SNGs) that need them the most.** It especially underfinances the pressing service and infrastructure needs of populous urbanizing areas, which are key economic drivers and home to many of the poor. In 2018, the least populous 20 percent of districts received about five times more revenues per citizen than the most populous 20 percent. These fiscal disparities contribute to disparities in service delivery outcomes.

58. **The government has reformed the legal framework for intergovernmental transfers to make them more equitable.** The GoI has addressed this challenge through a landmark reform of the General Allocation Grant (*Dana Alokasi Umum* or DAU), as part of the Law Concerning Financial Relationship Between the Central Government and Subnational Governments No. 1/2022 (hereafter Law on Intergovernmental Finance). The law envisages that the DAU will be allocated based on a "per client" fiscal needs measure, hence in proportion to the number of service users, both at the district and province level. The law also previews that the DAU allocation will account for differences in service delivery costs per client, through adjustment factors.[27] Thinly populated and remote areas, for example, will be compensated for higher per client costs. The DAU reform will take effect in 2023 and is projected to significantly equalize total revenues per capita across SNGs in the medium term, increasing allocations to SNGs of the most populous areas. At the same time, the law previews that earmarked Specific Allocation Grants (*Dana Alokasi Khusus* or DAK) will be allocated in view of reducing "service disparities". DAK allocations are hence expected to help close service gaps in less populous SNGs that may receive lower funding due to the DAU reform. Stronger reliance on earmarked DAK in these lagging SNGs is excepted to also improve spending efficiency, through tightened accountability to central government.[28]

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[27] At present, MOF is envisaging to include a construction cost index and area size among the adjustment factors.
[28] The law previews that the DAK will be allocated to achieve performance targets. This can provide the foundation for designing the DAK as a performance-based grant, tightening accountability for the quality of spending.

59. **The government is also encouraging SNGs to collect more own-source revenues.** While districts bear large spending and service delivery responsibilities, their own-source revenue collection remains very low, at only 13 percent of total district revenues in 2018. This makes districts highly dependent on transfers, entails large vertical fiscal imbalances and likely weakens the 'fiscal contract' between taxpayers and SNGs. This is predominately a problem of low collection, as districts have significant revenue bases and autonomy, including property taxes and sales taxes. The new reforms to intergovernmental finances also strengthen fiscal incentives for districts to exert more own-source revenue efforts, by avoiding that underperforming districts will be compensated through increased transfers. Subnational tax reforms in the law will also further ease tax administration and assign additional revenue bases to SNGs.[29]

Prior Action #4. To allocate fund transfers more equitably across subnational entities, the Borrower has adopted a legal framework for allocating the General Allocation Fund based on the per unit fiscal needs and potential revenues of subnational governments, as evidenced by the Law Concerning Financial Relationship Between the Central Government and Subnational Governments No. 1/2022.

60. **The law changes how SNGs' fiscal gap will be measured, by redefining how subnational governments' *fiscal needs and fiscal capacity* are measured.** The law requires *fiscal needs* to be estimated on a "per client" basis. Fiscal needs for education, for example, can be determined by multiplying the number of school-aged students (the "clients") with a per-student spending norm. This is a critical policy change in view of equalizing SNG revenues per capita. It replaces a DAU fiscal needs measure that largely assumed equal financing needs per SNG and that insufficiently adjusted for population. The reform will be introduced in a phased manner, however, to avoid unviable transfer reductions for some districts. To this end, the law previews a 5-year "hold harmless" period (until 2027), during which the DAU allocation cannot be reduced below baseline levels for any SNG. While full implementation of the new formula is envisaged to happen after the 5-year transition ends, Bank analysis suggests that transition arrangements may be required beyond 2027.[30] The law further requires that SNGs' fiscal capacity is measured based on their potential, rather than actual revenues.

61. **As a result, the reform will lead to a significant equalization of per capita revenues across SNGs over the medium term, although short term effects are modest by design.** Once the new DAU formula is fully in effect, the ratio of the national median of fiscal revenues per capita over the median of the most populous district quintile is expected to decline from 2.07 in 2020 to 1.75.[31] In other words, the DAU will equalize more effectively, by reducing the gap in revenue per capita between the most populous district quintile and the median district. Compared to the median district, per capita revenues of the most populous district quintile are expected to increase from about 48 percent in 2020 (=1/2.07) to 57 percent (= 1/1.75). The new DAU formula will fully take effect in 2028, unless the government decides to extend

[29] Administrative simplification includes consolidating of several taxes into a combined sales-based tax called PBJT. These comprise the hotel, restaurant, entertainment, parking and street lighting tax. The RUU will also increase districts' tax base by introducing district-level surcharges on provincial vehicle taxes. This concerns the Motorized Vehicle Tax (PKB) and the Transfer Fee for Motorized Vehicles (BBNKB).
[30] The expected growth of the DAU transfer pool during the 5-year transition period is projected to significantly lower the revenue cuts for losing districts by 2027, smoothing the transition. Nevertheless, Bank projections indicate that some districts would still face unviable losses under the new formula by 2027. The Bank is advising MOF on extended transition arrangements beyond 2027.
[31] This estimate is based on World Bank simulations and assumptions about the final formulation of the DAU formula in implementing regulations that are subject to uncertainty.

the hold harmless provision beyond 2027. Due to this provision, however, short-term effects are expected to be modest: this ratio is expected to decline to 2.02 by 2023 and to 1.87 by 2027. The reform of the fiscal capacity measure is expected to increase subnational revenue collection from both existing and new bases in the medium term.

5. Strengthening the Link between Planning and Budgeting

62. **Stronger linkages between medium-term planning and the annual budget process could help improve the performance orientation of the budget in Indonesia.** This will require addressing a rather fragmented approach to public resource management but also the establishment of institutions that foster harmonization and alignment between annual budgeting by MoF and medium-term planning by the Ministry of Planning (Bappenas). First, there is a deviation between the government's medium-term plan (RPJMN) and the annual work plan (RKP), and the ministry budget (RKA-KL) leading to a gap between plan outlays and budget allocations. Second, previously the budget for programs was aligned with the organizational structure of ministries with little attention to the planned outcomes, making it difficult to see the results chain between the outputs produced by budget expenditure and outcomes envisaged in the plan. Third, there is a lack of effective use of indicative forward budget estimates coming out of the Medium-Term Expenditure Framework (MTEF) in the annual budget process to provide line ministries with predictable indicative budget ceilings for the next 3 years. Fourth, monitoring and evaluation is fragmented, duplicative and focused on monitoring budget absorption and output achievements with little attention to measuring the impact of spending. To address this issue, the Bappenas and MoF have together redesigned their planning and budgeting systems to increase the alignment of planning and budgeting and has established an integrated system of planning, budgeting and evaluation linking the ICT applications that govern them.

63. **Follow-up reforms may also result in a better alignment of budget allocations with the national priorities on climate mitigation and adaptation.** These linkages are currently weak and there are large deviations between financing requirement for three climate programs in the annual plan by Bappenas and budget allocations by MoF: based on a World Bank study conducted in 2021, the program on strengthening of environment received only 40 percent of its financing requirement, low carbon development 79 percent, and resilience against disasters and climate change 364 percent. To meet its mitigation and adaptation commitment by 2030 the government is planning to extend an existing program on resilience against disasters and climate change to include low-carbon development and improving environment as well. The government also plans to improve the coherence and coordination of all climate change related outputs that support the implementation and target achievement of three national priority programs on climate change. This is intended to enhance the link between plan and budget with a thematic coherence, solid inter-ministerial coordination, and adequate allocation between the three national programs over time and help the government achieve its objectives of mitigation and adaptation to climate change. Furthermore, the government will identify the outputs related to the Climate Change mitigation and adaptation by strengthening budget tagging on Mitigation and Adaptation on climate Change.

Prior Action #5. To increase spending efficiency and effectiveness, the Borrower, through BAPPENAS and the MOF jointly, has provided the guidelines for strengthening the link between planning and budgeting, as evidenced by the Joint Letter No. S-122/MK.2/2020 and B-517/M.PPN/D.8/PP.04.03/05/2020 jointly issued by BAPPENAS and the MOF.

64. **This reform supports better alignment of planning and budgeting.** Prior to the implementation of the Redesign of Planning and Budgeting Systems (*Redesain Sistem Perencanaan dan Penganggaran* or RSPP) reform, budgets for programs and activities were aligned with the organizational structure of each ministry. The 'programs' were mapped to responsible Director General-level officials of ministries and 'activities' mapped to Director-ranked officials responsible for implementing them. This was the '*Money FolIows Functions*' principle that established a link between funding allocations and performance accountability of officials within the organization. Through RSPP reforms, the government has restructured its planning and budget classification structures based on the principle of the '*Money Follows Programs*' that establishes a more programmatic classification that cuts across administrative/organizational boundaries. A 'program' can now be aligned with multiple deputy-level officials under multiple ministries and making them accountable together for achieving a common objective based on their individual unit accountability and performance. The government has also reduced the number of programs from more than 600 to about 120, which will improve the efficiency of public expenditure. This has resulted in the introduction of an initial batch of 17 "cross-agency" programs that are implemented by multiple line ministries. The system allows the cross-ministerial programs to be enhanced to support national priorities such as climate, stunting, gender, and others as needed. The joint letter has also introduced 84 programs that are each implemented by one specific ministry and one generic program for managerial support that is used by all ministries. These new and harmonized classifications of programs and activities are now used consistently in the annual plan and budget documents contributing to harmonization and stronger linkages between budget expenditure and planned outcomes that supports accountability. These guidelines are fully enforced through integration of planning (KRISNA) and budgeting (SAKTI) IT systems that use harmonized planning and budget classification structures for the updated programs, which were used in the preparation of plan and budget for fiscal year (FY) 2O21 and FY2O22.

65. **As a result, the total number of programs in the budget will reduce from more than 600 in 2020 to fewer than 120 in 2023.** These programs will have a better harmonized plan and budget classification structure that will reduce the deviation between the plan and the budget. This will ensure that what was in the plan will be financed by the budget and the budget cannot add programs that are not part of the plan. Most importantly, the outputs financed by the budget can now be linked with outcomes envisaged in the plan at the design stage itself. If the results chain is strong, the budget realization under RSPP will ensure realization of planned outcomes.

Improving Capital Budget Execution

66. **Capital budget execution in Indonesia is low and slow.** Only 82 percent of the total capital expenditure budget was spent in 2019, of which 44 percent was spent in the last quarter and about 25 percent in the month of December. Since State budgets are approved on a strict timeframe of one fiscal year on cash basis, the year- end bunching takes place as spending units rush to spend their budget in the

closing stages of the year to prevent the lapse of their budget appropriation. It also increases fiduciary risks that arise due to hasty implementation and jeopardizes the quality of delivered outputs. The joint World Bank and MoF study on Institutional Diagnostic of Low and Slow Capital Budget Execution in Indonesia (2019-2020) found that of about 11,500 spending units with capital budgets in 2019, about 88 percent had a capital expenditure budget of less than IDR 10 billion (about US$ 700,000) and only 3 percent had a capital budget above IDR 100 billion (about US$ 7 million). The diagnostic study identified fragmentation of capital expenditure by spending units as a binding constraint for an efficient and effective execution of capital budget.

