
INDONESIA

2024

January

Component: Revenue

Module: RM I – Tax Policy

PROJECT SUMMARY

COUNTRY: Indonesia

LEAD DEPARTMENT: Fiscal Affairs Department

REGION: Asia and Pacific

PROGRAM ID: (To be filled out by Secretariat)

PLANNED DATES: February 2024 – April 2027

FUNDING PROGRAM TITLE: GPFP Indonesia

PROJECT MANAGERS: Sebastian Beer

RM I/TAX POLICY: Sebastian Beer – T2

PROJECT LEAD MANAGER: Sebastian Beer – T2

ESTIMATED BUDGET: \$299,607

BUDGET FOR ENDORSEMENT: \$299,607 (through FY25)

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I. PROJECT PURPOSE

Indonesia's tax-to-GDP ratio remains well below emerging market peers, reducing the government's capacity to pursue spending priorities. Over the past decade, tax revenue has declined from 12.5 percent of GDP in 2013 to 9.1 percent in 2021. Recent reforms, including the elimination of VAT exemptions and a hike in the standard VAT rate, somewhat improved revenue collections, but revenue needs remain elevated. With a tax-to-GDP ratio of 10 percent in 2023, Indonesia lags significantly behind other emerging market economies in Asia, which raise an average of 18 percent of GDP.

The authorities recognize the importance of structural reforms, including revenue reforms, and want to improve their tax policies. While early efforts to adopt a Medium-Term Revenue Strategy have not led to fruition, there is renewed interest in advancing tax reforms and mobilizing domestic revenue.

This new CD Project will provide support to increase the efficiency and revenue productivity of the tax system, enabling the implementation of Indonesia's development agenda. The Project will take stock of the current tax system, analyze regional disparities in economic growth and revenue generation, and provide recommendations to support revenue mobilization while ensuring that Indonesia's tax system is conducive to investment. As requested by the authorities, the first CD activity—expected to commence in March 2024—will focus on a general diagnostic of the tax system and assessment of its regional disparities. It will provide an opportunity to explore how FAD can assist the authorities in supporting Indonesia's medium-term revenue strategy.

This one-year project aligns with CD priorities agreed with the authorities for the medium term. The estimated budget for this one-year project is \$299,607 and endorsement is requested for the full amount through FY25.

II. BACKGROUND

Macro-fiscal situation

The Indonesian economy has emerged strongly from the pandemic but confronts an increasingly uncertain global economic environment. GDP growth is expected to moderate slightly, given tighter domestic policy settings and inflationary pressures are projected to subside. The fiscal performance has improved, restoring the pre-pandemic 3 percent of GDP deficit ceiling one year earlier. The authorities' 2023 budget targets a deficit of 2.8 percent of GDP. Revenues are expected to decline somewhat from the previous year due to lower commodity prices but otherwise track the cyclical recovery and continue to benefit from recent tax reforms, while expenditures are projected to fall, including on account of lower subsidies.

IMF priority areas / cross-cutting themes

The Project will help Indonesia improve revenue collections, thus enabling spending on priority areas, including health, education, employment, or regional disparities. The Project will also contribute to the country's efforts toward social and gender inclusion through support in improving the design and administration of personal income tax and VAT systems.

Country engagement and alignment to reform priorities

Indonesia is a surveillance country. The AD country team regularly engages with the authorities to support an inclusive and strong recovery and ensure continued macroeconomic and financial stability. FAD has not had significant CD engagement in the tax policy area in recent years.

The authorities recognize the importance of structural reforms and have started implementing tax administration and tax policy changes. The latter include finalizing the implementation of excise taxes on plastics and sweetened beverages by 2024 and increasing the VAT rate to 12 percent in 2025. The Project will help contextualize the implemented and tabled reforms and highlight remaining gaps. It will also support government priorities—the broad ones, i.e., domestic revenue mobilization, and more specific objectives, for example, promotion and diversification of downstream activities in the natural resource sector.

