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IEP | INDONESIA ECONOMIC PROSPECTS

Funding Indonesia's Vision 2045

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Preface

The Indonesia Economic Prospects (IEP) is a bi-annual World Bank report that assesses recent macroeconomic developments, the outlook, and risks, as well as specific development challenges for the Indonesian economy. In doing so, the IEP aims to inform the public policy debate and is geared towards a wide audience, including the general public, the government, the private sector, civil society organizations, and other domestic and international stakeholders.

The IEP is a product of the World Bank Jakarta office and receives strategic guidance from an editorial board chaired by Carolyn Turk, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade and Investment (MTI) Global Practice team, under the guidance of Lars Christian Moller (Practice Manager) and Habib Rab (Lead Economist). The report is co-led by Wael Mansour (Senior Economist) and Rong Qian (Senior Economist).

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Part B was prepared by Rong Qian and Ray Christopher Gomez, with contributions from Indira Maulani Hapsari. It is based on the "Tax flagship report" (World Bank, forthcoming 2025). Part B benefited from the comments of Habib Rab and Wael Mansour and was peer reviewed by Fernando Blanco (Senior Economist).

This report is available for download in English and Indonesian via: www.worldbank.org/iep
Previous report editions:

- June 2024: Unleashing Indonesia's Business Potential
- December 2023: Climate Action for Development
- June 2023: The Invisible Toll of COVID-19 on Learning

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Abbreviations

AFC	Asian Financial Crisis
ASEAN	Association of Southeast Asian Nations
BI	Bank Indonesia
BOS	Bantuan Operasional Sekolah
BPS	Badan Pusat Statistik
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CIT	Corporate Income Tax
CPI	Crude Price Index
CRM	Compliance Risk Management
DEA	Data Envelopment Analysis
DGT	Directorate General of Taxes
EAP	East Asia Pacific
EM	Emerging Markets
EMCI	Emerging Market Currency Index
EU	European Union
FDI	Foreign Direct Inflow
FX	Foreign Exchange
FSAP	Financial Sector Assessment Program
FSOL	Financial Sector Omnibus Law
GDP	Gross Domestic Product
GEP	Global Economic Prospects
GOI	Government of Indonesia
GVCs	Global Value Chains
HCI	Human Capital Index
IEP	Indonesia Economic Prospects
IMF	International Monetary Fund
JKP	Job Loss Guarantee Program
LAR	Loan at Risk
LCR	Liquidity Coverage Ratio
LICs	Low Income Countries
LMICs	Lower-Middle Income Countries
LPG	Liquefied Petroleum Gas
MOU	Memorandum of Understanding
MSMEs	Micro, Small, And Medium Enterprises
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
OSS	Online Single Submission
PROA	Pretax Return on Assets
ROA	Return-on-Assets
ROE	Return-on-Equity
SOEs	State-Owned Enterprises
SRBI	Sekuritas Rupiah Bank Indonesia
TFP	Total Factor Productivity
THL	Tax Harmonization Law
UMICs	Upper-Middle Income Countries
UNESCO	United Nations Educational, Scientific, and Cultural Organization
VAT	Value-Added Tax
VTTL	VAT Total Tax Liability
WBES	World Bank Enterprise Survey
WDI	World Development Indicators
YOY	Year-on-year

Executive Summary

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Executive Summary

I. Economic Update

Indonesia's economy remains resilient, buoyed by strong domestic demand and a recovering service sector. GDP has grown at 5 percent during the year, supported by robust private consumption and government spending. The services sector, across the board, continues to be the main driver of growth, while manufacturing shows mixed results. Inflation has gradually softened as food and energy prices abated, with headline inflation dropping to 1.5 percent in November. This follows a rebound in agricultural production and moderating global oil prices. The labor market also demonstrated some resilience, with a reduction in overall unemployment and an increase in labor force participation especially for females. Yet, a sluggish recovery in real wage and middle-class job creation especially for youth remain a challenge.

The current account deficit widened, driven by moderating terms of trade and cyclical factors that intensified services and income outflows. The goods trade surplus narrowed due to declining commodity prices and a relaxation in some import restrictions. Meanwhile, rising travel imports widened the services trade deficit. Despite these developments, global monetary easing and stable macro conditions in Indonesia have accelerated capital inflows, bolstered foreign currency reserves, and relieved pressures on the Rupiah. Meanwhile, the banking sector prudential indicators remain sound, but there remains room to improve financial sector depth.

After two years of consolidation, the fiscal policy stance loosened slightly. The fiscal deficit in 2024 is estimated to widen to 2.7 percent of GDP, up from 1.6 percent in 2023. This shift is attributed to declining commodity and taxes revenues combined with rising spending on social assistance and infrastructure projects. Despite the widening deficit, the public debt stock dropped slightly to 38.5 percent of GDP, with most of the debt denominated in Rupiah, thus reducing exchange rate risks. However, rising debt service costs, estimated to reach 4.9 percent of GDP in 2024, highlight the need for greater revenue mobilization to maintain fiscal sustainability and support growth-oriented spending.

Meanwhile, Bank Indonesia (BI) has been incrementally easing its policy stance while managing currency stability. In September, BI reduced its policy rate by 25 basis points to 6.0 percent, leveraging global monetary easing trends. To mitigate currency pressures, BI continued issuing high-yielding monetary instruments, such as the SRBI, which attracted significant foreign capital. Additionally, BI introduced new macroprudential incentives to promote private credit expansion, including reducing reserve requirement ratios for specific sectors. These measures boosted private sector credit growth, aligning it with BI's target range of 10-12 percent.

The economic outlook remains stable and is subject to balanced risks. Indonesia's economy is projected to grow at an average 5.1 percent over 2024-2027, supported by a boost in public consumption and investment as the new administration gradually implements part of its social assistance and investment programs. Inflation is anticipated to stay within BI's target band but may rise due to robust domestic demand and an anticipated VAT rate hike. The current account deficit is projected to widen, with FDI remaining a key source of external financing. Fiscal policy is projected to adhere to the fiscal rule, with the budget deficit averaging 2.6 percent of GDP over the outlook, supported by tax reform. However, elevated borrowing costs are also expected to keep interest payments elevated at around 2.2 percent of GDP. The outlook is subject to balanced risks. Downside risks include heightened geopolitical tensions, and a potential delay of fiscal and structural reform. Upside potential includes a stronger-than-anticipated recovery in major trading partners and favorable swings in key commodity prices.

Sustained acceleration in economic growth will require structural reforms to boost productivity. The Indonesian government aims to achieve high-income status by 2045 and targets an 8 percent of GDP growth by 2028 through a significant stimulus of aggregate demand. This strategy involves boosting significantly private investment in various sectors, over the 5-years mandate, and implementing fiscal stimulus focused on 17 priority programs, including several social protection initiatives. The strategy also involves a tax reform to finance all these fiscal programs while adhering to the fiscal rules. The report simulates the impact of this strategy on Indonesia's medium-term growth. Findings suggest that the impact of this demand boost depends on accompanying structural reforms. Without reforms, the economy may face steep inflation and other macroeconomic imbalances. However, combining demand stimulus with productivity-enhancing reforms could sustain high growth for a longer period and maintain macroeconomic stability.

Indonesia's long-term growth and job creation are closely linked to its progress in competitiveness reforms, which can be categorized into foundational, efficiency, and innovation reforms. Advanced upper-middle-income countries require all three types of reforms to sustain competitiveness. Indonesia has excelled in foundational reforms, enabling resource shifts to non-agriculture sectors. However, the country lags high-performing peers in efficiency reforms. This limits resource reallocation to more productive industries and firms. To boost its growth potential, Indonesia needs to invest in human capital, social protection, and accelerate domestic revenue mobilization (foundational reforms). Financial deepening, trade policy reforms, and investment openness, are essential for driving productivity growth (efficiency reforms). Despite significant steps, further efforts are also needed to address bureaucratic inefficiencies and inconsistent regulation enforcement to attract investment in high-value-added sectors.

II. Funding Indonesia's Vision 2045

Indonesia needs to significantly increase tax revenues to investment in human and physical capital to achieve its high-income status ambitions. The country's public capital stock (i.e., assets in transport, utilities, and health and education facilities) and human capital index (health, nutrition, and education outcomes) lag regional and structural peers, falling far short of advanced economies. Closing these gaps could enhance productivity growth and support the sustained 6 percent growth required to reach high-income status by 2045. However, the investment needed is substantial. A significant portion of this must be financed through increased tax revenues, as a substantial rise in debt would be risky and would violate statutory caps on deficit and debt levels.

Significant additional revenues can be generated by addressing the country's tax gaps, particularly in VAT and CIT. Indonesia's 2023 tax ratio of 10.2 percent of GDP is among the lowest compared to regional peers, the middle-income average, and other large emerging markets. Cross-country analysis suggests that Indonesia's tax collection is at least 6 percentage points of GDP below that of comparable countries. Between 2016 and 2021, Indonesia's foregone tax revenues from VAT and CIT averaged 6.3 percent of GDP. This shortfall resulted from a combination of policy design and compliance challenges. Special regimes, exemptions, and tax breaks significantly narrowed the tax base, while widespread tax evasion and weak enforcement mechanisms undermined compliance.

Weak compliance is a key factor in Indonesia's low tax revenue collection, with tax evasion prevalent among formal firms. At least a quarter of Indonesian firms engage in some tax evasion, with certain firm characteristics driving noncompliance. Tax evasion is more widespread among non-exporters, firms which report tax administration as a major burden, and firms which face strong informal competition. About half of firms report that it is easy to avoid paying CIT or VAT, while many consider compliance unduly complicated, especially among small businesses. These challenges reflect weaknesses in both tax administration and poor incentives for voluntary compliance, driven by complexity and low tax morale.

Indonesia's tax administration has significant opportunities to strengthen compliance enforcement and improve overall efficiency. By increasing the frequency and effectiveness of audits, the system can better identify and address tax evasion. Enhancing the enforcement process to efficiently manage outstanding tax liabilities will further boost revenue collection. Streamlining taxpayer dispute resolution and addressing regulatory ambiguities

can help foster trust and transparency. Additionally, improving access to timely third-party data presents a valuable pathway for the tax authority to enhance audit quality and enforcement efforts.

Developing Indonesia's financial sector could play a critical role in improving tax compliance by enhancing information transparency and encouraging formalization. Research shows that countries with developed financial markets collect more taxes. Formal financial systems help track activities, declare assets, and reduce tax evasion. In Indonesia, where the financial sector is shallow, expanding access to credit and financial tools could improve compliance. Firms using formal bank financing for at least 50 percent of their needs find it harder to evade VAT or CIT. However, distrust in formal systems discourages businesses from using banking transfers, making enforcement harder. Additionally, financially constrained firms may engage in aggressive tax planning or evasion to manage cash flow, underlining the financial sector's critical role in promoting compliance.

Overall, increasing tax revenues will require reforms that widen the tax base, improve tax administration, and address structural constraints to compliance. Reforms to widen the tax base could lower the registration threshold for VAT to align with middle-income country norms, which also applies to the temporary final tax for MSMEs. Meanwhile, a permanent final tax regime could be introduced for MSMEs below the threshold. Special CIT treatments, such as for construction services, publicly listed firms, and non-standard VAT exemptions, may be phased out gradually. Tax incentives need to become more strategic, time-bound, and systematically reviewed. Improving compliance requires better risk management, using high-quality third-party data and integrating fragmented government systems. Simplifying and clarifying VAT regulations can reduce disputes and administrative burdens. Lastly, addressing structural constraints involves deepening financial sector depth, which is expected to have the secondary effect of facilitating compliance through improved information and formalization.

A. Economic Update

A. Economic Update

1. Recent Economic Developments

Indonesia's growth remains resilient buoyed by strong domestic demand and recovering service sectors.

Global growth is stabilizing at a low pace, with high risks clouding global conditions. This year, global growth has stabilized at 2.6 percent, holding steady for the first time in three years despite widening geopolitical tensions and high interest rates. Supported by a resilient US economy, the global economy appears to be in a "soft landing" mode. However, global growth remains nearly half a percentage point (ppt) below its 2010-2019 average pace (World Bank GEP). Many developing economies still face high debt, slow investment growth, and climate-related challenges. The East Asia and Pacific (EAP) region, growing at 4.7 percent, continues to outperform the rest of the world, supported by a rebound in global goods trade, continued recovery in tourism, and buoyant domestic demand (World Bank EAP update). However, in China, economic activity has moderated amid subdued consumer confidence and weakening consumption growth. This adds to the numerous challenges confronting the global economy, including tight monetary policies, restrictive financial conditions, geopolitical tensions, and a decline in productivity growth, especially among emerging markets (EM).

Indonesia's GDP growth remains resilient, supported by strong domestic demand. The economy continued to grow at around 5 percent over the first three quarters of 2024 (3Q-24). A rapid deceleration in inflation has supported consumer confidence and retail sales, which have surpassed pre-pandemic levels. Private consumption contributed to a sizeable 55 percent of growth (Figure A.1). Government consumption also expanded, contributing 10 percent to overall growth, in line with rising public spending on social assistance programs and election-related expenditures in 2024. Meanwhile, investment through downstream activities in the mining sector, as well as construction activities in transport, warehouses, and communication sectors, contributed 27 percent of growth (the same as in 2023). These positive developments have compensated for the weak outcome of net exports, which resulted from moderating terms-of-trade and commodity prices coupled with a rebound in imports.

The services sectors continue to grow while manufacturing shows mixed results. The services sectors continue to be the main driver of growth. Low value-added services were up by 6.3 percent in 3Q-24 (year-over-year, yoy) as the retail & wholesale and hospitality sectors benefitted from robust consumption (both private and public) (Figure A.2). High value-added services also grew by 6.7 percent (yoy). This growth is attributed to investment in ICT, real estate, and business services sectors, as well as growth in the financial sector, with banks reporting rising lending and profitability. Manufacturing performance was more mixed. Commodity-based manufacturing and the construction sector have witnessed robust growth linked to downstreaming and the completion of major infrastructure and transport projects. Meanwhile, tradeable manufacturing growth has moderated, especially as sectors like textiles have experienced a loss in market share and large layoffs.

Figure A.1: Growth remains resilient in 2024 driven by robust domestic demand
(percentage point contribution to yoy growth)

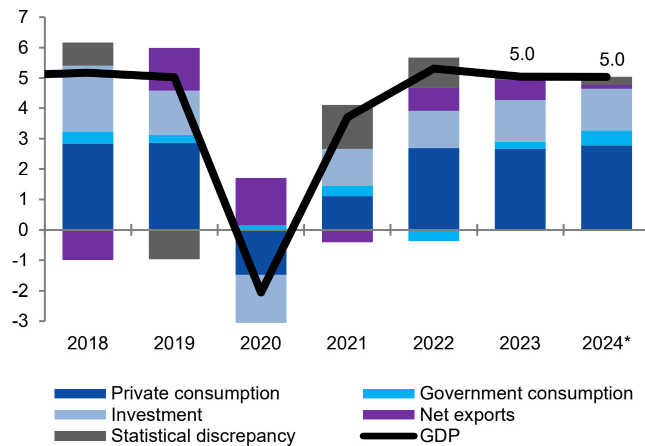
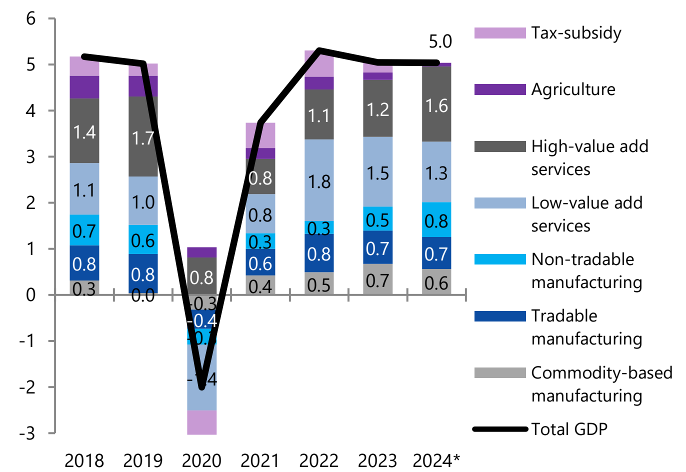


Figure A.2: Services remain the main driver of growth whilst manufacturing shows mixed results
(percentage point contribution to yoy growth)



Source: BPS, World Bank staff calculations.
Note: *2024 is for 3 quarters (3Q-24). High-value-add services are ICT, financial & insurance, real estate, business, public admin, defense & social security, education, health, and other services. Low-value-add services are retail & trade, transport & storage, and hospitality. Non-tradable manufacturing are utilities and construction. Tradable manufacturing is manufacturing excl. commodity-based industries. Commodity based manufacturing is mining & quarrying, coal and O&G refinery, rubber products, non-metallic quarrying, and basic metals manufacturing.