67. **Merging many small spending units is expected to improve the efficiency of budget preparation, procurement, and implementation, including climate-related budgets.** To achieve economies of scale, preparation of capital budget proposals with common items (such as building renovations, vehicles, office equipment) could be consolidated to be implemented by fewer larger spending units. This would make the preparation of capital budget proposals, procurement process, and implementation more efficient, leading to savings in time and costs. A recent MoF study found that more than 6,800 spending units out of more than 19,000 spending units can be removed to simplify the budget implementation and procurement processes. The MOF study focused on consolidation of some spending units that managed the central government's budget from different sources but based in one location. If in a district or city there are more than one spending units, they will be consolidated into one. This consolidation approach would improve efficiency from reduced spending units' operational expenditure and staff honorarium costs.

Prior Action #6. To improve its budget execution, the Borrower, through BAPPENAS and the MOF jointly, has directed the budget allocating ministry or institution to consolidate the spending units that are regional/vertical offices or regional government offices/work units, in each case, receiving budget allocations from different Echelon I units but within the same ministry or institution, as evidenced by the Joint Letter No. S-353/MK.02/2021 and B.301 /M.PPN/D.8/PP.04.02/04/2022 jointly issued by BAPPENAS and the MOF.

68. **As part of the continued PFM reforms, MoF is taking comprehensive steps to improve key aspects of public finance implemented at the spending unit level, including its budget planning, procurement management, budget implementation, financial management and internal audit.** Consolidation of spending units would contribute to improving the performance of capital budget implementation. As part of these reforms, MoF is institutionalizing criteria that must be fulfilled by line ministries for establishing spending units with authority to execute state budget transactions. These include: limiting the number of spending units that manage different central government ministry's program at a particular district and city location, the size of the budget being managed, whether spending units have authority to manage their staff, whether spending units manage only one Budget Implementation List (*Daftar Isian Pelaksanaan Anggaran*, DIPA), and whether spending units have sufficient staff to operate the new SAKTI web application. The MoF's institutionalization of the criteria to reduce the number of spending units for improving budget execution efficiency will be implemented in a phased manner in the coming years. Furthermore, as an immediate result from the smaller number of spending units, MoF sees a potential for improving efficiency by consolidating the procurement process of smaller spending units under one activity, so that bigger procurement packages can be procured in a centralized manner and benefit from economies of scale.

69. **As a result, the number of spending units based in districts and cities is expected to decline to 54 percent of its 2021 level.** This means that the number of those spending units will decline from 9,921 defined in the 2021 DIPA document (applying to FY2022) to 5,320 in the 2023 DIPA document (applying to FY2024).[32] Of the total 8,577 spending units working as a branch (vertical) office of the central government ministries at the districts and cities, 3,760 will be combined. Similarly, of the 1,344 spending units attached to the local government's unit to implement some delegated central government ministry's programs, 849 will be combined. Of the total 4,609 spending units to be consolidated, 2,535 spending units are estimated to have capital budget allocation. It is expected that those with less than 10-billion-rupiah capital budget allocation will decline from 8,863 in 2021 to 6,734 by FY2024.

70. **The reduced number of spending units is expected to accelerate the level and pace of capital budget execution since the government can focus on the budget implementation of only 363 spending units with a high annual capital budget.** Considering of the total 463 spending units managing the climate change program in 2021, 247 (53 percent) had annual capital budget allocation of less than IDR 10 billion and a capital budget execution of only 15 percent on an average, the consolidation of spending units will include budget execution of climate change mitigation and adaptation actions as well.

Table 6. DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar 1- Increase Tax Revenue and Improve Equity of the Tax System	
#1. To increase VAT revenue and improve its efficiency, the Borrower has (a) increased the statutory VAT rate (effective from April 1, 2022) to 11 percent, and (b) adopted a legal framework to remove the statutory VAT exemption status of several goods and services, including those for mining and drilling products taken directly from their sources, as evidenced by the Tax Harmonization Law 7/2021.	Two World Bank reports, Public Expenditure Review (2020) and Revisiting the Impact of government Spending & Taxes on Poverty and Inequality in Indonesia (2020), find that many VAT exemptions are badly targeted and the VAT threshold is very high compared to peer countries. A 2021 analysis titled "Analysis of Tax Harmonization Law Impact on VAT and PIT" (unpublished), discussed with MoF, estimates the distributional impact of the rate increase and exemption removal and the fiscal resources need to offset the impact on households. VAT microsimulations, presented to MoF (unpublished) analyze the impact VAT threshold reforms on revenue.
#2. To increase personal income tax revenue from high-income earning individuals, the Borrower has added a new personal income tax bracket for individuals with annual incomes higher than five billion Indonesian Rupiah, as evidenced by the Tax Harmonization Law 7/ 2021.	A 2021 analysis titled "Analysis of Tax Harmonization Law Impact on VAT and PIT" (unpublished), discussed with MoF, estimates the revenue and distributional impact of the PIT reform and finds that the reform is broadly revenue neutral and mildly progressive. According to the 2021 Wealth Report by Knight Frank, the number of ultra-high-net-worth Individuals (UHNWI) in Indonesia is expected to grow by 67 percent in Indonesia in the next few years, the fastest rate for any Asian country, raising the revenue potential of this measure.
#3. To limit greenhouse gas emissions, the Borrower has introduced a carbon tax regime initially applicable to the coal-fired power plants sector, as evidenced by the Tax Harmonization Law 7/2021.	The forthcoming Indonesia Country Climate and Development Report (2022) analyzes the impact if the introduction of the carbon tax using a CGE model and finds that the introduction of a carbon with the proceeds recycled through investment and social assistance can facilitate the low-carbon transition. Reports by the Partnership for

[32] The result will apply to the 2024 budget year, based on a budget document that is expected to be issued in late 2023.

	Market Readiness confirm this analysis.
Pillar 2- Strengthen Institutions for Planning and Budgeting, and Fiscal Transfers	
#4. To allocate fund transfers more equitably across subnational entities, the Borrower has adopted a legal framework for allocating the General Allocation Fund based on the per unit fiscal needs and potential revenues of subnational governments, as evidenced by the Law Concerning Financial Relationship Between the Central Government and Subnational Governments No. 1/2022.	World Bank Public Expenditure Review (2020); Decentralization Policy Review (forthcoming); SEMAR PASA: Policy note on the DAU Transition Strategy; Lewis, B.D. and Smoke, P., 2017. Intergovernmental fiscal transfers and local incentives and responses: The case of Indonesia. *Fiscal Studies*, *38*(1), pp.111-139. The PER highlights that the GAG underfinances the pressing service and infrastructure needs of populous urbanizing areas.
#5. To increase spending efficiency and effectiveness, the Borrower, through BAPPENAS and the MOF jointly, has provided the guidelines for strengthening the link between planning and budgeting, as evidenced by the Joint Letter No. S-122/MK.2/2020 and B-517/M.PPN/D.8/PP.04.03/05/2020 jointly issued by BAPPENAS and the MOF.	World Bank Public Expenditure Review (2020); World Bank non-lending technical assistance on the redesign of planning and budgeting systems; World Bank non-lending technical assistance on the Performance Based Budgeting implementation in Indonesia The PER highlights that Indonesia has a well-developed planning framework that provides strategic direction for medium-term development, but this has not yet been adequately integrated with the budget planning process, creating challenges to meet the performance result, including complex relationship between planning and budgeting, operational disconnect on “money follows program” approach, poor intervention logic, lack of reliable and good quality data constrains efficient and effective resource allocation. A forthcoming World Bank report titled “Aligning State Budget with Climate Priorities of Indonesia” highlight that, in 2021, of the total climate change budget of IDR 21 trillion (0.1 percent of GDP), there was a lopsided allocation of budget programs with 78 percent of resources allocated to only one program - improving resilience against natural disasters and climate change, while the low carbon development received only 16 percent and improving the quality of the environment only 6 percent. This puts at risk the achievement of a 29 percent unconditional reduction in carbon emissions by 2030.
#6. To improve its budget execution, the Borrower, through BAPPENAS and the MOF jointly, has directed the budget allocating ministry or institution to consolidate the spending units that are regional/vertical offices or regional government offices/work units, in each case, receiving budget allocations from different Echelon I units but within the same ministry or institution, as evidenced by the Joint Letter No. S-353/MK.02/2022 and B.301 /M.PPN/D.8/PP.04.02/04/2022 jointly issued by BAPPENAS and the MOF.	A 2020 World Bank report titled “Institutional Diagnostic of Low and Slow Capital Budget Execution in Indonesia” finds that the execution of the capital budget is low and slow, which is caused by a fragmentation of capital expenditure proposals prepared by spending units, spending units having a short time to prepare capital expenditure proposals, frequent budget revisions during implementation, lack of utilization of early procurement and multi-year contracts, lack of readiness of projects, delays in obtaining land for start of construction, delays in processing contractors’ invoices, and auditors focus on compliance delays implementation.

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

71. **The proposed DPL is well aligned with the World Bank's Country Partnership Framework (CPF) FY 21-25.** The proposed DPL contributes to achieving the objectives of Engagement Area 1: Strengthen Economic Competitiveness and Resilience. The objectives are achieved through attaining higher revenue collection and fiscal and debt sustainability, as well as through increasing efficiency, equity and effectiveness of spending. The pandemic resulted in an elevated debt level, which reduced the fiscal space for recovery spending as revenue mobilization is low. The proposed DPL also contributes to Objective 2.2: Transition to Low Carbon Energy and Attain Universal Access to Reliable and Sustainable Energy, under Engagement Area 2: Improving Infrastructure, through the introduction of the carbon tax.

72. **Each of the proposed actions and reforms under this DPL is supported by long-standing and intensive analytical work (Table 6) and technical assistance projects to the MoF.** The Strengthening Fiscal Policy Programmatic Advisory Services and Analytics (PASA, P174638) and the Knowledge-based Solutions for Poverty Reduction & Mobility in Indonesia PASA (P174943) provided analytical work and technical assistance to the MoF underpinning the revenue pillar, in particular on the carbon tax (Prior Action #3), and the distributional impact of VAT and PIT reforms (Prior Actions #1 and #2). The Modernizing the Management of Public Resources in Indonesia project (P173922) provided support on tax policy and compliance, in particular VAT microsimulations (Prior Actions #1) and on public financial management, in particular improving the performance orientation of expenditure (Prior Actions #5 and #6). The Subnational Finance and Management for Results (SEMAR, P174158) project and its predecessor Decentralization that Delivers PASA (P154976) provides intensive support to MoF on the subnational fiscal relations and financial management (Prior Action #4).