The Project is aligned with the objectives of the IMF CD strategy for Indonesia. The strategy aims to rebuild fiscal buffers by strengthening revenue mobilization and supporting structural reforms to boost productivity and facilitate the green transition by improving the tax system's efficiency. The Project will support these objectives by undertaking a general diagnostic and evaluating existing tax expenditures, including those directed at extractive industries' activities.

III. PROJECT LEVEL DESCRIPTION

A. Project Scope

This project will focus on tax policy, at least in its initial stage. It will support the authorities by taking stock of the tax system and providing context to recent and ongoing reforms. The authorities recognize the importance of structural reforms and of a fiscal strategy that clarifies budget objectives, risks, and contingency policies. However, recent reforms were implemented without the reach, rigor, synergy, and sustainability that is required for a medium-term revenue strategy.¹ The IMF's country team deems such a strategy necessary to support Indonesia's development agenda.

Module RM I / Tax Policy

The CD Project will cover Module I of the Revenue Component (Tax Policy). It will focus on assessing the general tax system and regional disparities, as agreed with the authorities. The CD will evaluate the revenue productivity and efficiency of the tax system, providing an in-depth analysis of major general- and local government taxes. In addition to providing a holistic analysis of the overall tax design, it will examine regional differences in revenue contributions and explore their potential drivers. The engagement will also provide an opportunity to assess the authorities' CD needs in other areas. These may include an in-depth evaluation of tax incentives, taxation of natural resources or overall support in revenue reforms in the medium term.

Table 1. Summary of Objectives Covered by the Proposal

Component	Module	Objective
Revenue	RM I / Tax Policy	• Improve Tax Policy Design • Strengthen Policy Monitoring, Evaluation, and Institutions

B. Country Engagement

FAD has not engaged with the authorities in the tax policy area since a joint mission on formulating a medium-term revenue strategy (MTRS) in 2018. While the authorities have not fully adopted the MTRS, several components included in the document have guided subsequent reform efforts. The authorities recognize the importance of a medium-term fiscal strategy to achieve their policy objectives. In April 2023, they requested CD support in assessing the efficiency and revenue productivity of the tax system on a regional level.

C. Delivery Modalities

The CD delivery will mainly be undertaken in-person to establish strong relationships and to overcome the time difference. Moreover, country authorities in Asia and the Pacific are keen to revert to in-person missions which they deem to be more effective in enabling hands-on trainings, cross-agency

¹ See Luis Breuer et al. (editors), 2018, *Realizing Indonesia's Economic Potential*, International Monetary Fund. Specifically, Chapter 6, Implementing a Medium-Term Revenue Strategy, by Ruud de Mooij, Suhasil Nazara, and Juan Toro.

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collaboration, and ownership building. Virtual meetings will be used for pre-engagement meetings and post follow-up meetings. The following CD activities will be delivered:

- **Headquarters-led (HQ) missions and staff visits** to provide strategic recommendations, conduct regular follow-ups, assess progress, coordinate with other TA providers, and adjust reform implementation plans.
- **Short-term expert (STX) visits** to help implement the recommendations delivered by the HQ missions; a limited number of STXs will be assigned to provide specialized assistance in specific areas of revenue administration.

D. Coordination / Cooperation

FAD is coordinating closely with the Ministry of Finance and the area department in preparation for the first engagement. Such coordination is used to identify CD priorities for surveillance and program activities, which has helped further strengthen collaboration between HQ and RCDCs. Staff from FAD have participated in surveillance missions for Indonesia, and country team members are involved in key CD missions. In addition, country teams, RCDCs, and functional CD departments have worked with the authorities to address their specific inquiries that have helped aid their policy formulation and catalyze strong CD ownership.

The project will also coordinate activities closely with other development partners to seek synergies and avoid duplication.

IV. RISK ASSESSMENT AND MITIGATION

Project risks based on the assessed probability and impact on the achievement of the expected results.