Despite Rupiah volatility, inflation gradually softened as food and energy prices abated.

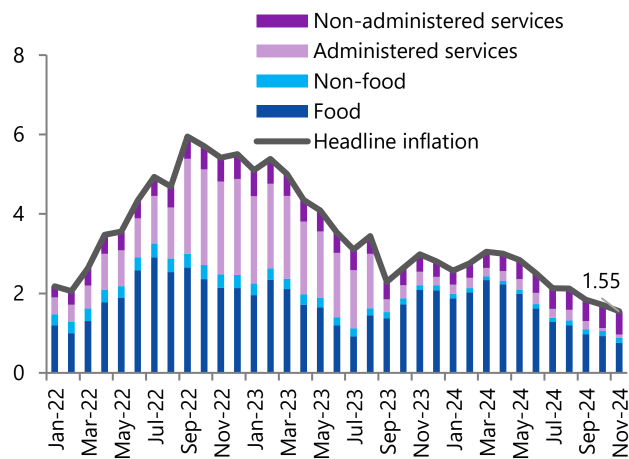
After accelerating in the first half of 2024, inflation gradually softened as food and energy prices abated. Headline inflation dropped to 1.5 percent in November (yoy), the lowest since July 2021 (Figure A.3). Such disinflation reflects a rebound in agricultural crop production, notably in grains, horticulture, and rice, following favorable weather conditions. Furthermore, moderating global oil prices, coupled with fuel subsidies and government policies to reduce air transport fares to priority tourist destinations, have stabilized overall transport prices. As a result, administered inflation eased to 0.8 percent (yoy), its lowest since August 2021. Meanwhile, core inflation edged up to 2.3 percent, from 1.7 percent earlier this year, amid rising prices for services, education, and personal care. This also reflects a narrowing gap between actual and potential economic output.

The distribution of price increases across CPI components shows broad-based disinflation, with narrowing of inflation drivers around non-tradeable services. Throughout 2024, no CPI components experienced price hikes exceeding 8 percent, unlike in 2022 and 2023 when rising commodity prices spilled over across the consumption basket (Figure A.4). From January to April 2024, on the other hand, prices for 70 percent of the CPI basket rose by up to 4 percent, while the remaining items (primarily food, beverages, and tobacco) increased by 4 to 8 percent. Between May and July, 60 percent of the basket saw prices rise by 0 to 4 percent, while 40 percent rose between 4 to 8 percent in mostly non-tradeable services. By the latter half of the year, the share of CPI components with price increases above 4 percent declined to 16 percent, reflecting rapidly moderating food and energy prices and broad-based disinflation.

Currency volatility has had a limited impact on inflation due to imperfect market transmission mechanisms. Analysis reveals that the exchange rate passthrough to inflation is minimal[1]. A 1 percent depreciation in nominal effective exchange rate (NEER) leads to an instant increase in the CPI by just 0.03 ppt[2]. The effect is depicted across two quarters and then dissipates throughout the year. The finding points to an imperfect market transmission mechanism. These market distortions could mostly be linked to government price controls and subsidies, especially in the food and energy markets, which constitute the largest share of the CPI basket. This also echoes previous findings on delays in passing through price shocks from producers

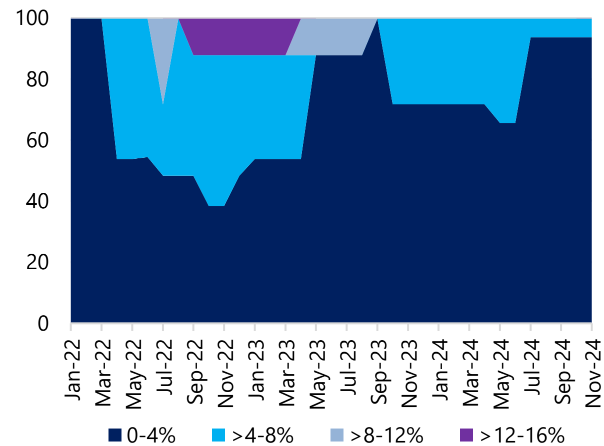
[1] The report uses a Structural Vector Autoregression (SVAR) model to assess the passthrough of nominal effective exchange rate (NEER) to headline inflation (CPI). The model also accounts for domestic demand growth, global oil price and Bank Indonesia's policy interest rate. Quarterly data is used from Q3:2005 to Q2:2024.
[2] Estimates of SVAR with two lags show these variables are statistically significant in causing responses on inflation. In contrast, global oil and NEER shocks are statistically insignificant to lead a response on inflation.

Figure A.3: Inflation has gradually softened, as pressure from food prices abates
(percentage point contribution to yoy growth)



Source: BPS, World Bank staff calculations.

Figure A.4: Inflation was broad-based in 2024 although softer than 2023
(Percent share of CPI basket)



Source: World Bank staff estimates.
Note: the y-axis refers to the share of CPI components whose price increase reached a specific bracket. Brackets are determined by color

to consumers (see IEP December 2022). Simulations also reveal that CPI is mostly sensitive to past inflation episodes[3]. More than 85 percent of the CPI change in the first year after a shock is explained by a change in headline inflation a quarter before. This effect moderates afterwards, with demand growth and BI policy rate becoming more prominent. Together they account for 13 percent of inflation variation. BI policy rate impact on inflation is most likely explained by its effect on inflation expectations.

While the labor market has shown overall resilience, middle class job creation especially for youth remains a challenge.

Indonesia's labor market demonstrates resilience, marked by a reduction in overall unemployment and an increase in labor force participation, though youth employment remains a concern. The unemployment rate dropped from 5.3 percent in August 2023 to 4.9 percent in August 2024. The labor force participation rate increased to 70.6 percent, driven by a 2 ppt rise in female participation to 56.4 percent. Yet, low youth labor force participation (49.6 percent) and a high youth unemployment rate (17.3 percent) highlight the need to focus on job creation and skill development for this demographic.

The growth in real wages has stagnated, particularly in labor-abundant sectors such as construction and manufacturing. The average monthly nominal wage rose by 3.3 percent (yoy) to IDR 3,040,719 whilst the average monthly real wage saw a modest drop, down 2.6 percent, now standing at IDR 1,393,562. The construction and manufacturing sectors have faced the most substantial real wage losses in the past year, at 9 percent and 4 percent, respectively.

The Indonesian economy continues to struggle to generate enough middle-class jobs. As of August 2023, only 8.4 percent of jobs in the labor market are classified as middle-class jobs, a significant decrease from 14 percent in 2019, prior to the COVID-19 pandemic. Instead, a significant proportion, 39 percent of jobs, are earning "aspiring middle-class" wages in 2023. This points to overall productivity and job creation concerns, as middle-class jobs are often associated with higher productivity and pay.

Supporting those in the aspiring middle-class category is particularly pertinent given recent job losses in the textile and manufacturing industries. According to the Ministry of Manpower, job losses due to employment termination more than doubled from 25,114 in 2022 to 64,855 in 2023. The highest peak was in November 2023, with 12,347 layoffs. Most job losses were concentrated in West and Central Java and Banten, provinces known for their significant contribution to Indonesia's manufacturing base. Historically, the manufacturing sector has been particularly susceptible to worker layoffs, potentially due to declining competitiveness[4].

[3] Variance decomposition of the forecast error (Forecast Error Variance Decomposition or FEVD) for each endogenous variable at different time horizons
[4] In 2018 and 2019, 44 percent and 47 percent of workers reporting employment termination in labor force surveys were in manufacturing. Although this share decreased in 2021 and 2022, it has since returned to 2018 levels.

Indonesia's current account deficit widened as terms of trade moderated and cyclical factors slightly intensified services and income outflows.

Moderating terms of trade and a relaxation in import restrictions reduced the goods trade surplus. Declining commodity prices have dampened export growth and offset higher demand for Indonesian metals exports, namely iron, steel, and aluminum (Figure A.5). Consequently, goods exports grew at a slower pace than imports, 6.4 percent compared to 8.6 percent respectively (yoy) (Figure A.6). Rising overall investment and private sector credit meant that processed intermediate goods drove imports acceleration. This follows a partial reversal of import restrictions on a wide range of goods, including those used for producing clothing, bags, footwear, and electronics[5] (Figure A.7). Imports of primary intermediates for the food industry also increased modestly, reflecting the government's measures to stabilize food prices such as expanding rice imports quotas and quotas of other select food items. As a result, goods trade surplus narrowed to 1.6 percent of GDP for the year-to-September, down 0.4 percentage points from the same period in 2023.

Cyclical factors have slightly intensified outflows from services and income accounts. The first factor is the Hajj season in June, which saw a 10 percent rise in the number of pilgrims compared to 2023. Rising travel imports widened the services trade deficit, up by 0.1 percent of GDP (year-to-September, yoy). Meanwhile, dividend payment and profit repatriation for foreign investors moderated after June, keeping the income account deficit almost at par with the same period last year. Indonesia's primary income deficit reflects profit repatriation by foreign companies, especially those in the commodity sectors. This is typical among resource-rich developing countries. Coupled with a deteriorating trade balance, these outflows led to a widening of the current account deficit (CAD). Year-to-September data reveals a deficit of 0.6 percent of GDP, up from 0.1 percent of GDP over the same period in 2023 (Figure A.8). With the end of the commodity boom cycle, the current account balance has returned to a deficit but remains below pre-pandemic levels (averaging 2.5 percent of GDP between 2012-2019).

Global monetary easing and stable macro conditions in Indonesia have accelerated capital inflows and helped lower the cost of financing amid rising external financing needs.

Global financial conditions eased over the second half of 2024 amid policy rate cuts in key advanced economies. In the US, declining inflation prompted the Federal Reserve to begin its easing cycle with a 50-basis point (bps) rate cut in September, followed by an additional 25-bps reduction in November. Consequently, market expectations of US policy rates have shifted, with rates anticipated to drop to 3 percent by the end of 2026, compared to 4 percent anticipated in June[6]. The European Central Bank and the Bank of England have also lowered their policy rates since June. This shift in monetary policy has eased global financial conditions, spurring a return of portfolio flows to emerging markets. Yet, policy rates globally remain much higher than pre-pandemic years, signaling continued high financing costs.

Figure A.5: Moderating terms of trade dampened exports growth
(contribution to percent yoy growth)

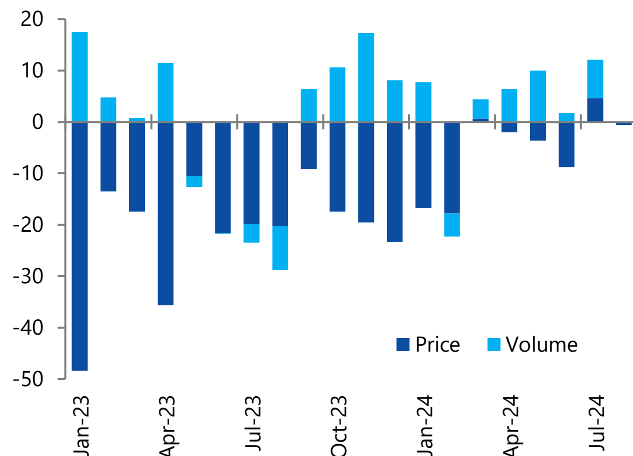
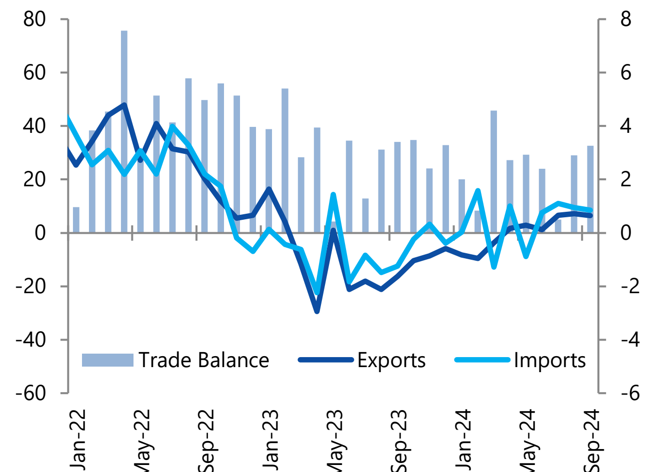


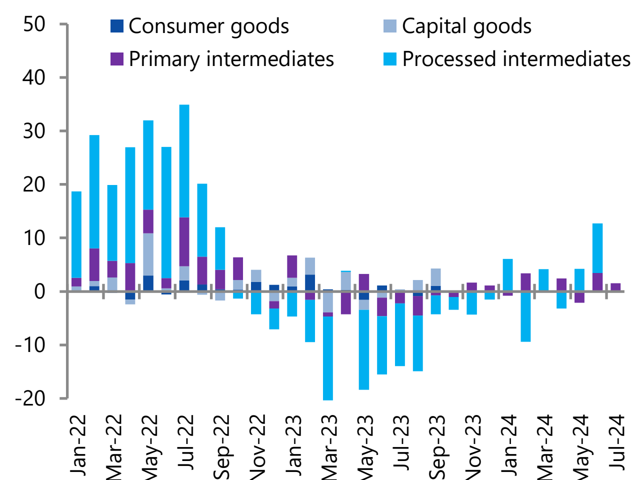
Figure A.6: Goods imports grew at a quicker pace than exports...
(percent yoy growth (LHS) and US$ billion (RHS))



Source: BPS, World Bank staff calculations.

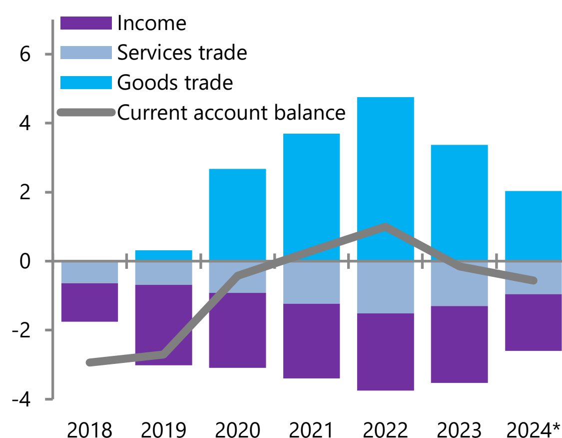
[5] Trade Ministry Regulation No. 8/2024 addresses the backlog of about 26,000 containers at Indonesia's major ports, caused by stricter import regulations introduced previously (Trade Ministry Regulation No. 36/2023).
[6] Policy rate expectations are derived from the Overnight Index Swap forward curve data, accessed as of June 1 and September 24, 2024.

Figure A.7: ...fueled by acceleration in imports of processed intermediate goods
(contribution to percent yoy growth)



Source: BPS, World Bank staff calculations.