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

73. **The Government has conducted consultations with internal and external stakeholders on the Tax Harmonization Law and on the Law on Intergovernmental Finance.** The consultations on the tax reforms were initiated in 2018 and accelerated in 2021. Prior to parliamentary approval of the Law, parliament and MoF conducted consultations with industry associations, environmental experts, and universities. After parliament approval, consultations focused on universities and power producers. The Indonesia Consumers Association, the main consumers' advisory body, stated that the 1 percentage point VAT rate would not impact consumption, especially in the middle-income group, and considered the time lag between enactment of the THL and the implementation to be sufficient. It noted that implementation should take into account prevailing conditions, such as a new COVID wave.[33] Similarly, the Law on Intergovernmental Finance was informed by a stakeholder consultation process, including with NGOs, academics, and subnational governments, which informed parliamentary discussion of the law. Issues related to General Allocation Grant (DAU) raised during the consultations mostly centered on the need to improve DAU equalization outcomes; to complement DAU with affirmative instruments for lagging

[33] Yayasan Lembaga Konsumen Indonesia (YKLI). *https://www.merdeka.com/uang/ylki-nilai-kenaikan-ppn-1-persen-tak-ganggu-konsumsi-masyarakat.html*

regions; to maintain the stability of the DAU pool, and objections over DAU earmarking.[34] The per client allocation issue was rarely raised during consultation processes. Further consultations and dissemination efforts are presently under way to inform the subsidiary government regulations to the Law.

74. **On carbon pricing specifically, the government organized consultations between ministries, and with the private sector and civil society.** Meetings on carbon pricing with all stakeholders, including the private sector (particularly energy and heavy industries), civil society, as well as academia were conducted in late 2020. The early consultation emphasized the remaining gaps related to the design and implementation of the instruments. After the Presidential Regulation was issued in October 2021, a series of interagency coordination meetings on the implementing regulations on carbon pricing, including carbon tax, were conducted between November 2021 and March 2022. The World Bank has supported some of these recent interagency consultations through the Partnership for Market Implementation (PMI).

75. **The proposed DPL also draws on the CPF consultations conducted by the Bank with the government, private sector, civil society and other development partners.** The proposed DPL is a key activity in the World Bank CPF for FY21–FY25 as part of the CPF's Engagement Area 1. As such, it has undergone several rounds of consultations between September 2020 and March 2021 with a wide set of stakeholders, including from Government, academia, civil society, the private sector, as well as development partners. These consultations are summarized in Annex 8 of the CPF. The annex highlights that "[r]epresentatives of the government, financial sector authorities and business community reaffirmed their agreement on increasing revenue collection, improving the efficiency and effectiveness of public spending".

76. **The Bank has collaborated with partners on the reforms.** For the revenue pillar, the Bank has collaborated on analysis joint workshops with the International Monetary Fund (IMF), Agence Française de Développement (AFD), the IMF and Prospera (a partnership between Australia and Indonesia to provide knowledge services to Indonesia). For the expenditure pillar, the Bank is working closely with the Public Financial Management Multi-Donor Trust Fund (PFM MDTF) donors (Canada, Switzerland and the European Union) and coordinates with Prospera on the intergovernmental finance agenda. The Bank frequently exchanges notes with these partners to ensure the work is coordinated and objectives are aligned.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

77. **The reform actions under this DPL are expected to have positive overall social and poverty outcomes.** Prior actions on taxes will increase the ability of government to increase revenues while actions that strengthen the institutions of expenditure will improve the efficiency and effectiveness of spending.

[34] The law contains a provision that authorizes central government to partially earmark the DAU, especially in low-performing SNGs.

Together, the DPL program is designed for government to sustainably finance its development agenda. However, potential adverse impacts in the short term would have to be managed.

78. **The increase of the VAT rate and removal of selected exemptions (Prior Action #1) will lead to a significant increase in revenue with relatively limited distributional impacts.** The reform is expected to generate additional revenue of 0.23 percent of GDP in 2019. Existing VAT exemptions accrue disproportionately to richer households: 19 percent of the total consumption of VAT exempted goods and services are consumed by the richest 10 percent while the poorest 10 percent only consume 4 percent of the total. Relative to their market income, however, the additional VAT burden for the poorest 10 percent is estimated to be 0.8 percent which is higher than for the richest 10 percent (0.1 percent of their market income) (Figures 5.1 and 5.2). Poverty is estimated to increase by 0.27 percentage points (or about 0.7 million people) relative to its pre-reform condition (Figure 5.3).[35]

79. **The negative impact on the poor and vulnerable can be mitigated while maintaining most of the fiscal gains of the VAT reform.** The anticipated increase in revenues substantially exceeds the estimated impact on the poorest 40 percent. A per capita transfer accounting for 30 percent of the additional revenue can fully compensate the poorest 40 percent. The Minister of Finance has announced that the government will protect the poor from adverse impacts of the VAT rate increase.[36] Indonesia has an effective social protection system with a targeting mechanism in place. As past experience shows, the system was able to successfully mitigate adverse impacts of energy subsidy reforms for the poor and vulnerable. Successful implementation of VAT reform needs a clear communication strategy transparently discussing the benefits and risks of the reform and the mitigation measures being deployed. The World Bank will continue to support the Government in monitoring the implementation of this reform and its mitigation measures.

80. **Adding a new personal income tax bracket for high incomes (Prior Action #2) will have limited impacts on poverty and inequality.** The new tax bracket for high-income individuals increases progressivity, but its revenue impact is offset by the widening of the lowest taxable income bracket. 63 percent of PIT payers in 2017 were in the lowest pre-reform bracket, contributing only 3 percent of the total PIT revenue, while less than 1 percent of PIT payers had taxable income above IDR 5 billion and contributed 12 percent of the total PIT revenue. It is estimated that around 85 percent of current PIT revenues will be affected by the lower PIT rate while only 12 percent of PIT revenue will be affected by the higher rate. Overall, the reform is expected to be largely revenue neutral in the short term (Figures 5.4 and 5.5). The poor will be unaffected as they will remain beneath the taxable income threshold.

81. **The introduction of a carbon tax (Prior Action #3) will not affect the poor directly in the short term given current electricity tariffs, but tariff liberalization in the future would lower – albeit marginally – household purchasing power.** A carbon tax of US$ 2 on coal power generation which mainly supplies power to the national electricity company (PLN) will not have direct impacts on the poor and vulnerable given the current electricity tariff structure that subsidizes low volume retail consumers. However, indirect impacts are possible if electricity tariffs are increased for larger – and, hence, non-poor – consumers of electricity. Indirect impacts are likely to be limited to 0.01 percent of households'

[35] The analysis is based on 2019 household consumption data. The estimate is a conservative estimate given that some of the poor are likely to purchase goods in informal markets which may not apply VAT.
[36] *https://www.thejakartapost.com/business/2022/03/23/vat-hike-to-go-ahead-as-planned-amid-surging-prices-sri-mulyani.html*

purchasing power and, hence, negligible.[37] If electricity prices are liberalized in the medium term, households' purchasing power would drop by up to 0.04 percent for the poorest and by up to 0.08 percent for the richest, rendering the liberalization progressive. In a hypothetical case of having only a carbon tax imposed on the sector the bottom 40 percent could be fully compensated using 40 percent of revenues gained from the carbon tax (Figure 5.6). In practice, with a combination of an ETS and carbon tax, a similar outcome could also be achieved if all ETS credits would be auctioned.[38] Providing free ETS credits correspondingly lowers the revenues and increases the proportion needed to compensate the bottom 40. Furthermore, the carbon tax is determined by the ETS price and, hence, can exceed US$ 2 in later years. For example, a carbon tax of US$ 5 would still be progressive but reduce purchasing power for the poorest by about 0.1 percent, and for the richest by almost 0.2 percent.

82. **Reform of the DAU (Prior Action #4) will direct more resources to populous districts with more poor people.** The new allocation formula will significantly reduce the bias against populous districts in terms of per capita fiscal resources once fully implemented.[39] Total revenues per capita are projected to be more evenly distributed across the districts reducing horizontal imbalances on a per capita basis (Figure 5.7). As the more populous districts are also home to a greater share of Indonesia's poor, additional resources under their control are likely to be beneficial. At the same time, poor people in less populous districts could become negatively affected. However, the law stipulates several provisions that will mitigate such effects. It contains a hold harmless condition that ensures that for five years (until 2027), no district will receive lower DAU than in 2020.[40] The law previews that earmarked grants (DAK) will be allocated in view of reducing service disparities. This will help ensure sufficient resources for basic infrastructure and services that are important for the poor. The law authorizes the central government to partially earmark the DAU in low performing regions, enabling it to intervene in SNG spending decisions, where needed. Furthermore, the Ministry of Finance is identifying potential transition strategies to mitigate socio-economic and political impacts of the reform after the five-year hold harmless period.

83. **Strengthening the link between budgeting and planning (Prior Action #5) should improve basic service delivery and benefit the poor.** Indonesia aspires to reduce extreme poverty to zero percent and has outlined an ambitious plan and priority programs to do so. The reform will help to improve the alignment of budget allocations with the intended outcomes of priority programs across all ministries, including programs to improve service delivery and poverty alleviation.

84. **Consolidating spending units (Prior Action #6) has the potential to improve the effectiveness of capital expenditure for basic infrastructure which will benefit the poor.** Effective use of capital budget for basic infrastructure such as water and sanitation, drainage and flood control will benefit all including the poor.

[37] The simulation using Carbon Pricing Assessment Tool (CPAT) estimates that a carbon tax of US$ 2 on coal power generation will increase the electricity price by five percent in 2030.
[38] The simulation targets the poorest 40 percent assuming 30 percent leakages taken from the current Integrated Social Welfare Data (DTKS).
[39] World Bank. 2021. "Towards Revising a Transition Strategy for a "Reformed" General Equalization Grant Formula (Dana Alokasi Umum, DAU) for Indonesia." Policy Note. Governance GP, World Bank, Jakarta, Indonesia.
[40] Art 187 (e). of Law 1/2022 on Subnational Finance.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

85. **The reform actions under this DPL are expected to have overall positive impacts on the environment.** Five of the prior actions have potential positive effects on environmental quality and natural resources. Prior Actions #2 and #4 do not have effects on the environment or on natural resources.

86. **Phasing out VAT exemptions for mining and gas and oil drilling (Prior Action #1)** will help correct mispricing of fossil fuel production, thereby reducing emissions of carbon and air pollutants as well as reducing direct impacts of extractive industries on the environment, forests, and other natural resources. There is a slight risk that companies will respond to the cost of the lost exemption by cutting back on environmental management, but the overall effect remains positive.

87. **Implementation of a carbon tax (Prior Action #3)** will reduce greenhouse gas (GHG) emissions and lead to more investment in renewable energy. However, given the low starting tax rate of US$ 2/ton, the effects will be small at first. The impact will also be limited to coal-fired power plants until potential expansion to other sectors in 2025.