General or Module	Description	Probability	Impact	Mitigation Measures
External climate/conditions				
General	Risk that external events create a more challenging environment to implement reforms.	Medium	Medium	Ensure sufficient flexibility in program execution across countries and allow for ability to adjust activities in the case of adverse events.
Political Support				
General	Lack of political support for reforms inhibits required actions or resources being allocated that are needed to enhancements to fiscal risk management institutions and practices.	Medium	Medium	A Fund coordinated approach with the country team to help track progress, get political support for reforms, and resolve key obstacles to sustained revenue performance.
Management and Technical Staff Support and Commitment				
RM I / Tax Policy	Low commitment of management and staff in finance and other ministries to adopt and implement fiscal risk management practices.	Low	Low	Engage with senior management and technical staff pro-actively and explain their role in driving reforms. Ensure frequent engagement to maintain momentum and rekindle commitment where needed.
Resource Adequacy				
RM I / Tax Policy	Insufficient technical capacity and human resources necessary to implement reforms are limited.	Low	Low	Prioritize CD to priority or highest risk areas where resources are limited.
Other Risks				
RM I / Tax Policy	Multiple donors providing technical assistance, leading to overlaps and/or conflicting advice.	Low	Low	Take an active role in engaging with other donors to ensure support is well coordinated.

V. CD DELIVERY PLAN COUNTRY LEVEL

Table 2. Summary of Indicative CD Delivery

CD Modalities (Remote or Field-based CD)	Total for FY24	Total for FY25	Total for FY26	Grand Total
RM I / Tax Policy				
HQ-led CD mission (2-week)	1	1	-	2
STX visits	-	1	-	1

Table 3. First Year Workplan

Timing	CD Delivery		Proposed Topics of CD
RM I / Tax Policy			
FY24 – Q4	HQ mission (FB)	1 staff, 2 STXs	General diagnostic and assessment of regional disparities
FY25 – Q2	STX (FB)	1 STX	Follow-up advice and further engagement
FY25 – Q4	HQ mission (FB)	1 staff, 2 STXs	Further advice on, implementation and operationalization of select recommendations by FY24HQ mission

VI. PROGRAM FINANCIALS

	FY24 Q4	FY25	TOTAL (USD)
Direct Delivery	137,934	142,072	280,006
Module RM I - Tax Policy	137,934	142,072	280,006
Module RM II - Revenue Administration	0	0	0
Module SM I - Spending Policy	0	0	0
Module SM II - Managing Public Finances	0	0	0
Subtotal	137,934	142,072	280,006
Trust fund management fee (7%)	9,655	9,945	19,600
TOTAL	147,590	152,017	299,607

The estimated budget for this one-year project is \$299,607 and endorsement is requested for the full amount through FY25.

ANNEX I. REVENUE MODULE I – TAX POLICY

A. Program Objectives

The objective of the Project is to support an increase in the revenue productivity and efficiency of Indonesia's tax system, and to explore causes for regional disparities.

In particular, the CD activities will focus on: (i) evaluating the revenue performance of major taxes over the past decade and identifying causes for their change (decline) over time, (ii) identifying revenue gaps of different taxes relative to international peers; (iii) analyzing sectoral contributions to value added on a regional level and the importance of sectoral value-added for regional revenue generation, (iv) assessing regional promotion strategies (tax incentives) and suggesting options for an improvement in their design, and (v) assessing the authorities' CD needs in tax policy area.

B. Expected Results (outcomes)

This CD Project aims to obtain the following results:

- Increased tax revenue quantity (tax revenue increases on account of new and/or revised policies and adoption of laws implementing them).
- Improved economic efficiency (economic distortions stemming from various taxes are reduced on account of improved tax design as implemented by new laws).
- Increased institutional capacity (authorities' ability to assess and monitor tax policies increases).

C. Targeted Logical Framework – TAX POLICY

Objective	
Improve Tax Policy Design	
Outcome(s)	Indicator(s)
Increased/decreased revenue quantity	Laws implementing amendments to raise revenue are passed
	Revenue change
Increased economic efficiency by minimizing economic distortions or addressing externalities or market failures	Adopt legislation that reduces economic distortions.
Objective	
Strengthen Policy Monitoring, Evaluation, and Institutions	
Outcome(s)	Indicator(s)
Improved structures (e.g., tax policy units) or capacity (e.g., models and tools) related to tax policy advice and analysis.	Improved models to evaluate tax policy adopted
	Tax policy and analysis unit is strengthened or set up