Figure A.8: Current account deficit widened to 0.6 percent of GDP year-to-September
(percent of annual GDP)

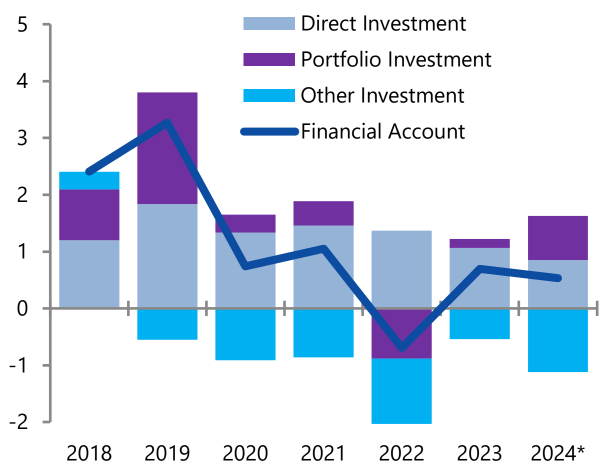


source: BI, World Bank staff calculations.
Note: *2024 is for 3 quarters (3Q-24)

Global monetary easing and stable macro conditions in Indonesia has accelerated capital inflows, bolstered foreign currency (FX) reserves, and relieved pressures on the Rupiah. Portfolio investment recorded net inflows of 0.8 percent of GDP by September 2024, compared to net outflows of 0.2 percent of GDP over the same period in 2023. Foreign direct investment (FDI) also recorded net inflows at 1.4 percent of GDP, up by 0.2 ppt compared to 2023. In contrast, other investments registered a net outflow of 1.1 percent of GDP as residents have increased financial asset purchases abroad[7]. Overall, the financial account turned into a surplus of 0.5 percent of GDP (Figure A.9), driving FX reserves up to a record of USD 151.2 billion in October. This level is adequate and covers 6.6 months of imports. As a result, the Rupiah performed relatively better than its peers. It depreciated by 2.5 percent year-to-November, less sharply than the 7.0 percent depreciation of JP Morgan's Emerging Market Currency Index (EMCI) (Figure A.10).

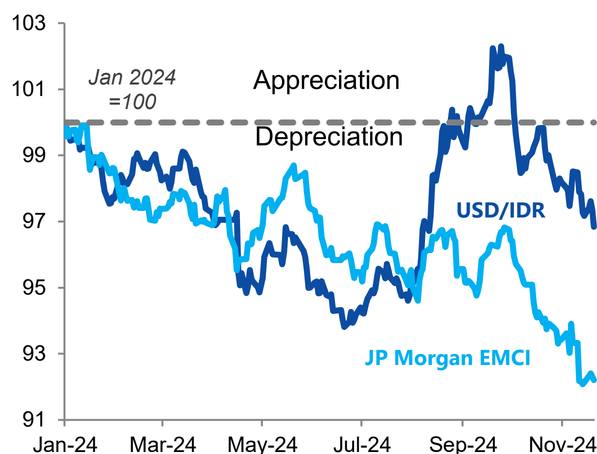
Global financial and Indonesia's stable macro conditions also combined into a significant drop in sovereign cost of financing. Spreads between US

Figure A.9: Healthy portfolio inflows led to a surplus in the financial account
(percent of annual GDP)



Source: BI, World Bank staff calculations.
Note: *2004 is for 3 quarters (3Q-24)

Figure A.10: Rupiah performed better than EM peers over the second half of 2024
(index, January 2024 = 100)



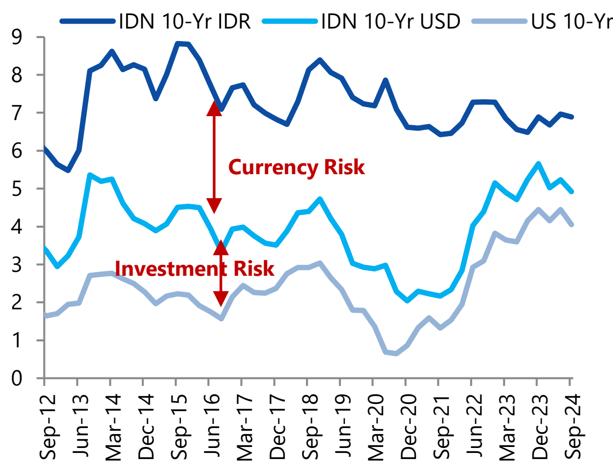
Source: BI, JP Morgan, World Bank staff calculations.

[7] These include loan assets, trade credits, currency and deposits abroad.

Treasury bonds and Indonesia's USD sovereign bonds fell, reflective of declining investment risk (Figure A.11). Spreads between Indonesia's USD sovereign bonds and Rupiah sovereign bonds also narrowed, reflecting declining currency risks (Figure A.12). In parallel, Indonesia's premia on risk of default on sovereign debt has declined and is now among the lowest compared to other emerging markets. Capitalizing on global monetary easing, fiscal authorities successfully issued dual-currency global bonds in September, raising EUR 1.6 billion and USD 1.8 billion[8].

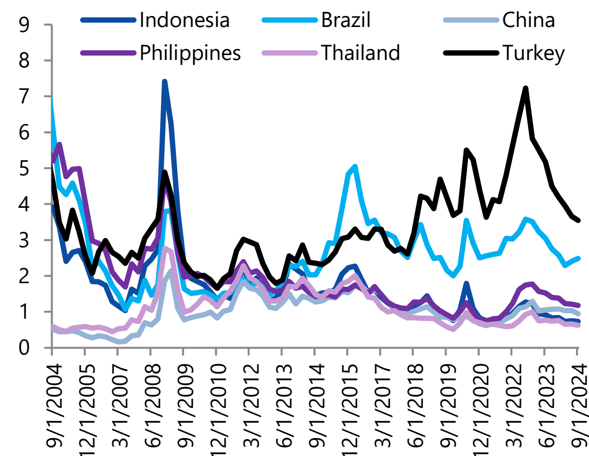
Rising external financing needs amid global uncertainty call for structural reforms to further boost FDI, Indonesia's largest source of external financing. A wider CAD and rising public debt amortization increase external financing needs. They are estimated at 3.3 percent of GDP in 2024, but still below the pre-pandemic average of 5.3 percent of GDP. FDI has been a steady source of external financing and has outperformed the more volatile and shorter-term nature portfolio investments. Structural reforms to accelerate FDI inflows become increasingly important, especially amid volatile global financial conditions.

Figure A.11: Favorable global conditions and stable macro conditions have helped reduce currency and investment risks for Rupiah sovereign bonds
(percent)



Source: Haver Analytics, Bloomberg.

Figure A.12: Indonesia's premia on risk of default on sovereign debt has declined and among the lowest compared to other emerging markets
(percent)



Source: Bloomberg.

Banking sector prudential indicators are sound but there is room to improve financial sector depth.

Bank asset quality is healthy, with banks having sufficient buffers to withstand potential adverse shocks while system-wide funding and market liquidity remain adequate. The non-performing loans (NPL) ratio was low at 2.2 percent as of September (Figure A.13). The capital adequacy ratio (CAR) stood at 26.9 percent, well above the regulatory minimum of 10.5 percent. The level of provisioning was at 192 percent of NPLs in August, providing ample loss-absorption capacity. Notably, the system-wide loan at risk (LAR) ratio[9] continued to trend down to 10.1 percent in September, much lower than its levels of over 20 percent during the pandemic[10]. Recent bank solvency stress tests suggest that the overall banking sector is resilient to multiple shocks, although there are tail risks for smaller banks (FSAP 2024). On the liquidity front, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), designed to gauge bank liquidity conditions in times of stress, stood at 223 percent and 130 percent, respectively, as of September 2024. Both are above the 100 percent regulatory minimum.

Banking sector profitability remains stable, as resilient lending growth rates continue to support the economy. In September, return-on-assets (ROA) and return-on-equity (ROE) stood at 2.7 percent and 14.7 percent, respectively, surpassing pre-pandemic levels. The banking sector continues to expand lending to the private sector. After almost three years of growth, lending to the private sector continued to expand by 10.9 percent in June (yoy). Moreover, the growth of loans used for investment has been outpacing the growth of loans used for consumption and working capital since March (Figure A.14). This outcome reflects the liquidity and macroprudential incentives used by BI to boost the economy.

[8] This marks the second issuance of Indonesia's SDG (Sustainable Development Goals) bonds denominated in Euro since 2021.
[9] LAR is a forward-looking indicator of bank asset quality defined as the sum of NPLs, restructured loans, and special mention loans.
[10] The nine largest banks saw a LAR level exceeding 20 percent between 2021-2022 but all have since seen continued improvement.

Nevertheless, the level of private credit is still relatively low and reflects structural constraints for financial deepening. Credit to the private sector was at 31.4 percent of GDP as of the end of 2023. This is one of the lowest ratios among peer EAP countries, which averaged 124 percent of GDP[11]. Low levels of private credit persist against a backdrop of a dominant banking sector with strong capital and liquidity positions. This follows limited incentives to target the riskier segments of the economy and preferences to focus on stability. Furthermore, a limited degree of competition in the banking sector and substantial pricing power by certain market players reduce intermediation efficiency and increase borrowing costs. Authorities have started tackling these structural constraints through the implementation of the financial sector omnibus law (FSOL), which remains key to tapping further into the sector's potential.

Access to financial services for underserved segments, including individuals and small firms, has been increasing but has room for further improvement. According to an unpublished 2023 National Socioeconomic Survey, 76.3 percent of Indonesians have an account with a formal financial institution, while 88.7 percent have used formal financial services. As of June, lending to micro, small, and medium enterprises (MSMEs) accounted for 19.6 percent of all bank lending. This is an increase from the lower baseline of 18 percent during the pandemic and marks an improvement in financial inclusion for the underserved segments of the economy. However, the 2023 Indonesia Enterprise Survey reveals that access to finance is considered the biggest obstacle to business by 29 percent of the surveyed firms, particularly small and medium firms (32 and 23 percent, respectively). In particular, the share of micro and small entrepreneurs who rely on savings to start or run their business is greater among women than men—64 percent vs. 55 percent, respectively[12]. Fintech and digital financial services have seen rapid expansion during the COVID-19 pandemic and have the potential to drive greater access to finance.

Borrowing costs and domestic funding conditions remain relatively stable, although funding costs are elevated relative to peers due to structural factors. Corporate bond issuance picked up in 2024. With risks largely contained and a resilient economic outlook, corporate borrowing costs remained stable. The 10-year AA corporate bond yield stood at 8.3 percent as of October, compared to 9 percent a year earlier. Taking a longer view, the capital market still lacks depth, with limited secondary trading happening in Indonesia compared to peers. Although the government securities market is relatively well-developed, the corporate bond and equity market segments remain shallow, offering limited choices for investors. The lack of demand from local long-term investors and a weak domestic investor base, including relatively small institutional investors, constrains market development and contributes to higher borrowing costs relative to ASEAN and emerging market peers[13].

Figure A.13: Banks asset quality is healthy, and have enough buffer to withstand adverse shocks
(percent)

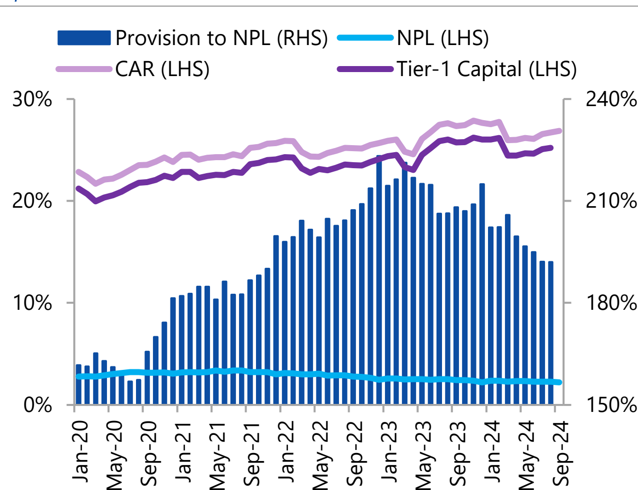
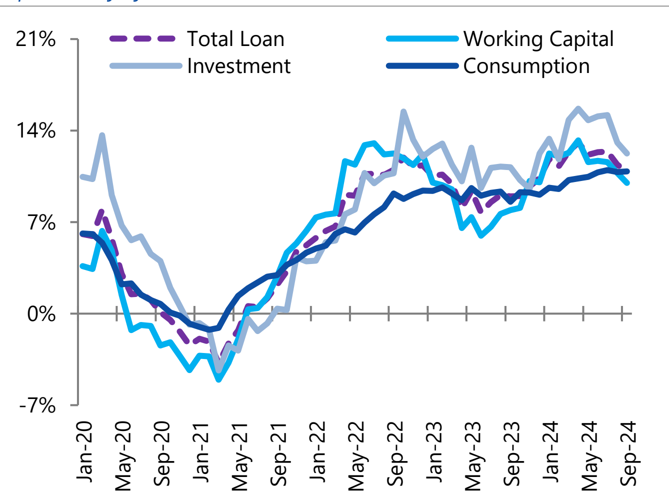


Figure A.14: Lending to the private sector continue to grow especially loans for investments
(percent yoy)



Source: The Financial Services Authority (OJK), World Bank Staff calculation.

[11] EAP peer countries used for comparison are Malaysia, Philippines, Thailand, and Vietnam (Finstat, 2020-2022).
[12] Opening Opportunities: The Economic Cost of Gender Gaps in Entrepreneurship in Indonesia. Washington DC: WBG. 2023.
[13] Peer countries with lower cost of borrowing relative to Indonesia, after controlling for other factors, include Malaysia. Thailand, the Philippines, Vietnam, as well as global peers such as Colombia, Hungary, Peru and Mexico. See Buzas et al (2021).

2. The Policy Stance

Falling commodity windfalls and a pick-up in social assistance and capital spending expanded the fiscal stance and raised debt service.

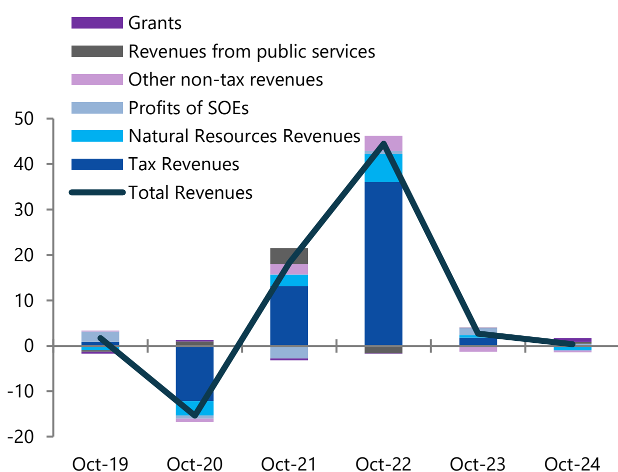
After two years of consolidation, the fiscal stance loosened slightly. With marginal growth in revenues and substantially rising spending, the fiscal deficit markedly widened to a 1.4 percent of GDP by October 2024 compared to a negligible deficit (0.01 percent of GDP) last year. By the end of the year, the Government of Indonesia (GoI) estimates that the deficit will reach 2.7 percent of GDP, exceeding the budgeted 2.3 percent, but remaining within the 3 percent fiscal rule.