88. **Reform of the General Allocation Grant (DAU) (Prior Action #4) could eventually change budgets for environmental management at the subnational level.** The net impact of the reform is expected to be positive. It increases allocations to the more populous districts (Figure 5.7), where limitations on capital and operating budgets constrain environmental management functions including solid waste management and air and water pollution control. Conversely, many of the less populous districts that are rich in natural resources would receive less DAU funding.[41] Reduced DAU allocations, however, are only expected to have insignificant impacts on environmental management in less populous districts. First, any effects will only be felt after five years, given the hold harmless condition. Second, effective environmental management and monitoring of forests, fisheries, mineral resources, and pollution control and prevention from development is mainly constrained by a lack of central standards and guidance (regulations) and enforcement thereof, less so by funding constraints.[42] Third, as districts only spend a small share of their expenditures on the environment (on average 1.5 percent in 2020), they should be able to protect these expenditures from cuts due to DAU losses, if needed. The Bank-supported activities described in para 91 will be particularly important in improving environmental management in the rural districts.

89. **Strengthening the link between budgeting and planning (Prior Action #5)** will help to ensure that budgets are better aligned with the desired outcomes of priority programs across all ministries, including those for climate change mitigation and resilience.

[41] One indicator of natural resource wealth is forest coverage. WB simulations suggest that only a minority of districts with high forest coverage would lose DAU. Whereas about 66 percent of districts are projected to lose DAU overall, only about 35 percent of districts with above median forest coverage are projected to lose DAU.

[42] In January 2022, the Ministry of Environment and Forestry (MoEF) established the National Standardization Agency for Environment. The agency's main task is to develop around 1,200 standards and guidance on environmental assessments. These include capacity building for SNGs and improving the quality of environmental approvals by delegating qualified environmental feasibility teams to lagging regions. These activities will become part of a TA loan that MoEF has requested from the World Bank. In 2019, the MoEF has also issued a ministerial regulation about strategic and regional environmental assessments to ensure that they consider a broader spatial and temporal interaction among districts at provincial level and that appropriate measures and resources are optimally allocated.

90. **Consolidating spending units (Prior Action #6)** should improve the effectiveness of the use of capital budgets for infrastructure, including for water and sanitation, drainage and flood control, climate change adaptation, air and water quality monitoring, and environmental and social impact assessments.

91. **The environmental benefit of these prior actions can be enhanced.** Diligent monitoring and enforcement of management and reporting requirements will mitigate the risk of cut-backs in environmental budgets by extractive industries in response to Prior Action #1. The environmental benefits of Prior Action #3 could be enhanced by introducing a time-bound plan in the currently developing Roadmap of Carbon Tax to extend the tax to other sectors and raise the tax rate to meet the cost-effective level that will fully internalize the negative externalities on the environment. For example, the IMF recommended a global carbon price level to reach US$ 75 per ton of CO2eq emissions by 2030 to meet the Paris Agreement goal). Mitigating the possible adverse impacts of Prior Action #4 can be achieved through the recently established Environmental Standardization Agency in 2022, to provide standards and guidance in environmental monitoring and management nation-wide including for the SNG level, and through the "hold harmless" provisions that are already in the proposed legislation, augmented by a phase-in period that the Bank has recommended. Together they will prevent abrupt budget cuts in districts and allow for orderly planning and budgeting for environmental management. The environmental benefits of Prior Action #6 will be enhanced if the Minister of Finance and Minister of Planning put in place the cross-program for environment, disaster and climate change resilience, and low-carbon development currently under consideration.

92. **Although this DPL will not support specific projects, some projects resulting from renewable investments and infrastructure development resulting from effective use of capital budget beyond this operation could have potential adverse environmental impacts that would have to be managed.** To the extent that the carbon tax (Prior Action #3) makes investment in renewable energy relatively more attractive, the wind, solar, biomass and hydro projects that might be forthcoming could also have adverse impacts. Indonesia has a well-established system for managing such impacts. Its cornerstone is a set of provisions in Law 32 of 2009 on Environmental Protection and Management that declare as criminal offenses (a) the operation of a business or activity that could adversely affect the environment without the required environmental approval, (b) the issuance of an environmental approval when the necessary environmental assessment has not been completed and approved, and (c) the issuance of a business license or activity without the environmental approval. The environmental impact assessment (AMDAL) process applies to projects with substantial potential adverse impacts, such as geothermal energy development[43] and large hydropower projects and produces a full Environmental and Social Impact Assessment with management and monitoring plans. Projects with lesser but still potential adverse impacts must prepare an Environmental Management Plan (*Upaya Pengelolaan Lingkungan* or UKL*)* and an Environmental Monitoring Plan (*Upaya Pemantauan Lingkungan* or UPL). This system is well designed and, when properly followed, conforms to international standards. It is currently in transition to a risk-based system following the enactment of Law No. 11 of 2020 concerning Job Creation. Regulations issued

[43] Government Regulation No. 5/2021 on Energy and Mineral Sectors defined all projects in the energy and mineral sectors as high-risk, requiring AMDAL. Previously, UKL and UPL were the instruments required for geothermal exploration. Since many potential geothermal sites are located in forest, both watershed protection forest (*hutan lindung*) and various categories of protected forest (*hutan konservasi*), the strengthening of the impact assessment requirement is a positive change. In addition, some of the environmental and social risks can be avoided or minimized when sites are being selected for exploration, through the use of the risk mapping of potential sites presented in the PROFOR/World Bank report Rapid Environmental and Social Assessment of Geothermal Development in Conservation Forest Areas in Indonesia (E. Meijaard et. al., 2019).

pursuant to Law No. 11 have strengthened some aspects of the system but have also created some gaps. Risks to proper implementation of the system include uneven awareness, resources, capacity, and commitment of technical counterparts across the spectrum of local governments and SOEs in preparing safeguards documents; shortage of qualified environmental consultants; weak law enforcement at district and provincial levels; and low community awareness of threats to environmental and human health. There have also been delays in completing some of the key changes pursuant to Law No. 11, such as issuance of environmental management standards for industrial subsectors. In addition to its longstanding support to improving system performance, such as through the establishment of the Safeguards Learning Center in 2017, funded by World Bank Australia Safeguards Partnership Trust Fund and endorsed by Bappenas, the Bank is in discussions with the Environmental Standardization Agency of the Ministry of Environment and Forestry on a prospective technical assistance operation to assist in preparing those standards and in implementing Law No. 11.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

93. **The Public Financial Management (PFM) system in Indonesia has shown significant improvements over time.** The latest Public Expenditure and Financial Accountability (PEFA) report (2017)[44] concludes that Indonesia has established a strong legal and regulatory framework that aligns with most international standards on PFM. Overall, the average PEFA performance score is slightly below 'B', which is above the basic level of performance broadly consistent with good international practices. Out of 31 PEFA performance indicators, 9 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. The Government also makes available to the public the annual budget law approved by the legislature based on Law No. 14/2008 on Access to Public Information.

94. **PFM institutions in Indonesia have important strengths, primarily associated with the development of instruments that have allowed prudent fiscal management and control of budget execution.** The fiscal rules to support major development initiatives has been effectively followed. The rollout of the financial management information system, 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, has created a solid platform for automation and integration of PFM processes for the improved quality of financial reporting and oversight. Commitment controls are in place at the spending unit level and effectively limit commitments to actual cash availability and approved budget (DIPA) ceilings. With the financial management information system, commitments are recorded in the system before the expenditure is incurred, ensuring adherence to the budget ceiling, reducing the time lags in processing payments and revising budgets, and allowing the strict maintenance of an electronic trail of all modifications to source data. On internal control, the government issued a Government Regulation No. 60/2008 (PP 60/2008) on the Government Internal Control System which adopted the COSO framework in August 2008. BPKP, the National Internal Audit Institution, is appointed the internal agency responsible for assisting ministries, departments and agencies in the implementation of PP No. 60/2008. The segregation of duties on budget execution including the roles and responsibilities of budget holders, commitment makers, payment

[44] World Bank, 2018, Public Expenditure and Financial Accountability (PEFA): assessment report (2017), Jakarta, World Bank.

verification staff treasurers and accounting staff in each ministry are also well defined in MoF Decree No. 190/ 2012 on payment processing mechanisms. The implementation of the control over budget execution is generally understood and complied with.

95. **The Government of Indonesia has made great strides during the last two decades towards strengthening the country's public procurement system.** The public procurement is currently governed by the Government Procurement Regulation No.16/2018 through Presidential Regulation (Perpres16/2018) as amended No.12/2021 (Government Procurement Regulation). One of the most significant reform achievements is the establishment of the e-procurement system and its further enhancement, which includes development of an e-contract platform to record the contract implementation and payment processing.

96. **A comprehensive assessment of the Indonesia public procurement system using the revised Methodology for Assessing Procurement Systems (MAPS) is being jointly conducted by the National Public Procurement Agency (LKPP), the Word Bank, Asian Development Bank (ADB) and Islamic Development Bank (IsDB).** The assessment's recommendations and action plan are expected to help the government prioritize the reform activities needed to enhance the effectiveness of the public procurement system in supporting government policy objectives, improve the efficiency in public services delivery particularly in emergency situations such as the COVID-19 pandemic, and increase the public trust while achieving value for money with high transparency and good governance. The assessment also analyzes the current level of integration of the e-procurement system with other procurement ecosystem information systems, particularly the public finance management systems. The MAPS is expected to be completed by June 2022 with the delivery of the assessment report including recommendations for future reform activities.

97. **However, there are still some weaknesses related to efficiency and accountability of budget implementation.** 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:

(a) Improving budget credibility by strengthening the budget forecast, integrating planning and budgeting with resource allocation consistent with government priorities as reflected in the national plan, and increasing revenue mobilization and compliance of tax and non-tax collection;

(b) The inclusion of performance information in the budget document, including the restructuring of the planning and budget classification structures following the '*Money Follows Programs'* principle to establish a more programmatic classification that cuts across administrative/organizational boundaries;

(c) Promoting effective reporting of subnational budget execution; and

(d) Strengthening internal audit and external audit and control measures, including the roll-out of SAKTI Web application and streamlining the number of spending unit that will improve the timeliness and accuracy of the budget execution data.

98. **The effective 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.** The Public Expenditure and Financial Accountability (PEFA) assessment also demonstrates that Indonesia shows good performance on indicators about comprehensiveness and transparency of PFM with "A" score

on PI-9 on Public Access to Fiscal Information. Information on government budget is made available to the public through the DG Budget MoF's website.

99. **The *Badan Pemeriksa Keuangan* (BPK), as Indonesia's Supreme Audit Institution, has a mandate to conduct financial audits of all central government entities, as well as local government agencies.** The audit reports include audit reviews on (a) the internal control system, (b) compliance with laws and regulations, and (c) the status of follow-up audit findings and recommendations. Besides government entities, BPK conducts audits on BI (central bank), SOEs, and other entities that manage state finances. BPK audits include financial audits, performance audits, and audits for special purposes.

100. **BPK audit reports on the central government's financial statements (LKPP) are submitted to the parliament within two months after the issuance of the unaudited financial statements.** As for BPK audit reports on line ministries are submitted semi-annually, three months after the end of the semester, together with a semiannual summary of audit reports (IHPS). BPK submitted LKPP audit report for FY 2020 to the People's Representative Council (*Dewan Perwakilan Rakyat*, DPR) on June 22, 2021 and to the President on June 25, 2021. BPK expressed unqualified (clean) opinion to LKPP for FY 2020. 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 audit report is accessible to the public on the BPK website.

