SM/07/224
Correction 1

July 31, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Indonesia—Selected Issues**

The attached correction to SM/07/224 (6/27/07) has been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 77, last bullet, lines 1–3: for "A land and building tax could be considered, with property assessed on an annual basis and the taxable value allowed"
read "An increase in the land and building tax could be considered. Properties are assessed on an annual basis and the taxable value does not exceed 40 percent although they are allowed"

Questions may be referred to Mr. Zavadjil (ext. 38730), Ms. Thacker (ext. 37464), and Mr. Reichold (ext. 39974) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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- could be higher, depending on the implementation of tax incentives included in the tax package and the investment law.

- **Lower Oil and Gas Revenues.** These are expected to be halved to about 3 percent of GDP in 2012, or about 18 percent of total revenues. These projections assume oil prices declining to US$63 a barrel (a 25 percent reduction in real terms) and some increase in oil production reflecting the coming on line of the Cepu Oil field[74]. The impact of lower oil prices on fiscal space would be offset by lower subsidies and transfers to regions.

- **The need for continued fiscal discipline.** The overall fiscal deficit is expected to fall slightly below 1 percent of GDP by 2012, allowing for continued reduction in the debt-to-GDP ratio (to about 26 percent of GDP). Such a policy would help to keep public debt sustainable even in the event of severe macroeconomic shocks.

135. **Several options are available to create fiscal space at the central government level without higher fiscal deficits.** The government is focusing on its continuing program to improve tax administration, which is expected to increase revenues by at least 0.2 percent of GDP a year following the modernization of medium taxpayers offices and the revamping of audit procedures—this yield is included in the baseline scenario shown in Table VI.4. However, as efforts to improve tax administration are likely to take effect only gradually, another option would be to increase non-oil and gas tax revenues, which are still low by international standards. Over time, additional yields of at least 1 percent of GDP on an annual basis (staff estimates) could be generated through:

- **Limiting VAT exemptions.** VAT, with a single 10 percent rate, is a major source of revenue for Indonesia, currently accounting for about 20 percent of revenues. However, many products continue to be exempt, including under upcoming legislation. The removal of a number of exemptions could be considered as a VAT is most effective when applied to virtually all goods and services at a uniform rate. Examples include mining, electricity (only households with meter capacity above 6,600 watts are taxed), agriculture, clean (piped) water, hotels and restaurants. Removing such exemptions could increase revenues by about 0.3 percent of GDP (staff estimate).

- **Adjusting property tax rates**. An increase in the ~~A~~ land and building tax could be considered~~,~~. ~~with property~~ Properties are assessed on an annual basis and the taxable value does not exceed 40 percent although they are allowed by law to be equal to 20–

[74] The decline appears large relative to output, as nominal GDP is expected to almost double by 2012. Projections for 2012 assume the same cost oil assumptions as those used in the 2007 budget.

100 percent of the assessed value. Currently, the annual component of land and building taxes produces relatively little revenue (about 0.4 percent of GDP), with most of the intake coming from industrial sectors, such as mining.

- **Introducing a fringe benefits tax.** The main source of non-oil and gas revenues in Indonesia are income taxes, mostly personal and corporate income taxes. Under the 1983 income tax reform, in-kind fringe benefits (company provided housing, motor vehicles, etc.) are not taxed and companies are no longer allowed to deduct the cost of these benefits. Some countries (e.g., New Zealand or the Philippines) have dealt with the problem of in-kind fringe benefits by imposing a separate fringe benefits tax usually at the highest marginal tax rate for individuals. All employers are subject to this tax, including loss making firms, as it is imposed in lieu of taxing employees directly on their fringe benefits. Such a measure, especially if the tax is charged at the highest marginal rate for individuals (and paid by all employers), could result in sizable revenues in Indonesia.[75]

136. **The rationalization of current expenditures could also provide additional room for priority spending.** Indonesia has a very uneven distribution of expenditures. Spending on interest, subsidies, personnel (outside of education, and health) and government apparatus and supervision, represents about one-half of all government expenditures. That trend is expected to continue in the future, thus limiting priority spending on infrastructure, health, and education.[76] According to staff estimates, efficiency gains, along with an elimination of the energy subsidies, could expand fiscal space by an additional 1.5 percent of GDP:

- **Efficiency of spending.** Substantial savings in expenditures could materialize through efficiency gains though they are difficult to quantify. For example, in both the health and education sectors, the most immediate challenge is to better coordinate across all levels of governments to avoid duplication of tasks. Another challenge in the health sector would be to channel spending to areas of most benefit to the poor. Currently, health resources are mostly directed to services predominantly used by higher income quintiles, or for salaries of health providers (World Bank, 2007). In addition, improvements in the procurement process and a simplification of budget execution procedures could reduce costs associated with project preparation and

[75] Potential valuation methods for fringe benefits could typically include the rental value of housing owned or rented by employer, percentage of the cost of the vehicle or school fees provided to the employee. It was not possible to calculate the potential revenue impact given the lack of information on in-kind benefits.

[76] While education and health functions have been devolved to local governments, about 60 percent total development expenditures in these sectors still comes from central government.