Tax collections recorded marginal growth while natural resource revenues contracted as the effects of high commodity prices abated. Natural resource revenues dropped by 10.9 percent (yoy), a 1.0 ppt contribution to the overall revenue decline (Figure A.15). Tax collections grew 0.2 percent (yoy), largely due to smaller company profits, particularly in the oil and gas sector. Remarkably, international trade tax grew by 12.3 percent (yoy), driven by rising customs receipts as imports picked up and by the GoI's decision to relax copper export restrictions. Nevertheless, the overall fiscal revenues fell to 10 percent of GDP by October 2024, down from 10.7 percent in the same period in 2023. This represents a lower collection rate of 80.2 percent of the budgeted target, compared to 90.9 percent in year-to-October 2023.

Spending increased substantially following policy decisions to boost social assistance and accelerate developments in the new capital city. Total expenditures grew to 11.4 percent of GDP by October 2024, up by 0.7 ppt from the same period in 2023. Multiple policy decisions contributed to this increase. First, an 8 percent adjustment of civil servant wages in January 2024[14] and government transition-related spending contributed to an increase in primary spending by 0.3 percent of GDP (Figure A.16). Second, accelerated construction in the new capital city ahead of the Independence Day celebrations and the completion of transport-related projects boosted capital spending by another 0.3 percent of GDP. Third, the expansion of social assistance programs, namely rice and fertilizer aid, to tackle the food shock. Finally, explicit subsidy spending marginally increased (up 1.5 percent year-over-year) due to rising fuel and LPG consumption.

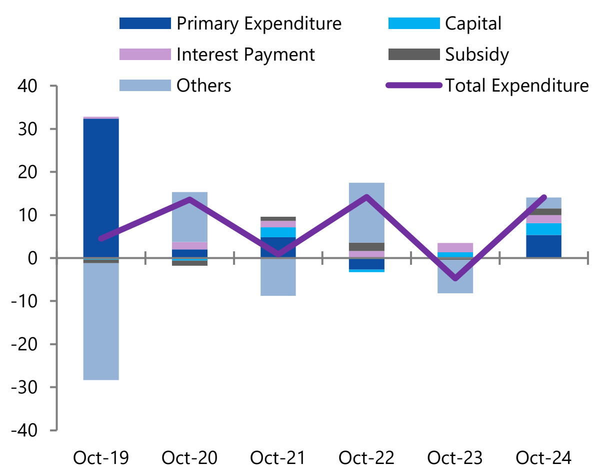
Fiscal financing needs have risen gradually due to a widening budget deficit and rising capital injections to SOEs, but financing was mainly available from domestic market borrowing. In addition to a widening deficit, capital injections, mainly into SOEs, rose by around 47 percent (yoy) but remained contained at 0.3 percent of GDP. Much of the financing has been sourced from bond issuance, amounting to 1.8 percent of GDP. The Ministry of Finance also utilized excess cash from 2023 as a financing source. As a result, net

Figure A.15: Fiscal revenues saw marginal growth
(percentage point contribution to yoy revenue growth)



Source: Ministry of Finance, World Bank staff calculation.

Figure A.16: While spending rose substantially in almost all areas
(percentage point contribution to yoy expenditure growth)



"Others" category includes social assistance programs.
Source: Ministry of Finance, World Bank staff calculation.

[14] The civil servants wage adjustment is the first in five years. Seknas Fitra, February 2024.

financing more than doubled to 1.7 percent of GDP by October 2024 compared to October 2023. Despite rising financing needs, the public debt stock decreased to 38.7 percent of GDP, down from 39.2 percent of GDP in 2023. Most of the debt stock is denominated in Rupiah (72.2 percent of total debt), primarily in the form of government securities, thereby reducing exchange rate-related risks.

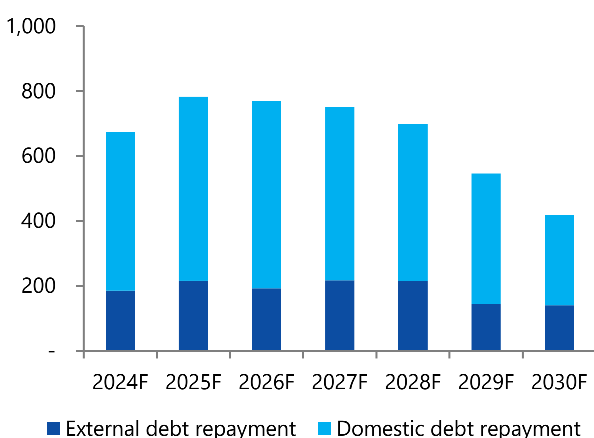
Debt service is also rising gradually as financing needs expand. With more than IDR 673 trillion of debt amortization due in 2024 (peaking further in 2025) (Figure A.17), debt service will reach a notable 4.9 percent of GDP by the end of the year. This situation increases pressure on fiscal space and underscores the need for greater revenue mobilization to maintain fiscal sustainability and support pro-growth spending. Nevertheless, compared to benchmark countries, Indonesia's short-term debt maturities have been among the lowest over the past three years (Figure A.18).

With the focus remaining on currency stability, Bank Indonesia is gradually easing its monetary policy and supplementing this stance with additional macroprudential incentives to promote private credit.

Bank Indonesia is actively smoothing currency volatility, but challenges remain if global uncertainty endures. Global monetary easing allowed BI to reduce its policy rate by 25 bps to 6.0 percent in September. To mitigate currency pressures, the central bank continued issuing the SRBI, a high-yielding monetary instrument introduced in 2023 (see IEP June 2024). Since January, SRBI has attracted USD 12.5 billion in foreign capital, raising its outstanding value to 4.1 percent of GDP as of October. BI managed the scale of SRBI issuances to counter currency pressures, as demonstrated by the peak in issuances when the Rupiah hit a multi-year low in June. With nearly one-third of SRBI held by foreign investors, the instrument has expanded BI's liabilities to non-residents, increasing from 0.7 percent to 1.9 percent of GDP between September 2023 and August 2024. A quarter of outstanding SRBI, equivalent to 10 percent of foreign currency reserves, is set to mature in Q4-2024. This will lead to smaller net issuances unless BI opts to increase new issuances (Figure A.19).

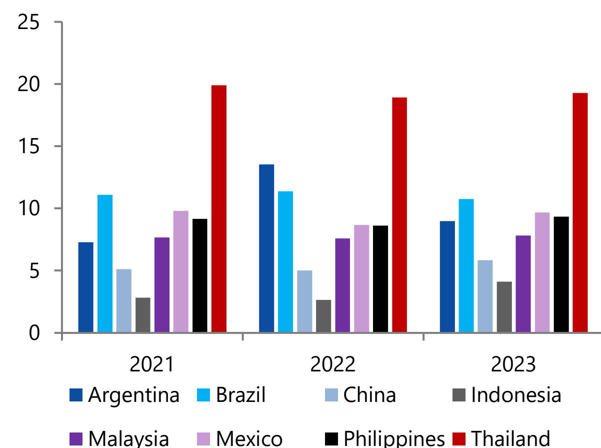
BI also announced three new macroprudential incentives in October to support private credit expansion. First, BI extended the 100 percent loan-to-value ratio for mortgages and zero down payment for car loans until the end of 2025. Second, BI offered zero fees on QR-based payments below IDR 0.5 million for micro enterprises. Third, BI expanded reductions in the reserve requirement ratio (RRR) to additional sectors, including agriculture, manufacturing, wholesale trade, and micro enterprises. With this incentive, banks will now benefit from a lower effective RRR (5-6 percent) compared to the official rate (9 percent). These three macroprudential measures are expected to further boost credit to the private sector, which grew by 10.9 percent in September, in line with BI's target range of 10-12 percent.

Figure A.17: Expanding fiscal financing could elevate debt repayments further which estimated to reach its peak next year
(debt repayment profile, IDR trillion)



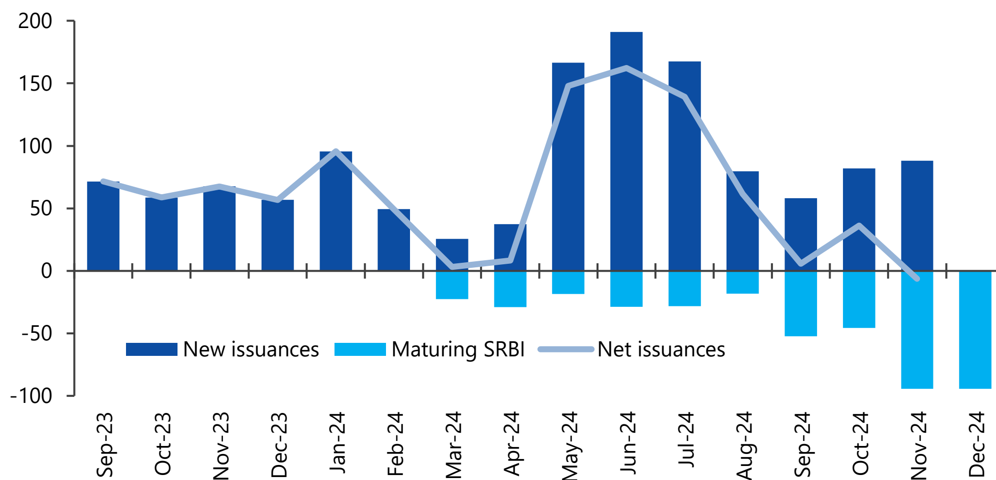
Source: Ministry of Finance, World Bank staff calculation.
Note: Data as of December 2023, F denotes forecasts.

Figure A.18: Though it remains among the lowest compared to peer countries
(debt maturing in 12 months or less, percent of GDP)



Source: Fiscal Space Data, Kose et. al., 2024, World Bank staff calculation.

Figure A.19: SRBI maturity peak is in Q4-24
(IDR trillion)



Source: BI, CEIC, World Bank staff calculations.
Note: Data as of 22 November 2024.

3. The Outlook and Risks

The economy is projected to remain resilient with balanced risks over the outlook.

Indonesia's economy is projected to remain resilient over the outlook period. Growth is expected to accelerate slightly to an average of 5.1 percent over 2024-2027. It will be supported by a boost in public consumption and investment as the new administration gradually implements its social assistance and investment programs, including those in the housing and food sectors and the new capital. Private investment is also projected to gain momentum. It will benefit from private sector credit growth due to expected easing in global monetary policy and continued liquidity incentives from BI. Meanwhile, private consumption is projected to maintain a steady pace, compensating for the lower trade contribution to growth. Exports and imports are projected to grow more modestly in 2024-2027. High base effects, global trade fragmentation, and China's growth slowdown will hamper export growth, while resilient domestic demand is expected to boost imports. On the supply side, services such as transport, warehousing, communication, trade, and hospitality will drive growth, benefiting from the pick-up in domestic demand. Manufacturing, particularly in the mining sector, is also expected to boost growth as more investments linked to the downstreaming agenda are realized.

Inflation is projected to stay firmly within BI's target band (2.5±1 percent) but is prone to domestic demand pressures. Favorable climate conditions for grain production and subsiding commodity prices are expected to keep food and administered prices in check over the outlook period. However, core inflation is expected to pick up following robust domestic demand, easing monetary conditions, a 1 ppt VAT hike (scheduled for January 2025), and the closing of the output gap by 2025. This will push overall inflation to an average of 2.5 percent over 2025-2027. Inflation expectations are also anticipated to remain anchored within this range. Pressures linked to food and energy price volatility, the two largest components in the CPI consumption basket, will be closely monitored. The authorities remain committed to maintain inflation in check by using monetary policy instruments as well as non-market-based measures like subsidies and prices controls. Targeted social assistance and market-based policies could be considered alternatively to avoid market distortions and reduce fiscal costs.

The external position will remain challenging amid global uncertainty. The current account deficit is projected to gradually widen to its pre-pandemic levels, reaching 1.6 percent of GDP by 2027, with moderating commodity prices and terms of trade hampering exports. FDI will remain the largest source of external financing, with competitiveness reforms, industrial downstreaming, and the construction of the new capital expected to attract new projects. Meanwhile, BI's monetary stance will stay focused on guarding against high exchange rate volatility and rapid or excessive capital outflows. Nevertheless, with inflation firmly anchored and global monetary

conditions easing, BI's policy stance could become more accommodating. The pace will be moderated and aligned with the normalization of US monetary policy. Foreign currency reserves are projected to remain adequate, covering six months of imports.

The fiscal policy stance will continue to adhere to the fiscal rule. The fiscal deficit is projected to average 2.6 percent of GDP over 2024-2027 even as the government rolls out new priority programs. Those programs, along with rising interest payments, are projected to push spending to an average of 15.3 percent of GDP in the medium term (a 0.2 percent of GDP yearly increase). The additional spending is assumed to be partially financed by a 1 ppt increase in the VAT rate as mandated by the 2021 Tax Harmonization Law as well as strengthened tax administration enforcement measures[15]. The subsidies bill is anticipated to drop with potential reforms next year, shifting support towards more targeted social assistance[16]. Public investment is also forecast to return to its pre-pandemic level average. Gross fiscal financing needs are expected to rise after a continuous decline since the pandemic, averaging 4.8 percent of GDP over 2024-2027. Expanding fiscal financing and elevated borrowing costs are also expected to keep interest payments elevated at around 2.2 percent of GDP or 17.6 percent of total revenues over the medium term.

The outlook is subject to balanced risks. Heightened geopolitical tensions might precipitate a steeper decline in terms of trade, causing inflation and potentially constricting fiscal space due to lower revenues. The pace of fiscal and structural reform will significantly impact FDI inflows, macroeconomic stability, and growth prospects. On the upside, a stronger-than-anticipated recovery in major trading partners, like China or the US, or a swing in key commodity prices, such as palm oil, nickel, iron ore, or coal, could boost exports, widen fiscal space, and enhance growth.

4. Medium-term Growth Simulations

Sustained acceleration in economic growth will require structural reforms to boost productivity

The new government is committed to achieving Indonesia Vision 2045 of reaching high-income and has targeted to reach 8 percent GDP growth by 2028. To reach 8 percent growth, the authorities are targeting a big boost in aggregate demand over the next five years. This strategy includes a major push for private sector investment accompanied by fiscal stimulus. Those private investments are planned in construction, housing, agrobusiness, natural resources, and manufacturing. A large portion of this investment is expected to come from FDI. The fiscal stimulus will be focused on the GoI's 17 priority programs, including a flagship Nutritious Food Program and other social protection programs. To finance those programs and maintain the fiscal deficit rule, the government is also planning to boost tax revenues to 16 percent of GDP by 2030.

The boost in aggregate demand could have different macroeconomic implications depending on the extent to which it is accompanied by structural reforms. The report simulates the impact of accelerating demand on growth and examines macroeconomic tradeoffs under two structural reform policy options. The first scenario (GovPlanFR) assumes that the total investment growth rate will double in the first five years and will gradually revert to the baseline growth in the second half of the decade. As a result of this investment push, gross capital formation will be 50 percent higher by 2030 compared to the baseline (55 percent higher by 2035). Those investments are expected to be financed primarily by FDI and are sustained at this level going forward. This scenario also assumes that the fiscal priority programs will be financed gradually from higher tax receipts, which are projected to rise to 16 percent of GDP after 2030. Eighty percent of new government spending is projected to be recurrent spending that will benefit households, and twenty percent is expected in the form of capital spending. Government investment will increase to an average of 2.4 percent of GDP, compared to 1.4 percent in baseline over the decade. The fiscal deficit is assumed to rise to around 2.8 percent of GDP, 0.3 ppt above the baseline, but will remain below the 3 percent of GDP fiscal deficit rule throughout the projection period. This scenario assumes business-as-usual in terms of structural reforms. The second scenario (GovPlanFRTFP) assumes that in addition to the demand stimulus package, the GoI will accelerate structural reforms that will double total factor productivity (TFP) growth and significantly boost returns on capital and labor. Examples of such reforms are discussed in the next section.

[15] Estimates show that an improvement of Indonesia's VAT C-efficiency ratio to a level that is equal to its regional peers and a 1 percentage point VAT rate hike could increase the country's current revenue collection by up to 32 percent (IEP June 2024).
[16] Reuters, November 4, 2024.