101. **BPK has expressed an unqualified (clean) opinion on the latest BI financial statements for FY 2020.** This means BI has maintained clean opinion for 18 consecutive years. Several DPLs were disbursed successfully in 2019 and 2020, which included the Third Fiscal Reform, the First Financial Sector Reform and the Covid Supplemental Financial Sector DPLs.

102. **The loan disbursement will follow the standard World Bank procedures for DPLs.** The loan amount, once the loan becomes effective and subject to; i) successful completion of the Program, and ii) adequacy of the macroeconomic framework, will be disbursed into a foreign currency account of the borrower at BI 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 DPLs. The borrower, within 30 days[45], will provide to the World Bank a written confirmation that this transfer has been completed and provide to the World Bank any other relevant information relating to these matters, including the exchange rate of the conversion from U.S. dollars to rupiah, that the World Bank may reasonably request.

103. **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 World Bank loan proceeds, as defined in the General Conditions for IBRD Financing: Development Policy Financing Dated December 14, 2018 (Revised on August 1, 2020, December 21, 2020, April 1, 2021, and January 1, 2022) (General Conditions). The

45 Similar certification letter issued by the borrower on December 16, 2021 for the ongoing Indonesia Investment and Trade Reforms DPL (P172439/IBRD 9244)

project is considered a FDL and is subject to the limits of ARM of 12 years including a grace period up to 5 years. If any portion of the loan is used to finance excluded expenditures as so defined in the General Conditions, the World Bank has the right to require the GoI to promptly, upon notice from IBRD, refund the amount equal to such payment to the World Bank. Amounts refunded to the World Bank will be cancelled from the loan. The project is expected to close on June 30, 2023.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

104. **Progress on the results indicators will be monitored and evaluated by the Recipient and the Bank.** The implementing agency for the operation is the MoF as the driver of all the reforms in this operation. The monitoring of the result indicators will draw on a mix of publicly available and private data, which the MoF committed to collect along with the Bank for this purpose.

105. **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

106. **The overall risk rating for the operation is 'substantial' with five sources of risk indicated as 'substantial'**.

107. **Political and governance risk is moderate.** There is a moderate risk that the THL is ruled invalid because of its use of the "omnibus method", where a single law (THL) was used to amend multiple other laws (e.g., the VAT Law of 1983, Income Tax Law of 1983 and the General Provisions and Tax Procedures Law of 1983). In late 2021 the Constitutional Court objected to the use of the omnibus method for the Job Creation Law 11 of 2021, as this approach was not a recognized method for enacting laws in Indonesia. However, there have been only two petitions against the THL's use of the omnibus method, which were either dismissed by the Constitutional Court or withdrawn.[46] In addition, the submission deadline for filing a petition opposing the THL expired in December 2021. While these facts do not necessarily remove the residual risk of the THL being challenged for its use of the omnibus method, the government and

[46] *https://en.mkri.id/news/details/2022-04-20/Past%20Deadline%2C%20Petition%20on%20HPP%20Law%20Dismissed*

parliament are in the final stage of amending Law 12 of 2011 on Formulating Legislation to explicitly accommodate the use of the omnibus method.[47] Once the amendments are in place, expected by the middle of 2022, the risk would no longer exist. The Bank will closely and proactively monitor the development of this process.

108. **The macroeconomic risk is substantial.** First, while Indonesia's direct exposure to Russia and Ukraine is limited, increasing energy and food commodities may is leading to increased inflation and to increased pressure for explicit or implicit food and energy subsidies or tax incentives. It has policy space to respond to limited shocks transmitted through global financial and commodity markets. Second, there is a risk is that global shocks, as the global recovery is uneven, will affect Indonesia's macroeconomic stability. Indonesia's monetary financing arrangement could become less viable if global financial conditions tighten. The tax reforms supported by this operation will mitigate some of this risk, as it will support Indonesia's return to the 3 percent of GDP fiscal deficit rule a growth-friendly way. Third, however, there is a risk that the tax reforms will have a negative impact on growth, for example, the VAT rate increase's impact on private consumption. Analysis suggests that this impact will be small and recycling part of the revenue to targeted social assistance to the poor will support consumption. More generally, there is still plenty of fiscal and monetary support for the economy and Indonesia is undertaking structural reforms to attract private investment, which will allow the private sector to play a larger role in driving GDP growth. The World Bank has frequent dialog with the MoF and BI on policies to support the recovery and the exit from extraordinary measures.

109. **The technical design of the program and institutional capacity risks are substantial.** The Bank has carefully selected a limited number of policy actions that are key government priorities. It conducted substantive discussions around the implementation requirements for each action to ensure that expectations regarding capacity and timing are realistic. However, the implementation of the carbon tax (Prior Action #3) alongside an emissions trading scheme is technically demanding with a substantial set of regulations to be issued and institutions to be created. It also requires a great deal of collaboration between ministries, especially the MoF and Ministry of Environment and Forestry, operating under two different coordinating ministries. The resulting risk is partly mitigated by the strong support of the World Bank and other development partners to the government for these policies.

110. **Stakeholder risk is substantial.** The tax and subnational finance reforms will create winners and losers. Rationalizing statutory VAT exemptions may result in requests from losing sectors for an alternative VAT treatment reversing the reform impact. The fact that these exemptions are not fixed in the law anymore and MoF has the option to grant temporary or partial exemptions through regulations mitigates this risk. While most implementing regulations are expected to be issued in early 2022, the regulations implementing the subnational DAU reform (Prior Action #4) will only be issued by the middle of 2022. There is a risk that these implementing regulations will weaken the equalizing effect of the reform, given its sensitivity. The Bank is closely advising MoF on the DAU reform design to mitigate this risk. Consolidation of spending units with low capital budget (Prior Action #6) could lead to push-back from line ministries with a large number of spending units with lower capital budget allocation and the affected spending units themselves. To mitigate these risks, the Bank is working closely with MoF to help the affected ministries and spending units to reorganize in a way that a ministry benefits from the centralized

[47] The draft amendments are published on the Parliament's website: *https://www.dpr.go.id/uu/detail/id/276*

procurement in consolidated units and affected individuals are protected by reassigning them in a way that they retain their authority in procurement and financial management to the extent possible.

111. **The social risk is substantial.** The VAT rate increase and exemptions removal (Prior Action #1) is expected to increase the burden on poor households, while the carbon tax (Prior Action #3) is expected to increase the burden on poor households once energy tariffs are liberalized. There is a risk of social pushback to these reforms. To mitigate this risk, it will be important to use part of the VAT and carbon tax revenue to compensate poor households and support other affected industries with the transition to a low-carbon business model without jeopardizing the integrity of the carbon tax and to communicate it well. Indonesia has experience with compensating the poor through targeted social transfers after energy subsidy reforms. The Bank has advised the MoF on estimating of the reforms the impact on the poor and on options to compensate them. The Minister of Finance has announced that the government will protect the poor from adverse impacts of the VAT rate increase.

Table 7: Summary Risk Ratings

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

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ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions	Result Indicator	Baseline	Target
Pillar 1: Increase Tax Revenue and Improve Equity of the Tax System			
#1. To increase VAT revenue and improve its efficiency, the Borrower has (a) increased the statutory VAT rate (effective from April 1, 2022) to 11 percent, and (b) adopted a legal framework to remove the statutory VAT exemption status of several goods and services, including those for mining and drilling products taken directly from their sources, as evidenced by the Tax Harmonization Law 7/2021.	Value -Added Tax and Luxury Goods Sales Tax revenue (percent of GDP)	3.2 percent (2021)	At least 3.4 percent (2023)
#2. To increase personal income tax revenue from high-income earning individuals, the Borrower has added a new personal income tax bracket for individuals with annual incomes higher than five billion Indonesian Rupiah, as evidenced by the Tax Harmonization Law 7/ 2021.	Personal Income Tax revenue collected from individuals with income over five billion Indonesian Rupiah as a share of total PIT revenue	15.9 percent (2020)	18.0 percent (2023)
#3. To limit greenhouse gas emissions, the Borrower has introduced a carbon tax regime initially applicable to the coal-fired power plants sector, as evidenced by the Tax Harmonization Law 7/2021.	Percent of total emissions from grid-connected coal powerplants that is accounted for by powerplants that are subject to a carbon tax	0 percent (2021)	75 percent (2023)
Pillar 2: Strengthen Institutions for Planning and Budgeting, and Fiscal Transfers			
#4. To allocate fund transfers more equitably across subnational entities, the Borrower has adopted a legal framework for allocating the General Allocation Fund based on the per unit fiscal needs and potential revenues of subnational governments, as evidenced by the Law Concerning Financial Relationship Between the Central Government and Subnational Governments No. 1/2022.	Ratio of national median revenues per capita over the most populous district quintile	2.07 (2020)	2.02 (2023)
#5. To increase spending efficiency and effectiveness, the Borrower, through BAPPENAS and the MOF jointly, has provided the guidelines for strengthening the link between planning and budgeting, as evidenced by the Joint Letter No. S-122/MK.2/2020 and B-517/M.PPN/D.8/PP.04.03/05/2020 jointly issued by BAPPENAS and the MOF.	Number of programs in the budget	More than 600 (2020)	Fewer than 120 (2023)

#6. To improve its budget execution, the Borrower, through BAPPENAS and the MOF jointly, has directed the budget allocating ministry or institution to consolidate the spending units that are regional/vertical offices or regional government offices/work units, in each case, receiving budget allocations from different Echelon I units but within the same ministry or institution, as evidenced by the Joint Letter No. S-353/MK.02/2021 and B.301 /M.PPN/D.8/PP.04.02/04/2022 jointly issued by BAPPENAS and the MOF.	Number of spending units in districts and cities (percent share of 2021)	100 percent (2021)	54 percent (2023)[48]

[48] The dates are based on the year when the budget implementation document (DPIA) with the number of spending units is issued (e.g., late 2023) and will apply to the following fiscal year (e.g., 2024).

ANNEX 2: FUND RELATIONS ANNEX

PRESS RELEASE NO. 22/84

IMF Executive Board Concludes 2022 Article IV Consultation with Indonesia

March 22, 2022

Washington, DC : The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation [1] (file:///Q:/COM/MR/Press%20Releases/2022/PR2284-%20Indonesia-%20IMF%20Executive%20Board%20Concludes%202022%20Article%20IV%20Consultation%20with%20Indonesia.docx#_ftn1) with Indonesia.

As elsewhere, the COVID-19 pandemic has led to tragic loss of life and triggered a major economic downturn in Indonesia. The authorities have responded with a bold and comprehensive, and well-coordinated policy package that has successfully maintained economic and financial stability. With the recovery underway, they have begun to withdraw the exceptional support measures. Nevertheless, the pandemic has caused scarring and reinforced the need to tackle longstanding challenges, including a low revenue intake and shallow financial markets.