A demand stimulus package could achieve high growth, but it could also create steep macroeconomic imbalance if not accompanied by productivity enhancing reforms. The GovPlanFR scenario could see an acceleration of GDP growth to 8 percent (Figure A.20) but the impact might be short-lived as the economy risks overheating. A big boost to private and government investment could fuel inflationary pressures, which could reach as high as 9 percent (Figure A.21). Inflation could erode the purchasing power of households and lower consumer demand. It could also reduce export competitiveness as the real exchange rate appreciates. Furthermore, rising investment levels typically lead to higher imports, a widening current account balance, and pressures on foreign currency reserves and the Rupiah. All these factors could create a drag on growth and pull the economy back down to its potential output. These pressures will also trigger tighter monetary policy to manage inflation and reduce exchange rate volatility. This in turn could hurt credit expansion and domestic investment.

A boost to demand accompanied by structural reforms could on the other hand fuel sustained growth within a more stable macro environment. This requires policies and structural reforms that boost productivity growth and increase returns on capital and labor. By creating additional capacity, the economy generates more space for demand to catch up, minimizing the risks of a boom-bust cycle. Combining demand-side stimulus with structural reforms aimed at increasing productivity (Scenario GovPlanFRTFP) leads to higher GDP growth (8 percent) for a relatively longer period compared to demand stimulus alone (GovPlanFR). Critically, it also achieves lower inflation (5.6 percent at peak in scenario GovPlanFRTFP).

TFP-boosting reforms create room for demand-side measures to stimulate growth without triggering inflationary pressures as they address supply-side inefficiencies and enhance the economy's productive capacity. Reforms that boost Total Factor Productivity help ensure that demand stimulus does not create inflationary pressures by increasing the economy's capacity to supply goods and services efficiently. These reforms enhance productive capacity, reduce structural bottlenecks, and encourage innovation, enabling the supply side to respond effectively to rising demand. By improving labor market efficiency, fostering competition, and supporting investment in technology and infrastructure, they lower production costs and mitigate cost-push inflation. As a result, the economy can expand output in response to higher demand without significant price increases, maintaining price stability while supporting growth.

Figure A.20: A demand stimulus package will boost GDP growth
(percent)

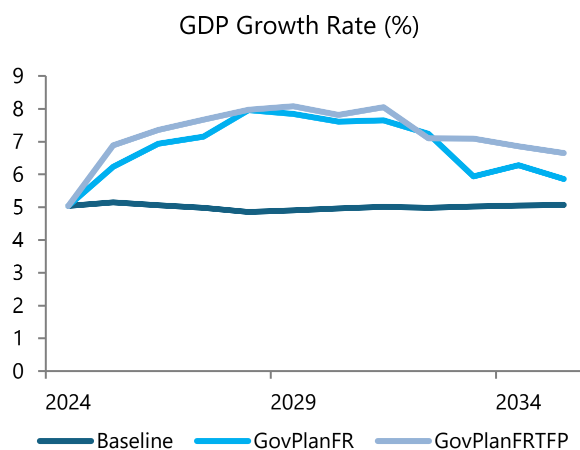
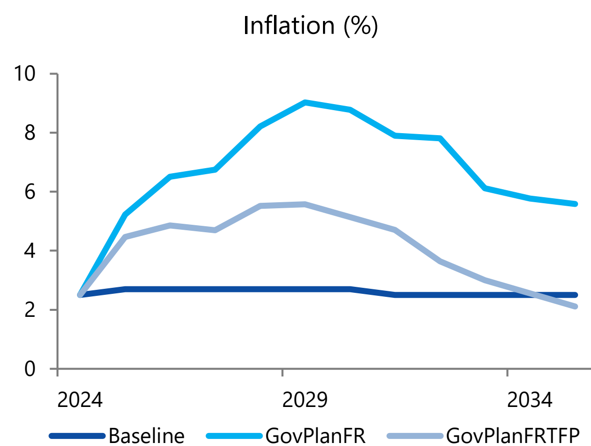


Figure A.21: ... but it could be accompanied by high inflationary pressures
(percent)

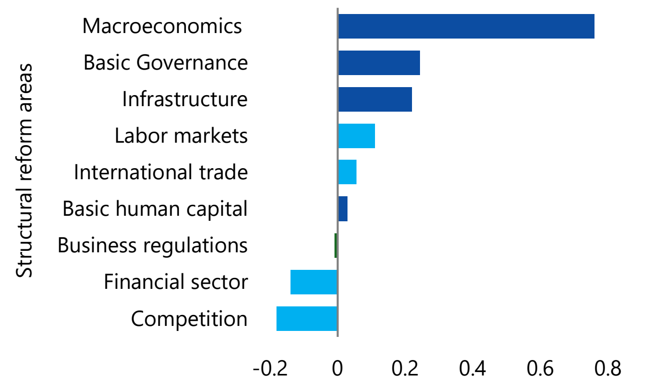


Source: World Bank Staff Calculations.

5. Policy Priorities

Indonesia's performance on long-term growth and job creation aligns with its progress and gaps in competitiveness reforms. As countries transition from low to high income, the relative importance of policy and institutional drivers of competitiveness evolves. Building on existing literature, competitiveness reforms can be categorized into three groups: foundational, efficiency, and innovation. Foundational reforms tend to be most critical for Low-Income Countries (LICs) and early-stage Lower-Middle Income Countries (LMICs), while advanced LMICs and early-stage Upper-Middle Income Countries (UMICs) benefit from solid foundations and a stronger emphasis on efficiency reforms. Advanced UMICs require all three—foundations, efficiency, and innovation reforms—to sustain competitiveness. Indonesia has performed well on foundations relative to its peers, enabling resource shifts to non-agriculture sectors. However, it lags high-performing peers in implementing efficiency reforms, which limits the reallocation of resources to more productive industries and firms, constraining its growth potential (Figure A.22).

Figure A.22: Indonesia performance in structural reform areas relative to peers
(z scores based on multiple competitiveness indices)



Source: World Bank Staff Calculation.
Note: Z score (higher score= stronger performance relative to peers; lower score = weaker performance relative to peers). Dark blue bars indicate reform areas associated with foundational areas of competitiveness. Light blue bars indicate reform area associated with efficiency drivers.

Despite big advancements, Indonesia has room to pursue critical foundational reforms in the areas of human capital, social protection and domestic revenue mobilization to boost its growth potential. Critical foundational reforms for Indonesia include the need for investment in human capital and more specifically in education. This include addressing the learning losses from the pandemic, investing in skills, and investing in education quality to boost education outcomes and close the gap with UMIC and HIC (see IEP June 2023 – special focus education). Other examples of foundational reforms include revenue mobilization reforms to expand Indonesia's fiscal space in support of funding Vision 2045 (see IEP December 2024 - special focus on tax).

Efficiency reforms are important for infusing skills, knowledge, and technology that help drive productivity growth. Among the most important of those efficiency reforms needed in Indonesia is financial deepening and the implementation of the financial sector omnibus law (FSOL). This law not only expands access to credit but also channels large savings into productive investments including underserved segments of the economy (see IEP June 2022 – special focus on financial deepening). Furthermore, trade policy reforms can lead to greater specialization, higher competition, and incentivizes domestic firms to innovate, thereby improving overall economic efficiency. Those reforms include reducing non-tariff barriers on goods and services, simplifying customs procedures, and improving the logistics ecosystem (see IEP December 2022 – special focus trade for growth). Finally, investment openness and business regulatory reforms could incentivize access to higher quality inputs, capital, and technology. Indonesia has taken important steps to reform its investment climate including the Omnibus Law on Job Creation. This eased restrictions under the Negative Investment List and streamlined business licensing via the OSS system. Yet, more can be done to tackle bureaucratic inefficiencies and inconsistent regulation enforcement, and address remaining sectoral restrictions, which hinders investment in high-value added sectors (see IEP June 2024 – special focus on business regulatory reforms).

Table A.1: Selected Macroeconomic Indicators

	2020	2021	2022	2023	2024	2025	2026	2027
	Actual				WB projection			
Real GDP growth and inflation, percent change								
Real GDP	-2.1	3.7	5.3	5.0	5.0	5.1	5.1	5.0
Consumer Price Inflation (average, %)	2.0	1.6	4.1	3.7	2.3	2.4	2.6	2.5
Consumer Price Inflation (end of period, %)	1.7	1.9	5.5	2.7	1.7	2.7	2.5	2.5
Private Consumption	-2.7	2.0	5.0	4.9	4.9	5.0	4.9	5.0
Government Consumption	2.1	4.3	-4.5	2.9	5.3	4.2	3.9	5.4
Gross Fixed Investment	-5.0	3.8	3.9	4.4	4.5	5.4	6.3	4.8
Exports	-8.4	18.0	16.2	1.3	4.1	3.9	3.4	5.8
Imports	-17.6	24.9	15.0	-1.6	2.1	2.9	3.5	4.8
Fiscal accounts, central government, percent of GDP								
Revenues	10.7	11.8	13.5	13.3	12.6	12.5	12.7	12.8
of which Tax Revenue	8.3	9.1	10.4	10.3	10.2	10.4	10.5	10.5
Expenditures	16.8	16.4	15.8	14.9	15.3	15.1	15.3	15.5
Primary Balance	-4.1	-2.5	-0.4	0.5	-0.5	-0.2	-0.4	-0.5
Fiscal Balance	-6.1	-4.6	-2.4	-1.6	-2.7	-2.5	-2.6	-2.7
Central Government Debt	39.3	40.7	39.5	39.0	39.3	39.6	39.5	39.6
Balance of Payments, percent of GDP unless indicated otherwise								
Current Account Balance	-0.4	0.3	1.0	-0.2	-0.9	-1.4	-1.6	-1.6
Exports, Goods and Services	16.8	20.8	23.9	21.2	20.9	20.6	20.3	20.4
Imports, Goods and Services	15.1	18.3	20.7	19.2	18.7	18.5	18.5	18.7
Net Foreign Direct Investment	1.3	1.5	1.4	1.1	1.3	1.4	1.5	1.5
Gross Reserves (months of imports of goods and services)	10.2	8.0	6.0	6.6	6.9	6.7	6.5	6.2
Memorandum items								
Nominal GDP (IDR trillion)	15,443	16,977	19,588	20,892	22,501	24,105	25,828	27,708
Real GDP Per Capita (IDR thousand)	39,203	40,237	41,952	43,599	45,313	47,138	49,048	51,146

B. Funding Indonesia's Vision 2045

B. Funding Indonesia's Vision 2045

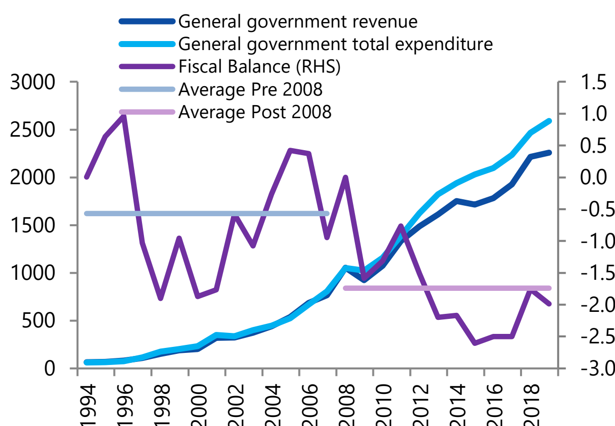
1. Introduction

Indonesia's strong economic development was underpinned by the government's prudent approach to fiscal policy over the past two decades. Indonesia's economy grew an average of 5.4 percent per year between 2000 and 2019, while the poverty rate dropped from 23.4 percent to 9.4 percent based on the national poverty line. This impressive progress was supported by a well-managed government spending and borrowing strategy after the Asian Financial Crisis, institutionalized by the State Finance Law in 2003. The law set a fiscal deficit ceiling of 3 percent of GDP and a debt ceiling of 60 percent of GDP. These policies have translated into moderate fiscal deficits, averaging 0.8 percent during 1995-2008, before widening to 1.6 percent up to 2019 (Figure B.1), and declining public debt (Figure B.2), which dropped from a peak of over 80 percent during the Asian Financial Crisis (AFC) to around 30 percent before the pandemic.

Looking forward, the country needs to find new strategies to reinvigorate economic growth as it pursues Vision 2045 of becoming a high-income country. Growth has moderated in the past decade. After peaking during 2010-2012, when the economy grew by above 6 percent per year, growth averaged 5.1 percent from 2013 to 2019. Though growth moderation is typical in many nations at the lower to upper-middle-income stage, this slower growth trajectory is insufficient to reach high income status by 2045. While fiscal policy played a supportive role, Indonesia's public sector has been small relative to the size of its economy (Figure B.3) and compared to other countries at similar levels of development. Public spending has decreased, partly due to declining revenues, falling from 20 percent of GDP in 2009 to 15 percent by 2019 (Figure B.4), largely driven by reduced non-tax revenue from declining oil and gas exports. To support Vision 2045, fiscal space must be expanded to responsibly finance increased investment and human capital enhancements essential for boosting productivity and accelerating growth.

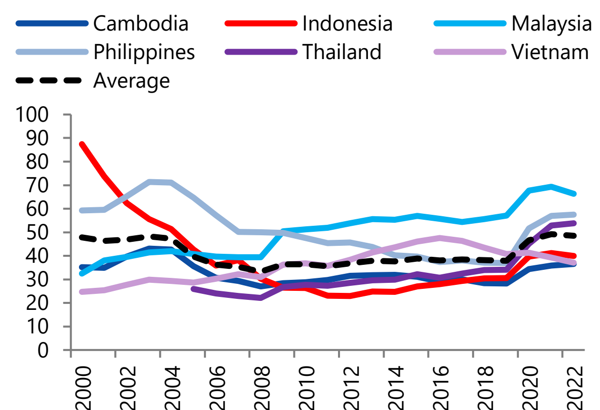
Achieving high-income status by 2045 requires action to address infrastructure and human capital gaps. Indonesia's public capital stock[17] per capita is low—less than half the emerging market average

Figure B.1: Fiscal balance, Indonesia
(trillion IDR, LHS; percent of GDP, RHS)



Source: IMF MCM Department, Arslanalp and Tsuda (2014 updated), World Bank staff calculations.

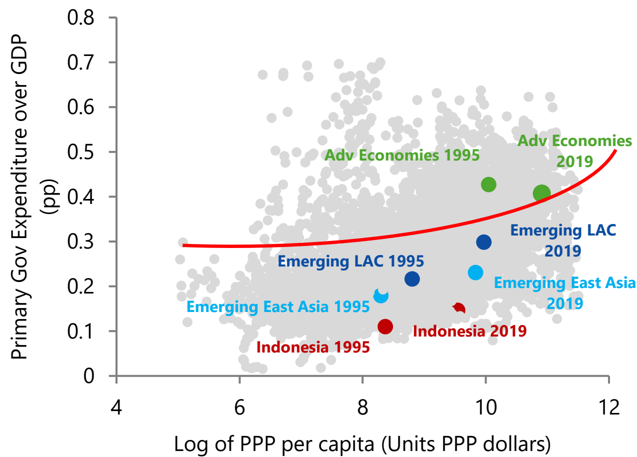
Figure B.2: Total government debt
(percent of GDP)



Source: IMF WEO, Author Calculations.

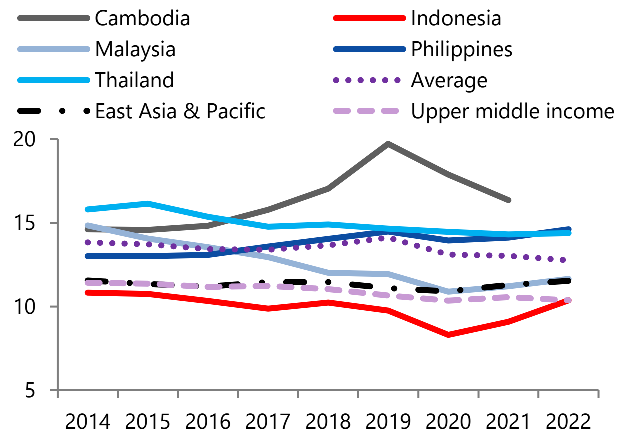
[17] Refers to accumulated public investments including those in transport, utilities, and health and education facilities.

Figure B.3: Public spending is substantially smaller than countries with the same level of developments



Source: IMF WEO. Authors calculations.

Figure B.4: Public revenue relative to peers has been historically low



Source: IMF WEO, Author Calculations.

and far below advanced economy levels (Figure B.5). Bridging this deficit requires higher spending over the coming years, yet public investment continues to fall short, lagging other emerging economies (Figure B.6). As regards to human capital development, Indonesia is marginally behind regional and income-level peers (Table B.1), although gap on education outcomes is larger. Strategic investments in both physical and human capital present a transformative opportunity for the nation to achieve and sustain the 6 percent annual growth rate needed to reach high-income status by 2045.[18] With statutory limits on deficits and debt currently in place, raising tax revenues, particularly by addressing the country's large tax gap (see more below), is the most cautious financing option.

Fiscal policy reforms should be complemented by structural reforms that boost productivity and growth, which further enhances fiscal capacity. In addition to reforms that raise revenue and enhance public spending efficiency, policies that promote productivity are key for long-term economic growth and strong fiscal capacity. Reforms that lower regulatory barriers for business entry and exit, increase market competition, and foster a supportive environment for innovation will stimulate productivity and investment growth, ultimately contributing to a higher and broader tax revenue basis.

Figure B.5: IDN public capital stock per capita, versus advanced and emerging market (EM) averages
(2019, 2017 PPP terms)

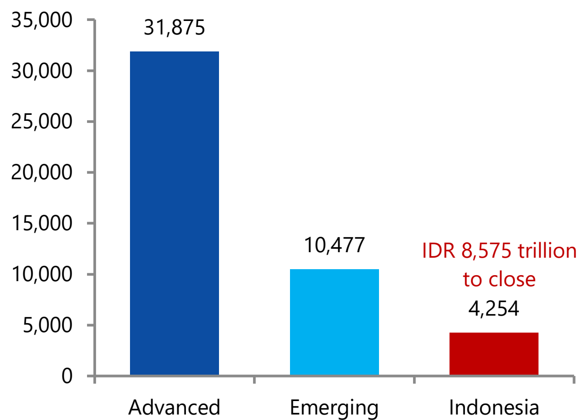
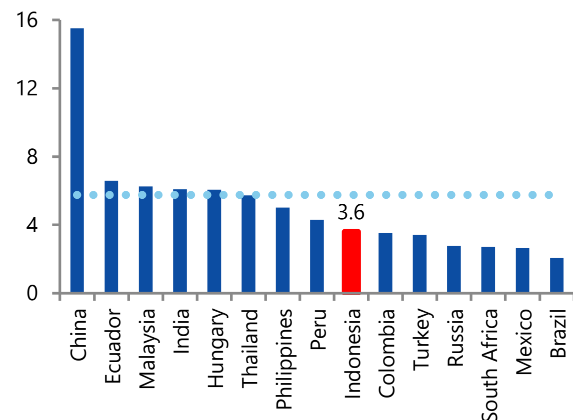


Figure B.6: IDN general government investment versus emerging market peers
(2019, percent of GDP)



Source: IMF Investment and Capital Stock Dataset 2021, World Bank staff estimates.

[18] Assuming Indonesia's HCI grows at the past rates until 2045, HCI will reach 0.689, still below high-income countries' HCI average.

Table B.1: Human capital index breakdown, Indonesia

Indicator	Indonesia	East Asia & Pacific	Upper middle income	High income
HCI Component 1: Survival				
Probability of Survival to Age 5	0.98	0.98	0.98	0.99
HCI Component 2: School				
Expected Years of School	12.4	11.9	11.8	13.2
Harmonized Test Scores	395	432	411	487
HCI Component 3: Health				
Survival Rate from Age 15-60	0.85	0.86	0.86	0.92
Fraction of Children Under 5 Not Stunted	0.72	0.76	0.87	0.80
Human Capital Index (HCI) 2020	**0.54**	**0.59**	**0.56**	**0.71**

Source: World Bank Human Capital Project.

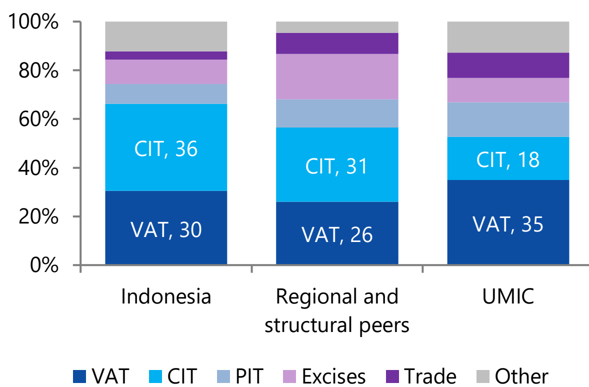
2. Unpacking Indonesia's tax gap

2.1 Indonesia's tax revenue performance

Indonesia has significant untapped tax potential, with actual tax collections at least 6 percentage points of GDP below what similar countries collect. This difference is among the largest in a sample of middle-income countries and is driven by low tax efficiency—the share of potential tax revenues actually collected—which is considerably lower than in many low- to high-income economies. Fully harnessing this tax potential could yield substantial revenue gains. Indonesia has achieved Investment Grade in its sovereign credit rating.[19] Its low tax revenue and the underdeveloped financial markets could be a source of risk for sovereign credit risk rating. Closing the tax gap could not only generate resources for development but also reduce the sovereign borrowing costs in international credit markets.

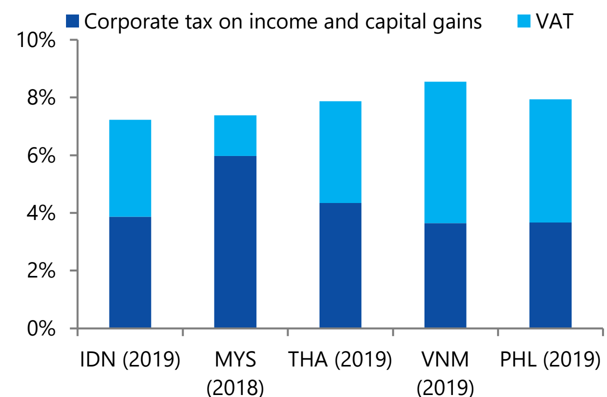
Taxes on Corporate Income Tax (CIT) and Value-Added Tax (VAT) have been the main sources of tax collections and correspond to the largest foregone revenues. Due to high labor informality and limited excise taxes, VAT and CIT, these taxes made up 56 percent of total tax revenues in the 1990s and increased to 66 percent in 2019.[20] Meanwhile, contributions from personal income tax declined markedly from 26.6 percent in the 1990s to only 8.1 percent of total revenues (Figure B.7). Despite relying heavily on VAT and CIT, revenue from these sources is still lower than that of structural and regional peers (Figure B.8), which

Figure B.7: Both CIT and VAT have been the largest components of tax collections in Indonesia...
(percent of total revenue)



Source: World Bank staff estimates, IMF data. Regional peers include Cambodia, Malaysia, Philippines, Thailand, and Vietnam.

Figure B.8: ...but they remained below what is collected by peer countries...
(percent of GDP)



Source: IMF WEO, Author Calculations.

[19] Buzas et al (2021) found Indonesia to have a higher risk premium on domestic currency bonds compared to peers even after controlling for macroeconomic and financial variables. The combination of higher risk premium and low revenue base results in higher ratio of interest payment as share of revenue. From 2015 to 2022, interest payments averaged 14 percent of government revenue, compared to just 8.5 percent for UMICs and 4 percent for HICs.
[20] Property and certain sales taxes are collected by local government, which are not included in this report.

also have more diverse tax sources.[21] This can be attributed to the narrow tax base, low compliance, and a relatively low effective tax rate. Even after the 2021 Tax Harmonization Law (THL), which increased the VAT standard rate to 11 percent and eliminated certain exemptions, the revenue gap remains sizeable.

We use a simple framework to understand what factors affect tax revenue collection in Indonesia. The first step is to quantify the amount of foregone revenue (i.e., tax gap) from CIT and VAT (1). This is then decomposed by policy design of the tax system (2) and by factors that influence tax compliance. Unpacking tax compliance, we analyze the enforcement effectiveness of the tax authority (3), the behavior of taxpayers, the prevalence of tax evasion and their potential underlying causes (4). Additionally, (5) structural factors like the development of the financial sector and levels of informality within the economy impact overall compliance rates (Figure B.9).

2.2 Policy and compliance gaps

The tax gap, or foregone revenues, consists of two components: the policy gap and the compliance gap. The policy gap represents the difference between potential tax revenues and the amount collected by the government based on existing laws and regulations. These laws and regulations often provide special arrangements and exemptions to certain groups. Hence, the policy gap reflects the impact of policies that move the effective tax rate away from the standard rate (e.g., reduced or preferential rates) or shrink the tax base (e.g., exemptions, tax breaks). The compliance gap, on the other hand, is the difference between the tax owed to the government and the tax revenue collected. It measures losses from non-compliance, including underreporting, insolvencies, legal tax optimization, and administrative errors.

Around 6.4 percent of GDP in additional VAT and CIT revenues can be raised if policy and compliance gaps are closed. Overall, more than half of foregone revenues from VAT and CIT can be attributed to the compliance gap (Figure B.10). Non-compliance is the primary driver of foregone VAT revenue, while the policy gap accounts for a larger share of foregone CIT revenue. Based on limited international comparison, Indonesia's non-compliance levels are high compared to peers and while its policy gaps can be deemed relatively modest. The large compliance gap suggests that administrative measures such as improvements in audit and enforcement may help to recover foregone revenues. Additionally, policies that facilitate compliant behavior among taxpayers (e.g., deepening of the financial sector, improvements in tax morale) can further amplify the positive effects of such administrative efforts.

Figure B.9: Decomposing the tax gap into policy and compliance gaps

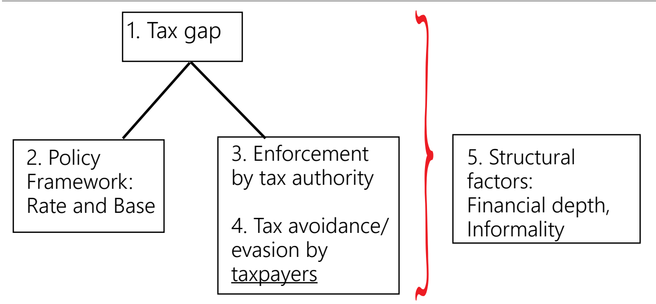
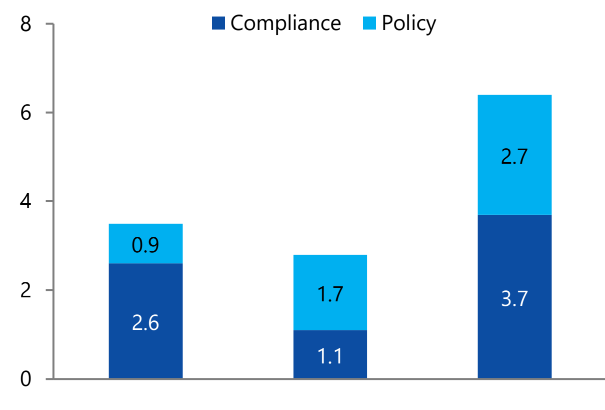


Figure B.10: Tax gap breakdown, VAT and CIT
(average 2016-21, percent of GDP)



Source: World Bank staff elaboration.
Note: Numbers may not add up due to rounding.

While separate analysis of policy and compliance gaps may be useful, these concepts are closely linked. Revenue improvements from reducing the policy gap can only be realized if the compliance gap is addressed simultaneously. For example, if deductions are removed for certain sectors but taxpayers then avoid paying the additional taxes, no additional revenues will be gained. Instead, the reduction in the policy gap will only turn into a larger compliance gap. However, breaking down foregone revenues for any given tax type (e.g., VAT or CIT) into policy and compliance gap components remains useful to determine which measures should be prioritized to maximize collections.

[21] High income countries tend to rely more on direct taxation (i.e., CIT and PIT) as VAT tends to be regressive. The VAT payment as share of income can appear regressive in Indonesia when compared to a household's market income – that is, the income a household receives from labour, capital and private remittances. However, high prevalence of informal sellers who do not collect VAT and that poorer households have higher informal consumption than richer ones, VAT in Indonesia is broadly neutral across the income distribution.

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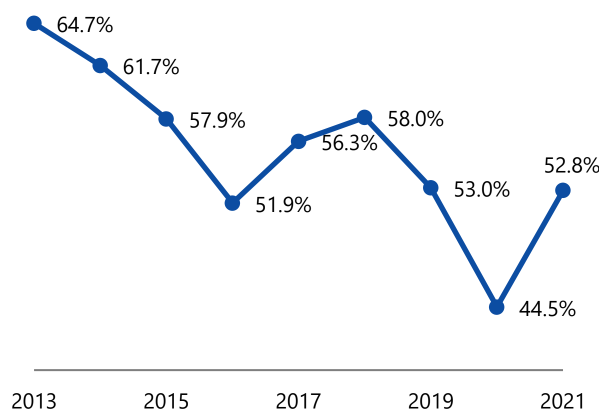
2.3 Value-added tax (VAT) gaps

Indonesia's large VAT gap has been worsening and is above some of its regional peers'. This is indicated by the VAT system's declining overall C-efficiency – the ratio of VAT collections to final consumption. This measures of how much VAT revenue is collected compared to what would be collected if the standard VAT rate were applied uniformly across all consumption without exemptions or reduced rates. Indonesia's VAT C-efficiency has been on a downtrend trend since 2018 (averaging 52.8 percent during 2016-2021), reaching a low of 44.5 percent during the pandemic in 2020 (Figure B.11). This low collection efficiency is especially concerning given that Indonesia's statutory VAT rate is comparable to that of its peers (Figure B.13). This translates to a widening VAT gap, suggesting that if the government can address the compliance and policy gaps, the country could nearly double its current VAT receipts. Moreover, Indonesia's VAT C-efficiency is about 17 percentage points lower than the average of its regional peers[22], collecting nearly one percentage point below the average of its peers (Figure B.12). Notably, Thailand collects 4.7 percent in VAT (compared to 2.3 percent in Indonesia) despite a substantially lower standard statutory rate and similar scope of exemptions. This indicates significant amounts of forgone revenue due to non-compliance in Indonesia.

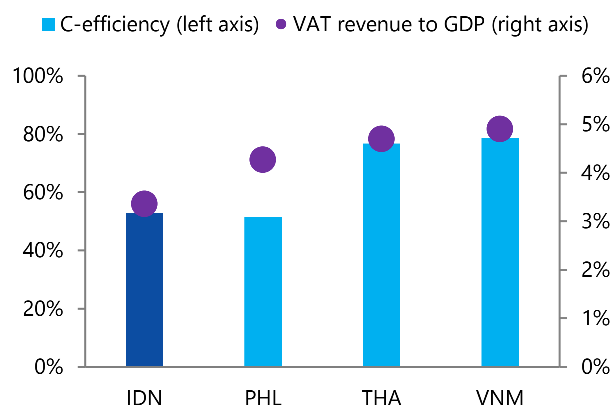
Indonesia had a stable tax system with minimal policy changes over the last two decades, resulting a stable VAT policy gap. The VAT policy gap remained relatively stable at around 13.5 percent of potential, or 0.9 percent of GDP, between 2016 and 2021 due to a stable tax rate prior to the THL introduction (Figure B.14). Major sources of foregone revenue due to policy design included the non-taxability of financial and insurance services, private education and health services, and hospitality services (Figure B.15). The non-taxability of mining and quarrying activities contributed to a decline in policy gap. This is because the output of this industry is used mostly as intermediate inputs. In cases when the final products and services are still subject to taxation, when the input VAT cannot be deducted, mining and quarrying producers end up overpaying VAT. This results in a decrease in the policy gap.