The Indonesian economy is recovering at a brisk pace. The Delta variant surge slowed the economic recovery in mid-2021, but growth picked up in the fourth quarter and is expected to strengthen over 2022–23. IMF staff project GDP growth at 5.4 percent for 2022 and 6.0 percent in 2023, supported by favorable global commodity prices, easing restrictions on activity, continued policy support, and rising mobility and confidence as the vaccination program expands into more remote areas. Inflation has remained lower than in other emerging and advanced economies, allowing Bank Indonesia (BI) to support the recovery through accommodative policies, and is expected to rise gradually within the inflation target range in 2022. The outlook is improving but the balance of risks remains tilted to the downside.

Executive Board Assessment [2] (file:///Q:/COM/MR/Press%20Releases/2022/PR2284-%20Indonesia-%20IMF%20Executive%20Board%20Concludes%202022%20Article%20IV%20Consultation%20with%20Indonesia.docx#_ftn

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for maintaining macroeconomic and financial stability despite the severe impact of the COVID-19 pandemic, helped by substantial policy buffers accumulated over years of strong macroeconomic performance. While the outlook is improving, the balance of risks remains tilted to the downside. As the recovery takes hold, Directors considered that it would be appropriate to gradually phase out the exceptional policy support deployed during the pandemic and encouraged the authorities to press ahead with structural reforms.

Directors agreed that the authorities' gradual withdrawal of fiscal policy support would be appropriate. They noted that restoring the pre-pandemic 3 percent of GDP budget deficit ceiling in 2023 will bolster the credibility and sustainability of the fiscal framework. Directors supported the authorities' plans to develop a medium-term revenue strategy to finance high priority spending critical to achieving Indonesia's development goals. Savings from energy subsidy reforms could also be used to strengthen the social safety net.

Directors noted that monetary policy has remained appropriately accommodative to support the recovery. They welcomed the authorities' commitment to stay ahead of the curve and urged them to closely monitor developments to ensure that inflation and inflation expectations remain well anchored. While the temporary deployment of additional policy tools has helped to successfully contain bouts of market volatility, Directors encouraged the authorities to end central bank primary market purchases and allow the policy rate to provide a clearer signal of the monetary stance. They also highlighted the role of exchange rate flexibility in absorbing shocks.

Directors noted that the Indonesian financial sector remains stable, and that intensive supervision is necessary while crisis-related regulatory relief is in place. They welcomed the authorities' efforts to promote financial deepening and inclusion, including through an extensive digitalization agenda and measures to reduce information asymmetries, through credit information sharing, which should support the recovery of credit markets.

Directors commended the Indonesian authorities for their ambitious structural reform agenda. They encouraged the authorities to maintain the momentum with labor and financial market reforms aimed at increasing investment, boosting growth, and mitigating the scarring effects of the pandemic. Improvements to education, women's labor force participation, and governance frameworks can also support medium-term growth.

Directors welcomed the authorities' efforts to tackle climate change and took positive notes of their recent climate change mitigation measures. They encouraged the authorities to undertake further reforms, including on energy subsidies, measures on carbon pricing and the emission trading system, and fostering a green financial market.

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[1] (file:///Q:/COM/MR/Press%20Releases/2022/PR2284-%20Indonesia-%20IMF%20Executive%20Board%20Concludes%202022%20Article%20IV%20Consultation%20with%20Indonesia.docx#_ftnref1) Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] (file:///Q:/COM/MR/Press%20Releases/2022/PR2284-%20Indonesia-%20IMF%20Executive%20Board%20Concludes%202022%20Article%20IV%20Consultation%20with%20Indonesia.docx#_ftnref2) At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm (http://www.imf.org/external/np/sec/misc/qualifiers.htm) .

Indonesia: Selected Economic Indicators

	2018	2019	2020	2021	2022	2023
				Est.	Proj.	Proj.
Real GDP (percent change)	5.2	5.0	-2.1	3.7	5.4	6.0
Domestic demand	6.3	4.0	-3.8	2.9	4.7	6.1

Of which:						
Private consumption 1/	5.1	5.2	-2.7	2.0	4.9	5.9
Government consumption	4.8	3.3	2.0	4.2	4.7	4.0
Gross fixed investment	7.9	4.5	-5.0	3.8	5.2	7.1
Change in stocks	0.4	-0.6	-0.7	0.1	-0.2	0.0
Net exports 2/	-1.0	1.4	1.4	1.0	0.9	0.3
Saving and investment (in percent of GDP)						
Gross investment 3/	34.6	33.8	32.4	31.5	31.0	31.3
Gross national saving	31.6	31.1	31.9	31.9	31.0	29.8
Prices (12-month percent change)						
Consumer prices (end period)	3.2	2.6	1.7	1.9	3.5	3.2
Consumer prices (period average)	3.3	2.8	2.0	1.6	2.9	3.3
Public finances (in percent of GDP)						
General government revenue	14.9	14.2	12.5	13.6	13.2	13.2
General government expenditure	16.6	16.4	18.6	18.2	17.1	16.2
Of which: Energy subsidies	1.0	0.9	0.7	0.8	0.9	0.7
General government balance	-1.8	-2.2	-6.1	-4.6	-4.0	-3.0
Primary balance	0.0	-0.5	-4.1	-2.6	-1.3	-0.5
General government debt	30.4	30.6	39.8	42.8	42.9	42.9

Rupiah M2	6.3	6.5	12.5	13.9	8.4	9.0
Base money	0.2	2.9	0.4	19.3	8.8	4.7
Claims on private sector	10.3	5.8	-0.4	6.1	9.2	9.7
One-month interbank rate (period average)	6.3	6.5	4.5	3.6	...	...
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)						
Current account balance	-30.6	-30.3	-4.5	4.7	-0.8	-20.6
In percent of GDP	-2.9	-2.7	-0.4	0.4	-0.1	-1.5
Trade balance	-0.2	3.5	28.2	43.9	43.3	25.9
Of which : Oil and gas (net)	-11.4	-10.3	-5.4	-9.7	-6.7	-11.5
Inward direct investment	20.6	23.9	18.5	20.2	22.1	24.5
Overall balance	-7.1	4.7	2.6	9.0	14.2	10.8
Terms of trade, percent change (excluding oil)	0.8	-2.3	-5.6	8.9	2.9	-2.8
Gross reserves						
In billions of U.S. dollars (end period)	120.7	129.2	135.9	144.9	159.1	169.9
In months of prospective imports of goods and services	7.1	9.7	7.9	7.4	7.3	7.1
As a percent of short-term debt 4/	201	204	209	213	224	226
Total external debt 5/						
In billions of U.S. dollars	375.4	403.6	417.0	436.8	454.4	488.1
In percent of GDP	36.0	36.0	39.3	36.8	35.4	34.8

Exchange rate						
Rupiah per U.S. dollar (period average)	14,235	14,152	14,529	14,297	...	...
Rupiah per U.S. dollar (end of period)	14,390	13,866	14,050	14,253	...	...
Memorandum items:						
Jakarta Stock Exchange (12-month percentage change, composite index)	-2.5	1.7	-5.1	10.1	...	...
Oil production (thousands of barrels per day)	810	805	806	803	800	797
Nominal GDP (in trillions of rupiah)	14,839	15,833	15,438	16,971	18,471	20,220

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.

MEDIA RELATIONS

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ANNEX 3: LETTER OF DEVELOPMENT POLICY

MINISTER OF FINANCE
OF THE REPUBLIC OF INDONESIA

Number : S-423/MK.08/2022 17 May 2022

Mr. David Malpass
President
World Bank

Subject : Indonesia Fiscal Reform Development Policy Loan - Letter of Development Policy

Dear Mr. President

1. Since taking office in October 2019, the Government of Indonesia has placed a particular emphasis on fiscal reforms, recognizing its crucial link with the country's economic and broader development performance. The Covid-19 pandemic highlighted fiscal policy's role to protect households, and support firms, accelerating the pace of fiscal reform. The purpose of this Development Policy Letter is to provide an overview of the Government's medium term reform agenda with regard to increasing tax revenue and improving the equity of the tax system, and strengthening institutions for planning and budgeting and fiscal transfers, and to provide an update on recent progress towards implementing the reforms.
2. On behalf of the Government of Indonesia, we would like to express our appreciation for the technical assistance provided by International Bank for Reconstruction and Development (the World Bank) and other partners to fiscal reforms in Indonesia over the recent and longer terms. We would also like to request the support of the World Bank in the form of the Indonesia Fiscal Reform Development Policy Loan.

Indonesia's Economic and Fiscal Situation

3. Despite impressive development achievements over recent decades, Indonesia still faces large human capital and infrastructure gaps that impede its competitiveness and its ability to create jobs and reduce poverty. Poverty fell from 19.1 percent in 2000 to 9.4 percent in 2019, life expectancy increased from 66 to 69 years, and households' access to improved drinking water and sanitation services nearly doubled over the same time. However, the speed of poverty reduction has slowed significantly since 2010. Human capital levels are far below that of peer countries. A child born in Indonesia today will be only 53 percent as productive when they grow up, as they could have been if they had enjoyed complete education and full health. On the other hand, public capital per person is only a third of other emerging market economies, suggesting a gap in infrastructure assets of around US$ 1.6 trillion (134 percent of GDP). There are also large geographic and income-related disparities in service delivery and outcomes.
4. The COVID-19 pandemic has made it more difficult to close the human capital and infrastructure gaps. The pandemic has led to a sharp increase in poverty, peaking at 10.2 percent in September 2020 and remaining high at 10.1 percent in March 2021. Cuts to infrastructure spending to accommodate the pandemic response have delayed infrastructure development, while school closures have reduced learning outcomes. The widening fiscal deficit and elevated below-the-line spending have increased the debt-to-GDP ratio, although it

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remains sustainable and below the authorities' debt ceiling. Rising interest payments risk crowding out priority spending on health, social assistance, and infrastructure.

5. Low and volatile fiscal revenues constrain the fiscal space available for development priorities. General government revenue was 12 percent of GDP in 2020, less than half the emerging market average of 27 percent of GDP. Taxes amounted to just 9.1 percent of GDP in 2021, which is well below the estimated tax potential. The tax system is characterized by high tax-free thresholds, wasteful exemptions, uneven treatment across sectors, and low health, wealth, and environmental taxes. Altogether, these result in a narrow tax base. Indonesia could potentially collect 6 percent of GDP more in revenue given its economic and other conditions.

6. There are spending misallocations and systemic constraints to the quality of spending. General government spending was 18 percent of GDP in 2020, just over half the emerging market average of 35 percent of GDP. Spending on health and social protection is also low, only one third of spending in peer countries. Although the cost of energy subsidies was brought down over the past two decades from over 3 percent of GDP to less than 1 percent of GDP, they have re-merged and remain significant and not well targeted. The government is planning to better target the liquified petroleum gas (LPG) and electricity subsidies in 2022. At the same time, the government lacks tools to adequately support and incentivize fiscal performance of local governments. Public financial management suffers from inadequate budget planning, poor links to results, misallocation of resources, and lack of good data.

7. The Ministry of Finance recently announced a 2023 budget deficit target 2.81 to 2.95 percent of GDP, in line with its commitment to return to the 3 percent of GDP fiscal deficit rule. The authorities are also committed to phasing out monetary financing of the budget by end-2022 and have already significantly reduced monetary financing in 2022 compared to the same period in 2021.