Figure B.11: VAT C-efficiency in Indonesia (2016-21)



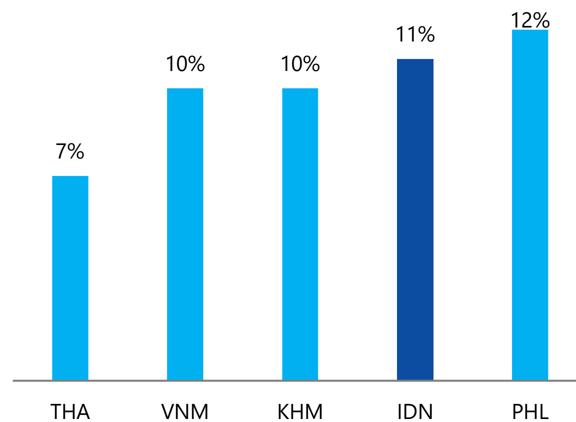
Source: World Bank staff calculation.

Figure B.12: C-efficiency and VAT revenue-to-GDP ratios (2019)



Source: World Bank staff estimates.

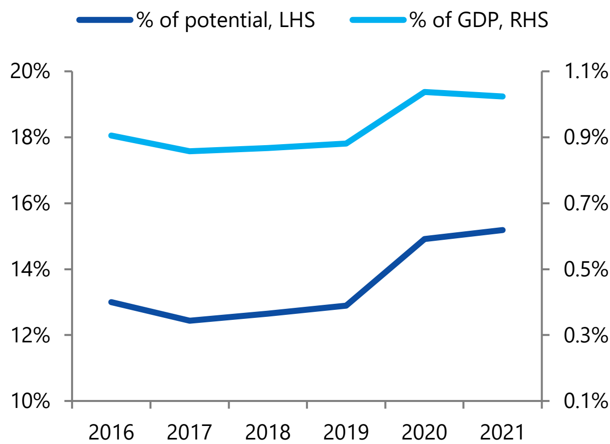
Figure B.13: Statutory VAT rates, Indonesia versus regional and structural peers



Source: World Bank staff estimates.

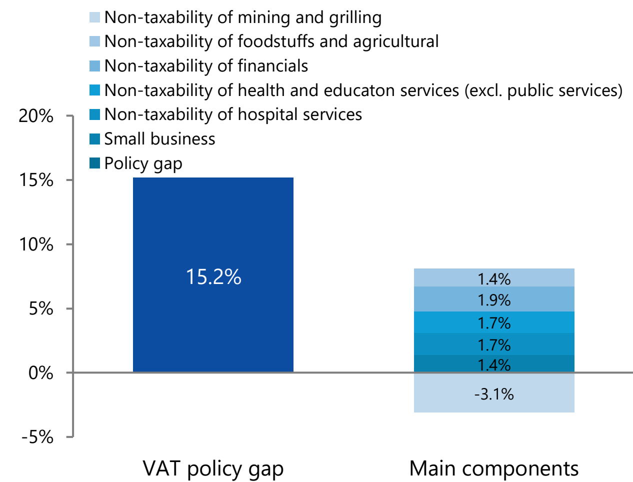
[22] C-efficiency captures the overall efficiency of tax policy design and compliance.

Figure B.14: VAT policy gap in Indonesia (2016-21)



Source: World Bank staff calculation.

Figure B.15: Core components of the VAT policy gap (2021)



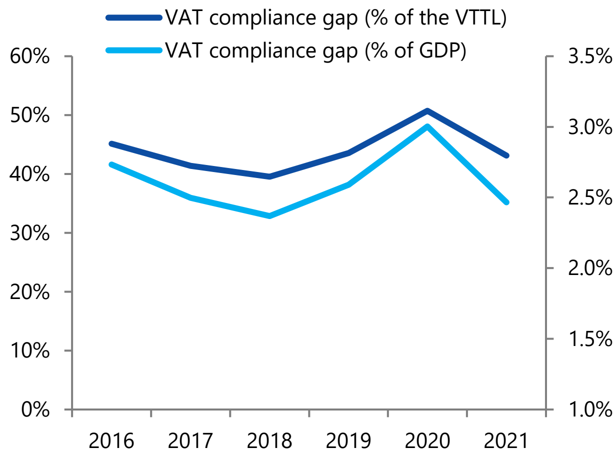
Source: World Bank staff elaboration.
Note: Due to the interdependence between non-deductible VAT and rate applied on intermediate use, components of the VAT policy gap are not cumulative.

Compared to peers, Indonesia's VAT policy gap is relatively low. This is primarily due to relatively low expenditure on health, education, and financial services which typically are not taxed in most VAT systems. For instance, in the EU, where the average policy gap is approximately 46 percent of the potential revenue, health, education, and financial services contribute about 21 percentage points to the gap. In contrast, these categories accounted for only 7 percentage points in Indonesia. The size of the policy gap is often influenced by the type of relief implemented–exemptions without the right to deduct input tax, non-taxability, or flat-rate taxation without the right to deduct input tax. Middle-income countries that rely heavily on reduced rates, such as Turkey (with a VAT policy gap above 40 percent) and South Africa (with a VAT policy gap of about 30 percent), tend to have higher policy gaps.

However, VAT compliance gap is relatively high in Indonesia. Between 2016 and 2021, Indonesia's VAT compliance gap averaged 43.9 percent of the total potential VAT collection, or 2.6 percent of GDP (Figure B.16). In 2020, compliance gap peaked at 50.7 percent likely due to the economic impact of the pandemic, as well as the deferred VAT payments. When the economic situation improved in 2021, the compliance gap fell to 43.1 percent. Compared to peers, Indonesia's compliance gap is high, ranking among the top 25 percent in Asia and the Pacific as documented by the IMF's RA-GAP program, which covers data up to 2022 (Gupta and Jalles 2022). Moreover, Indonesia's VAT compliance gap surpasses that of the Philippines where the IMF estimated gap was 38 percent in 2015. It is also higher than the compliance gap observed in those other middle-income countries where reliable estimates of the compliance gap are publicly available (Figure B.17).

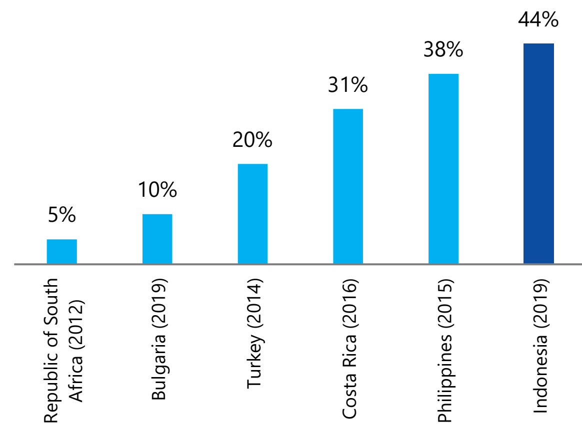
Administrative reforms have helped curb compliance losses, but more could be done. Tax administration efforts, such as mandatory e-invoicing introduced in 2016, contributed to the reduction in VAT non-compliance. Similar experiences in high income countries indicate that improved access of tax administration to taxpayer information through

Figure B.16: VAT compliance gap (2016-21)



Source: World Bank staff elaboration.

Figure B.17: VAT compliance gap in Indonesia and select middle-income countries
(percent of liability)



Source:World Bank staff calculation based on Canıkalp et al. (2016), IMF (2015), IMF (2018), OECD (2018), and European Commission (2022).
Note: Data on compliance gap data is scarce, particularly among regional peers. Data above from various middle-income countries on varying years, sourced from different studies.

digital reporting requirements increases voluntary compliance and strengthens enforcement measures (Box B.1).[23] Among developing countries, Georgia and Cambodia managed to increase tax revenue substantially through a combination of reforms that include tax code simplifications, human resource and organizational changes, and leveraging modern IT systems to improve the efficiency and curb corruption (Box B.2). The increase in the compliance gap during the economic downturn in 2020 highlighted how strong economic conditions play an important role in bridging tax compliance gaps. Additional efforts to improve tax enforcement and boost tax morale among taxpayers are needed to reduce tax evasion.

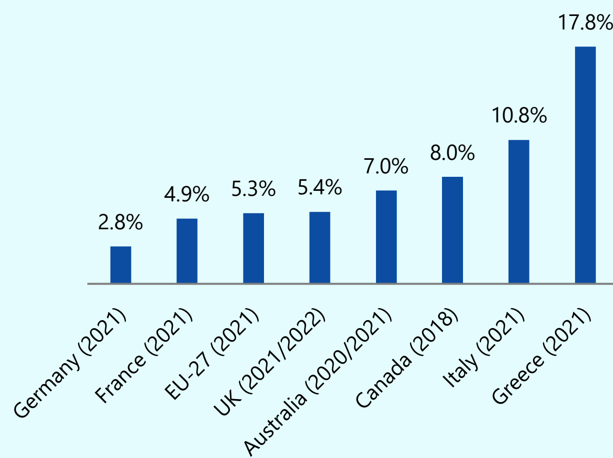
BOX B.1
High income countries are not immune to compliance challenges

Among OECD countries, VAT compliance gap is non-negligible. The VAT compliance gaps in advanced economies typically range from 2 to 20 percent (Figure B.1.1). This indicates that advanced economies also face taxpayer compliance challenges and complete sealing of the compliance gap is difficult, if not impossible. At the same time, there is broad evidence of success stories, where countries have much lower gaps than other comparators. Overall, more than one-half of the European Union (EU) member states recorded a compliance gap of below 5 percent of the VTTL in 2021.

The evolution of the compliance gap in recent years in selected high-income countries also indicates that the compliance gaps are actionable. In 2009, the EU-wide compliance gap reached its peak of over 18 percent before reducing to 5.3 percent in 2021 (Figure B.1.2). The increase in taxpayer compliance was accompanied by numerous reforms and efforts of tax administrations. For example, actions such as the introduction of domestic reverse charge, later replaced with the split-payment mechanism, the introduction of e-reporting, and increased penalties for fraud have contributed to a decrease in the VAT compliance gap in Poland from 24 percent in 2015 to under 10 percent in 2021.

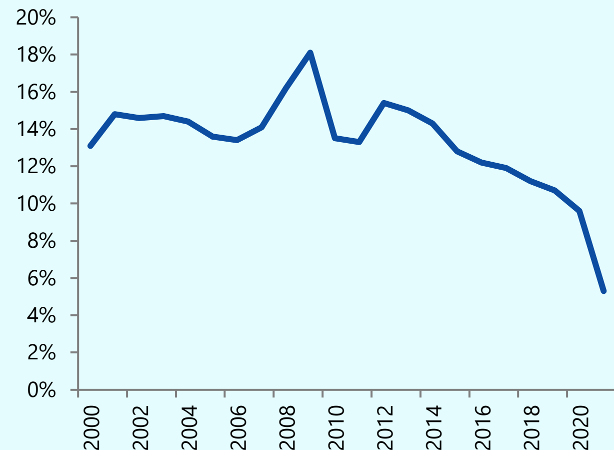
[23] See European Commission (2022) on the analysis of the impact of digital reporting requirements in the EU, https://op.europa.eu/s/yKu6

Figure B.1.1: VAT/GST compliance gap in selected high-income countries (2021 or most recent available data)
(percent of potential revenue)



Sources: European Commission (2023), Canada Revenue Agency (2022), Australian Taxation Office. (https://www.ato.gov.au), HM Revenue & Customs (2023).
Note: Non-compliance could have increased during pandemic years, leading to elevated tax gap estimates as some countries granted delayed payments options.

Figure B.1.2: Total VAT compliance gap in the EU (2000-21)
(percent of the EU-wide potential revenue)



Source: Own elaboration based on European Commission (2023).

BOX B.2
Georgia and Cambodia's successes in tax policy and administration reforms

Georgia implemented a comprehensive tax reform focused on tax code simplification and reducing incentives for evasion, leading to a three-fold increase in their tax ratio. During the early 2000s, the government drastically simplified the tax code, consolidating the number of general tax types from 21 to 6, all of which were low, flat, and easier to understand. These policy reforms were complemented by innovative tax administration reforms, including compulsory e-filing, IT-based audit risk assessment, and outsourcing tax audits to private firms to encourage tax compliance. Additionally, the introduction of fairer and more transparent dispute resolution mechanisms, as well as targeted measures to ease the administrative burden on small businesses, further improved business-tax authority relations and boosted tax morale. These policy and administration reforms translated to massive increases in tax revenues from 7 percent of GDP in 2003 to 24 percent of GDP by 2011.[24]

Under its Revenue Mobilization Strategy (RMS) 2014–18, Cambodia implemented a series of key tax administration reforms that significantly boosted tax revenue performance to be at par with other emerging markets. Reforms under this strategy included digitalization (e.g., introduction of a centralized taxpayer registration database, full implementation of e-filing and e-payment systems, and strengthened large taxpayer management), HR improvements that expanded the staff to focus on larger taxpayers, and enhanced audit activities which focused on risk-based audits. Similar to Georgia, the government also improved dispute resolution mechanisms and prioritized easing administrative burdens of small businesses. As a result, Cambodia's tax-to-GDP ratio exceeded its targets under the RMS, increasing from 15.2 percent in 2014 to 17.2 percent in 2017, with tax revenue growing significantly faster than the rate of economic growth during the period.[25]

[24] Source: Gilauri, Nika. *Reforming Taxes and Customs.* Chapter 5 in Practical Economics, pp. 97–104.
[25] Source: Adams, Debra; Jenkins, Charlie; De Mets, Patrick; Wilcox, Stephen. *Cambodia: Technical Assistance Report—Tax Administration Modernization Priorities 2019–23.* IMF Country Report No. 18/305

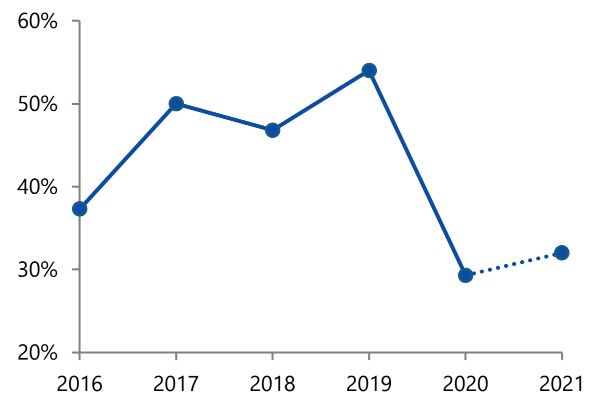
2.4 Corporate Income Tax (CIT) gaps

The government collects less than half of its potential CIT revenues. Between 2016 and 2021, Indonesia's CIT revenue averaged 42 percent of its potential, despite a statutory CIT rate in-line with regional and structural peers (Figure B.20). This sharply drops in 2020 to 29.3 percent (Figure B.18). Due to the impact of the pandemic on firms' profits, CIT revenue declined by about 35 percent, widening the gap between potential and actual collections (Figure B.19). The decline in efficiency is partly due to a six-month postponement of CIT payments and difficulties in accounting for late payments. Nevertheless, despite economic headwinds in 2021, collection efficiency is estimated to have improved only marginally.