Government Response and the Medium-Term Fiscal Reform Agenda

8. The government of Indonesia (GoI) is aiming to improve fiscal space by increasing fiscal revenue and improving the efficiency and effectiveness of government spending. The Ministry of Finance (MoF) Strategic Plan 2020-2024 supports the development agendas of the National Medium-Term Development Plan 2020-2024. It comprises five Policy Directions: 1) sound and sustainable fiscal management; 2) optimum state revenues; 3) management of quality state expenditures; 4) management of treasury, state assets, and accountable and productive financing with controllable risks; and 5) an agile, effective and efficient bureaucracy and public services. The MoF has also set out a 5-year public financial management (PFM) roadmap of key institutional reforms to modernize public finance institutions, through the introduction of technology and by making them more performance oriented.

9. It passed two landmark laws: the law number 7 of 2021 regarding the Tax Harmonization (THL), which expands the tax base, increases tax rates, and improves the equity of the tax system, and the law number 1 of 2022 regarding the Intergovernmental Finance, which aims to (i) ensure a better horizontal equalization of fiscal capacity across subnational governments; (ii) improve the quality of transfer-financed spending; (iii) better integrate national and subnational spending; and (iv) increase subnational own-source revenue (OSR).

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Pillar 1 - Increase tax revenue and improve equity of the tax system

10. The Government has also set out an ambitious tax policy reform agenda with revisions of multiple tax laws achieved through the Tax Harmonization Law (THL), which expands the tax base, increases tax rates, and improves the equity of the tax system.

11. Increasing VAT revenue and improving its efficiency. As part of the THL, the government has: (i) increased the statutory VAT rate (effective from April 1, 2022) to 11 percent; (ii) adopted a legal framework to remove the statutory VAT exemption status of several goods and services, including those for mining and drilling products taken directly from their sources. Increasing the VAT rate brings it closer to average rates imposed by other large upper and middle-income economies. Furthermore, the removal of statutory VAT exemptions will partially correct distortions of the tax system.

12. *Increasing the Personal Income Tax (PIT) Revenue from High-Income Earning Individuals*. PIT collection in Indonesia is low but is progressive compared to peers. To increase PIT revenue, the government has added a new PIT bracket for high-income earning individuals, defined as those individuals with annual incomes higher than five billion Indonesian Rupiah (about US$ 330,000). In addition, the income range for the lowest marginal individual income tax rate has been broadened from IDR 0 – 50 million (US$ 0 – 3,300) to IDR 0 – 60 million (US$ 0 – 4,000). As a result, the PIT revenue collected from individuals with income over IDR 5 billion as a share of total PIT revenue is expected to increase. Moreover, as incomes grow in-line with GDP growth, this reform of the PIT structure is expected to generate additional revenue over the medium-term.

13. *Introducing a carbon tax*. The largest sources of greenhouse gas (GHG) emissions in Indonesia are land use and energy, an unusual emissions profile among global top 10 emitters. To deliver significant emission reductions in-line with its NDCs, the government has enacted legal instruments that set the stage for a domestic price on carbon-dioxide-equivalent (CO2eq) emissions in Indonesia. Indonesia introduced a framework for a carbon tax through the THL and is preparing a medium-term carbon tax roadmap. The carbon tax regime, which is initially applicable to the coal-fired power plants sector, will become effective in July 2022. With this, Indonesia will become the second country in Southeast Asia (with Singapore), to introduce a carbon tax. Alongside the carbon tax, Indonesia has also introduced the regulatory framework for two more ways to price carbon This includes an Emissions Trading Scheme (ETS) and Results-Based Financing, through Presidential Regulation No. 98 of 2021 on the Economic Value of Carbon. The carbon tax will expand the tax base, while working in tandem with the ETS to mitigate CO2eq emissions.

14. *MoF is also preparing other important complementary tax reforms*. (i) As part of broadening tax bases, the THL provided the government with the legal framework to introduce new excises, such as on plastics, plastic bags or on sugar-sweetened beverages. These additional excises are being assessed and could be introduced as part of the Budgets for 2023 or 2024. (ii) The government is also working on updating VAT and income tax rules so that they better capture the rapidly expanding digital economy. The income tax system is set to be strengthened in a number of ways, including (iii) replacement of the Tax Identification Number with the National ID to broaden the tax base and enable better integration with third-party data; (iv) reform of fringe benefits taxation to strengthen the revenue and progressive impact of the PIT reform; (v) introduction of a new core tax IT system at the Directorate General of Tax in the medium-term to enable better tax enforcement, including management of much larger taxpayer datasets; and (vi) expansion of Medium Tax Offices for tax base expansion via better

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and more targeted enforcement. (vii) The government will lower the VAT threshold and introduce a simplified VAT regime for small firms.

Pillar 2 - Strengthen institutions for planning and budgeting, and Fiscal Transfers

15. *Reform of the legal framework for allocating General Allocation Grant* (DAU) *to subnational governments* (SNGs). The general allocation grant (DAU) constitutes about half of all transfer to SNGs. As part of the law number 1 of 2022, the government is reforming the DAU to make its allocation more equitable. The present DAU formula especially underfinances the service and infrastructure needs of populous urbanizing areas, which are key economic drivers and home to many of the poor. To address this challenge, the law requires the DAU to be allocated based on a "per client" estimate of SNGs' fiscal needs, hence in proportion to the number of service users. To ensure that the reform will not adversely affect the poor in thinly populated and remote areas, the law previews that the DAU allocation will account for differences in service delivery costs, through adjustment factors. The law also previews that earmarked grants (DAK) will be allocated in view of reducing service disparities. This will help ensure sufficient resources for basic infrastructure and services that are important for the poor. To ensure that the reform will not cause significant disruption to local service delivery, the DAU reform will be introduced in a phased manner. During a 5-year "hold harmless" period, no SNG will receive a lower DAU allocation than in 2020.

16. *Strengthening the link between planning and budgeting.* The government has recently taken a series of steps to establish a strong linkage between the medium-term planning and the annual budget process to improve the performance orientation of the budget. The annual budgeting by MoF and medium-term planning by the Ministry of National Development Planning (Bappenas) are better harmonized and aligned. The Bappenas and the MOF jointly issued pathbreaking guidelines on the Redesign of Planning and Budgeting Systems (*Redesain Sistem Perencanaan dan Penganggaran* or RSPP) reform, for strengthening the link between planning and budgeting in their joint Circular in June 2020. Through this, they have restructured the planning and budget classification structures following the '*Money Follows Programs*' principle that establishes a more programmatic classification that cuts across administrative/organizational boundaries. These guidelines were fully enforced through integration of planning (KRISNA) and budgeting (SAKTI) IT systems that use harmonized planning and budget classification structures for the updated programs. The new and harmonized program classification structure is consistently being used in the annual plan and budget documents for the last two fiscal years of 2021 and 2022, and will be used for 2023 budget.

17. *Consolidating spending units to improve capital budget execution.* The government is taking 5 strong steps for improving the level and pace of capital budget execution in Indonesia. Following the recommendations of the joint World Bank and MoF's "Institutional Diagnostic of Low and Slow Capital Budget Execution in Indonesia (2019-2020)", the government is taking concrete steps towards focusing on few spending units and ministries with high allocation and consolidation of rest and requires the budget allocating ministry or institution to consolidate the spending units that are regional/vertical offices or regional government offices/work units, in each case, receiving budget allocations from different Echelon I units but within the same ministry or institution. Consolidation of spending units would contribute to improving the performance of capital budget implementation. As an immediate impact from the smaller number of spending units, MoF sees a potential for improving budget execution efficiency by

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consolidating the procurement process of smaller spending units under one activity so that bigger procurement packages can be procured in a centralized manner and benefit from economies of scale.

18. Going further, the government is working towards improving the medium-term perspective in investment planning to enable multi-year contracting, systematically monitoring compliance of directives on early procurement, and providing flexible budget allocation for land acquisition so that it does not constrains implementation of infrastructure projects.

Conclusions

19. In summary, the Government is firmly committed to the program of fiscal reforms set out above in order to increase tax revenue and improve the equity of the tax system and improve the quality of spending by strengthening institutions for planning and budgeting and fiscal transfers. These fiscal reforms, in turn, can help strengthen fiscal sustainability, contribute to broad-based economic growth, and support the government's continued efforts to reduce poverty.

20. The Government greatly values the support provided by the World Bank over the years to help finance 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 your continued engagement and support in the coming years.

Minister of Finance

Ditandatangani secara elektronik
Sri Mulyani Indrawati

Cc:
1. Coordinating Minister of Economic Affairs
2. Director General of Budget Financing and Risk Management, Ministry of Finance
3. Head of Fiscal Policy Agency, Ministry of Finance
4. Director General of Taxation, Ministry of Finance
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ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects
Pillar 1- Increase Tax Revenue and Improve Equity of the Tax System		
#1. To increase VAT revenue and improve its efficiency, the Borrower has (a) increased the statutory VAT rate (effective from April 1, 2022) to 11 percent, and (b) adopted a legal framework to remove the statutory VAT exemption status of several goods and services, including those for mining and drilling products taken directly from their sources, as evidenced by the Tax Harmonization Law 7/2021.	Positive	Negative
#2. To increase personal income tax revenue from high-income earning individuals, the Borrower has added a new personal income tax bracket for individuals with annual incomes higher than five billion Indonesian Rupiah, as evidenced by the Tax Harmonization Law 7/ 2021.	No	No
#3. To limit greenhouse gas emissions, the Borrower has introduced a carbon tax regime initially applicable to the coal-fired power plants sector, as evidenced by the Tax Harmonization Law 7/2021.	Positive	No
Pillar 2- Strengthen Institutions for Planning and Budgeting, and Fiscal Transfers		
#4. To allocate fund transfers more equitably across subnational entities, the Borrower has adopted a legal framework for allocating the General Allocation Fund based on the per unit fiscal needs and potential revenues of subnational governments, as evidenced by the Law Concerning Financial Relationship Between the Central Government and Subnational Governments No. 1/2022.	No	Positive
#5. To increase spending efficiency and effectiveness, the Borrower, through BAPPENAS and the MOF jointly, has provided the guidelines for strengthening the link between planning and budgeting, as evidenced by the Joint Letter No. S-122/MK.2/2020 and B-517/M.PPN/D.8/PP.04.03/05/2020 jointly issued by BAPPENAS and the MOF.	Positive	Positive
#6. To improve its budget execution, the Borrower, through BAPPENAS and the MOF jointly, has directed the budget allocating ministry or institution to consolidate the spending units that are regional/vertical offices or regional government offices/work units, in each case, receiving budget allocations from different Echelon I units but within the same ministry or institution, as evidenced by the Joint Letter No. S-353/MK.02/2021 and B.301 /M.PPN/D.8/PP.04.02/04/2022 jointly issued by BAPPENAS and the MOF.	Positive	Positive

ANNEX 5: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS CHARTS

Figure 5.1. Richer households pay more VAT after reform
VAT Payment and Incidence by market income decile (IDR billion)

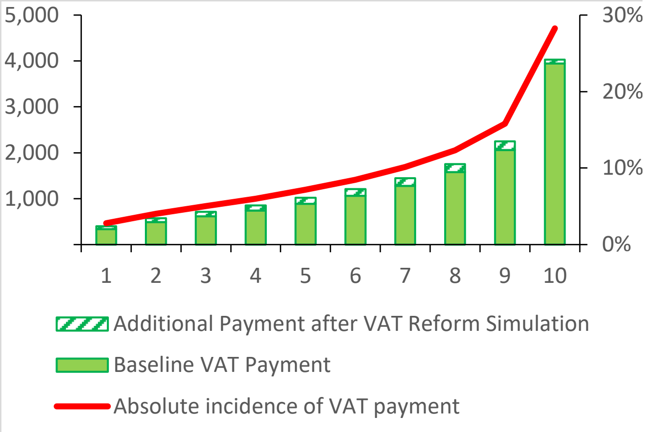
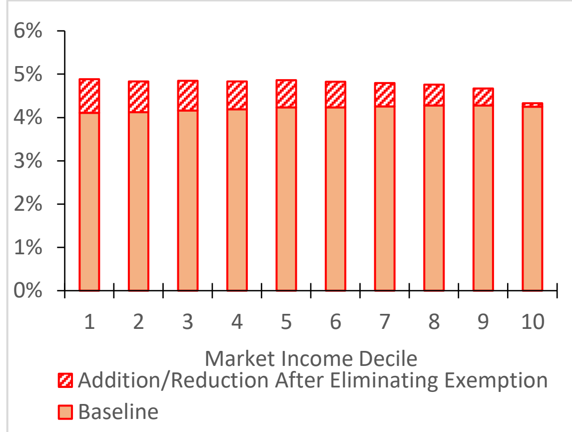
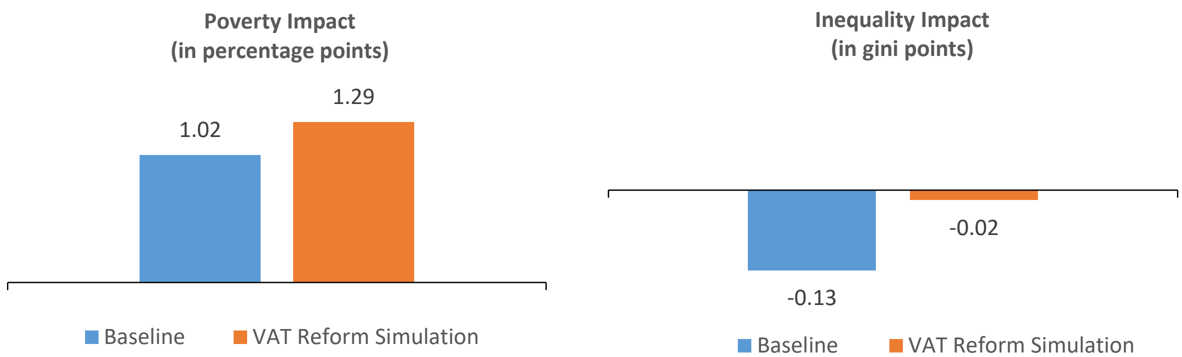


Figure 5.2. As a share of income, the poor pay more VAT
VAT payment as share of market income (percent of market income)



Source: World Bank Staff calculations using Commitment to Equity (CEQ) method based on SUSENAS 2019 data.

Figure 5.3. The VAT reform may increase poverty while maintaining the inequality reducing impact of VAT



Note: The results presented in figure 5.1 are based on an analysis using the Commitment to Equity (CEQ) framework. The VAT reform scenario simulates the rate increase and revised tax exemptions and treats VAT payable but not collected as exemptions. The poverty impact is the difference between poverty rates with and without the VAT. For example, at the baseline the poverty rate would have been 1.02 percentage points lower had there been no VAT and in the VAT reform scenario, the poverty rate would have been 1.29 percentage points lower had there been no VAT. Thus, the impact of the reform is the difference between the baseline and the reform which is 0.27 percentage points.
Source: World Bank Staff calculations method based on SUSENAS 2019 data.

Figure 5.4. PIT reforms are expected to be revenue neutral
Share to total PIT, by taxable market income (IDR)

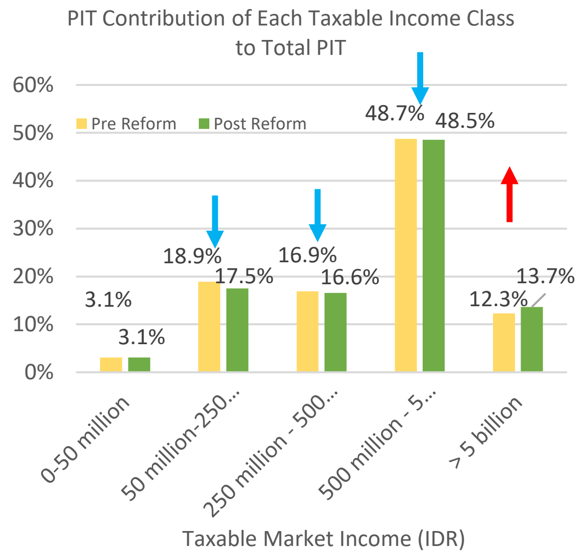
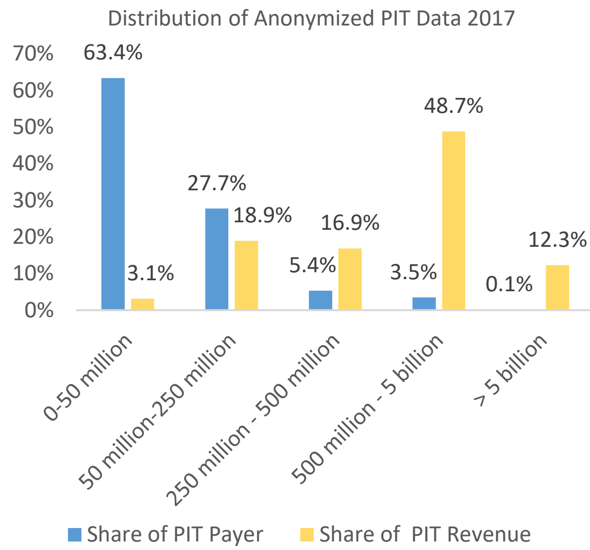
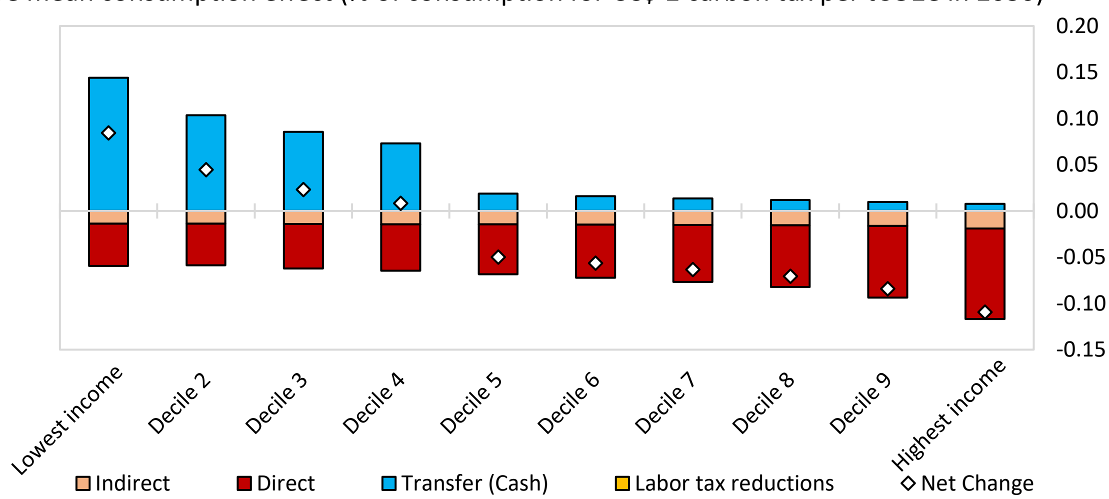


Figure 5.5 The poor are unaffected as they fall below the PIT threshold
Share to total PIT, percent, by taxable market income (IDR)



Source: World Bank staff calculations based on anonymized PIT data 2017, DG Tax.

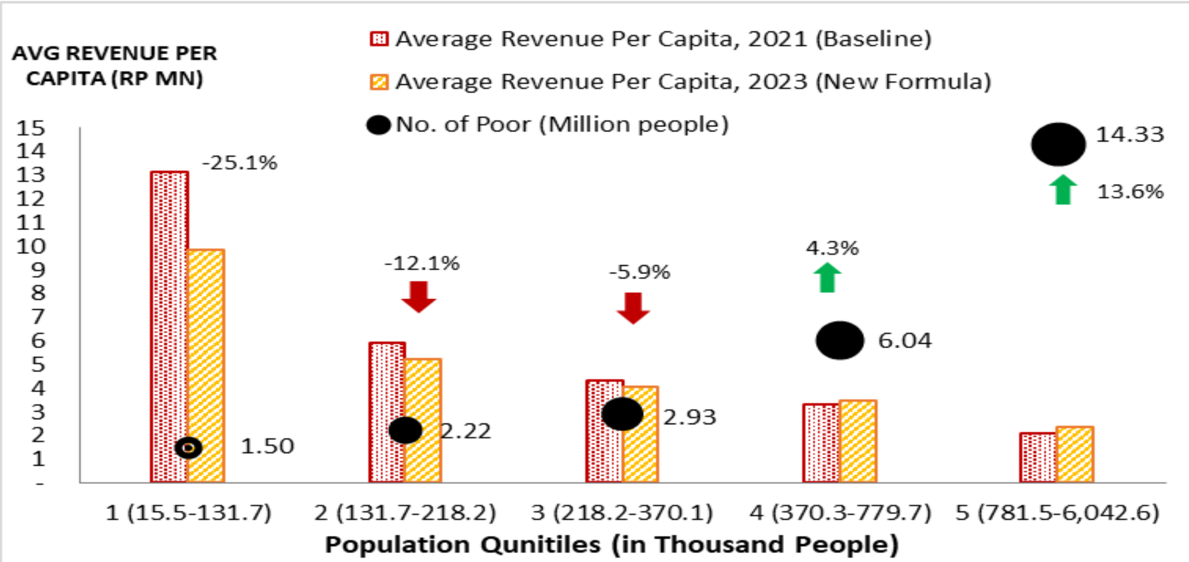
Figure 5.6. Households in the poorest 40 percent deciles can be fully compensated from the negative impact of the carbon tax if the electricity price is liberalized.
Relative mean consumption effect (% of consumption for US$ 2 carbon tax per tCO2e in 2030)



Source: WB staff calculations based on Carbon Pricing Assessment Tool Indonesia.

Figure 5.7. The DAU reform better equalizes fiscal resources on a per capita basis and increases fiscal resources to the poor

Total revenues per capita by district population quintiles and no. of poor in each quintile



Source: World Bank staff estimation based on data from DJPK-MoF (fiscal) and SUSENAS (population).