The policy gap accounts for a larger share of foregone CIT revenues. The CIT policy gap accounted for about 35.9 percent of its potential, or 1.8 percent of GDP, between 2016 and 2021. The top three sources of foregone CIT revenues are: (i) reduced rates for enterprises with gross turnover below Rp 4.8 billion; (ii) tax rate discounts for small companies with yearly turnover below Rp 50 billion; and (iii) tax rate reductions for public companies. The long-term decline in the CIT policy gap is primarily due to fewer companies benefiting from preferential regimes over the years, driven by inflation and real economic growth for companies with turnover below Rp 50 billion.

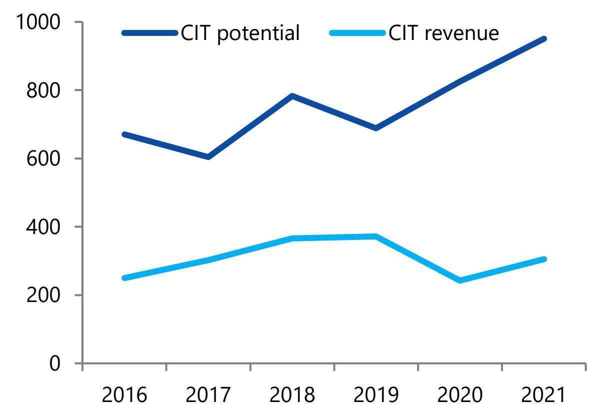
Compliance challenges in CIT contributed to a third of foregone revenue, at levels that are comparable to international trends. Between 2016 and 2021, the average CIT compliance gap was about 33 percent of total CIT potential, equivalent to 1.1 percent of GDP. This fluctuated significantly due to misalignments between tax revenue figures and liability estimates, influenced by audits and tax amnesties in 2016 and 2017, which caused discrepancies between cash and accrual-based revenue. Despite these issues, the general trend suggests a rising compliance gap. However, these levels are comparable to international trends, with Costa Rica at a 60 percent gap in 2015, South Africa between 8 and 12 percent from 2015 to 2017, Poland's 30 percent gap in 2019 and 2020, and the UK's 8.7 percent gap in 2017-18.

Figure B.18: CIT collection efficiency (2016 to 21)
(percent)



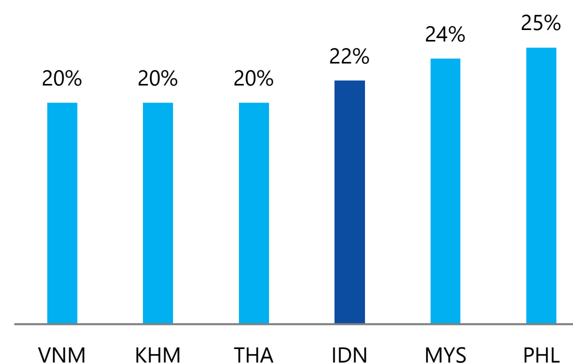
Source: World Bank staff elaboration.
Note: Estimates for 2021 may be subject to larger imprecision due to data unavailability.

Figure B.19: CIT revenue versus potential (2016 to 2021)
(IDR trillion)



Source: World Bank staff calculation.

Figure B.20: Statutory CIT rates, Indonesia versus regional and structural peers
(percent)



Source: PwC tax summaries.

3. The drivers of Indonesia's tax non-compliance

Tax compliance is a multifaceted issue influenced by both individual and systemic factors. Non-compliance with tax obligations arises from a variety of elements, including taxpayer behavior, government enforcement effectiveness, and broader structural conditions. Taxpayer evasion can stem from attitudes toward taxes (tax morale) and complexities within the tax system, while government actions, such as audits, enforcement mechanisms, and dispute resolution processes, play a critical role in ensuring compliance.

3.1 Behavioral factors that incentivize tax evasion[26]

At least a quarter of registered firms admit to not paying all the taxes they owe. These are findings from a double-list experiment embedded in the 2023 World Bank Enterprise Survey (WBES). Respondents were divided randomly into two groups, each receiving two lists of statements about their firm. Both groups are given almost identical lists, except the treatment group contains an extra statement, "This establishment does not pay all the taxes it is required to pay." (Table B.2). Firms in each group are then asked to state the number of statements applicable to their business (i.e., statements which are applicable are not disclosed). The prevalence of tax evasion is indirectly estimated by comparing the average responses in each group. While this technique, which avoids directly asking a firm whether they avoid taxes, is likely to be a more credible way to interrogate sensitive topics. However, these estimates are still based on self-reported information and should be treated as a lower bound for the prevalence of tax evasion.

Certain types of firms are more likely to evade taxes. Tax evasion has been found to be more common among firms that do not export, face substantial competition from the informal sector, and believe tax administration is a major obstacle to their business activities (Figure B.21). These findings provide insights on areas where tax administration efforts can facilitate better compliance. For instance, the higher rates of tax evasion among non-exporting firms suggest that many firms may perceive that the revenue authority lacks third-party data information about economic activities that do not cross international borders. Furthermore, the notably higher rates of tax evasion by firms that see tax administration as a major obstacle to their business activities provide suggestive evidence that efforts to simplify the tax system may lead to increases in compliance.

Table B.2: Design of the double list experiment

	GROUP A	GROUP B
List 1	• This establishment had to let go of an employee over the last year • This establishment's last month sales increased by 200 percent • This establishment was temporarily closed during the COVID-19 pandemic	• This establishment had to let go of an employee over the last year • This establishment's last month sales increased by 200 percent • This establishment was temporarily closed during the COVID-19 pandemic • This establishment does not pay all the taxes it is required to pay
List 2	• This establishment almost went bankrupt in the last year • At least one of the employees of this establishment contracted COVID-19 since the start of pandemic • The price of the main product of this establishment changed over the past year • This establishment does not pay all the taxes it is required to pay	• This establishment almost went bankrupt in the last year • At least one of the employees of this establishment contracted COVID-19 since the start of pandemic • The price of the main product of this establishment changed over the past year

Source: 2023 WBES, Hoy et al. (2024).

[26] This sub-section draws upon the experiment Hoy et al 2024.

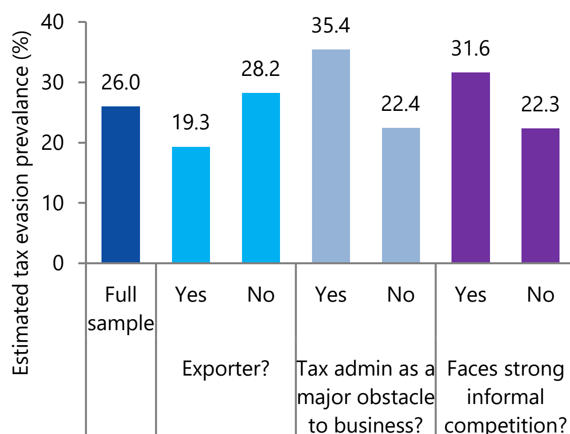
To understand the drivers of non-compliance and tax evasion, it can be helpful to take a firm-based perspective on paying taxes. There are financial and time costs associated with complying with tax obligations, and these may amount to a substantial obstacle to operating a business. Firms will look for opportunities to minimize these burdens, sometimes even going beyond what is permitted under the tax code. In other cases, firms may be non-compliant simply because they have low capacity to understand their obligations or to carry out the necessary steps. Furthermore, firms' decisions are also shaped by their underlying attitudes and beliefs about the tax system. Recent data from the 2023 WBES sheds light on all these factors in the Indonesian context.

One third of firms say that taxes are an obstacle to their operations and an even larger share believe that taxes are discouraging formalization. Firms were asked whether tax rates and tax administration are a minor, moderate, major, or very severe obstacle to their business, or not an obstacle at all. On tax rates, 34.0 percent of firms responded that it was a moderate or worse obstacle, while for tax administration, 33.7 percent of firms said the same. While grievances on the tax system are common findings in enterprise surveys, these results still suggest that the tax system is a more widespread pain point for firms than the courts, transport, workforce education, and electricity (Figure B.22). Moreover, these concerns about taxes have been becoming more widespread since 2009. Firms' perception of the tax system may be contributing to informality. Of the 55.6 percent of firms that claim to have informal or unregistered competitors, about 95 percent believe that taxes are the main reason for those competitors not formalizing.

About half of firms reported that it is easy to avoid paying some of the taxes that they owe. Among firms that report being subject to the CIT, about 52 percent say that it is easy or very easy to avoid paying the full amount of CIT owed. For firms subject to VAT, about 44 percent say the same. The link between the ease of evasion and the act of evasion may not be straightforward; for instance, many taxpayers may pay all their taxes irrespective of how easy it is to avoid. Nonetheless, at the margin, higher non-compliance should be expected in environments where firms believe it is easier to get away with.

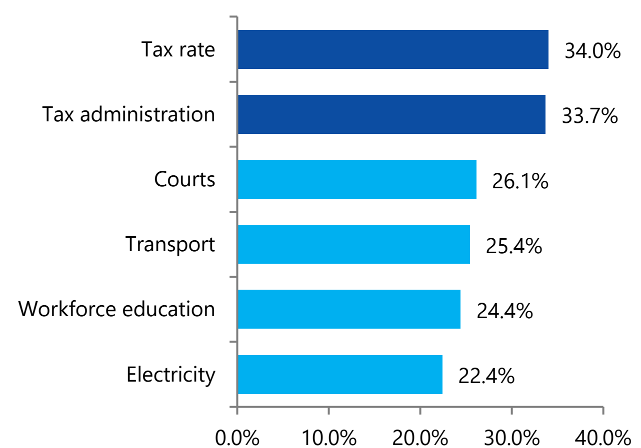
Firms that perceive tax evasion as easy tend to share certain characteristics. Specifically, firms are more likely to believe it is easy to evade CIT if they: (i) have better understanding of their tax obligations, (ii) find complying is complicated, (iii) finance their working capital entirely through their own funds, and (iv) use external expertise to partially help with their tax preparation, filing, or payment.[27] Interestingly, using external expertise to fully complete all these tax steps did not affect perceptions of ease of evasion. This possibly indicates a distinction between capable firms seeking specialized help to exploit loopholes versus less capable firms needing full compliance support.

Figure B.21: Tax evasion prevalence, by firm characteristics
(percent of firms)



Source: World Bank staff estimates from 2023 WBES.

Figure B.22: Share of firms that find tax rates and administration as moderate or worse obstacles to business
(percent of firms)



Source: WBES 2023, World Bank staff estimates.

[27] Findings based on logistic regression with size, sector, and location controls.

Even when firms want to comply, doing so may prove unduly challenging. Almost 70 percent of firms say that complying with CIT is complicated, while over 40 percent say the same of the VAT. Among those holding such a view, over two thirds attributed the complexity primarily to either conflicting requirements, unclear procedures, or low-quality DGT guidance. The burdens of such tax system complexity usually fall hardest on small, low-capacity firms as evidenced by a negative correlation between perceived complexity and firm size—only 44 percent of firms with 100 or more employees felt CIT compliance was complex. Moreover, about 15 percent of firms say that the complexity of CIT compliance has increased over the past three years, with most attributing the increase to either conflicting requirements or complex tax forms.

Promoting favorable beliefs and attitudes towards tax institutions may improve voluntary compliance, reducing firms' inclination to evade taxes and increasing their willingness to navigate tax complexity. Since no tax authority can monitor every taxpayer or investigate all potential infractions, promoting voluntary compliance is essential for effective revenue collection worldwide. Emerging research highlights the importance of taxpayer morale and trust for shoring up voluntary compliance. Taxpayer morale refers to the intrinsic motivation or willingness of firms to comply with tax laws and pay taxes. Taxpayer trust refers to the confidence and belief that taxpayers have in the fairness, equity, transparency, and effectiveness of the tax system and the institutions that administer it. Governments and tax authorities likely have a more immediate influence on fostering trust through their policies and behavior, whereas building taxpayer morale may require a longer-term effort.

Taxpayer morale and trust are strongly linked and are influenced by factors such as tax enforcement activity, access to taxpayer services, and tax system complexity.[28] Interactions with tax authorities, especially inspections and use of taxpayer services, increases taxpayer trust, while tax complexity lowers it.[29] The positive effect of interactions with the tax authority on trust may be related to the favorable view that firms have of the DGT—in fact, inspected firms are more likely to state that the DGT is fair, impartial, and uncorrupted. Second, while trust and taxpayer services positively influence taxpayer morale, both tax enforcement and complexity have a negative effect on it. The negative effect of tax enforcement on morale may seem puzzling. However, this result likely reflects the perception of inspections as an added layer of complexity rather than a supportive measure. While inspections can foster trust by demonstrating fairness and transparency, they may simultaneously reduce morale by increasing administrative burdens and creating an environment that feels more punitive than service oriented. This interpretation is reinforced by the direct negative effect of tax inspections on morale, contrasted with its indirect positive effect through the trust it builds.

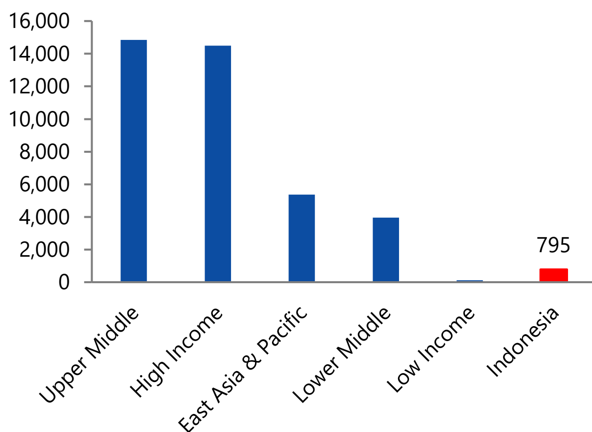
3.2 Weakness in the tax enforcement

Tax administration can be broken down into the core functions of audit, enforcement, and dispute resolution. During the audit phase, cases are selected either by discretion or through a parametric/risk-based approach, and data and evidence are used to generate tax liabilities (i.e., how much the taxpayer should pay but has not paid). At the enforcement stage, these tax liabilities are collected using a range of tools, from warning letters to asset seizures, implemented sequentially. Lastly, taxpayers have the right to dispute tax liabilities generated in audits. Disputes arising from interpretations of laws and regulations are first attempted to be resolved through DG Tax's objection channels and then elevated via an appeal process to the Tax Court,[30] if necessary.

Audits have not been effective at identifying tax evasion. Indonesia's tax authority conducts less audits than peers, measured as number of audits per capita. (Figure B.23) Moreover, audit-derived tax liabilities for VAT and CIT have been on a consistent decline, suggesting that less tax evasion is being identified. This could in part be driven by the decrease in the number of audit cases, particularly for VAT. This decline may be attributed to the impact of the COVID-19 pandemic, during which the government might have opted for less stringent measures to support businesses amid the economic downturn. In addition, the tax authority may be overwhelmed with processing routine refund requests, which, by law, must be resolved within 12 months or the taxpayer has to be compensated, diverting resources from more revenue-generating audits.

[28] Findings based on two-stage structural equation model.
[29] Tax enforcement is a measure of how often firms get inspected, whereas tax services reflect the intensity with which firms use taxpayer services and their level of satisfaction with such services. Tax complexity, on the other hand, is based on firms' understanding of the requirements for compliance with CIT and VAT.
[30] This is an independent institution under the Ministry of Finance. However, a recent reform has shifted the administration of this institution from the Ministry of Finance to the Supreme Court. The reorganization will take effect no later than December 31, 2026.

Figure B.23: Annual audits per million
(average from 2018 to 2020)



Source: World Bank staff estimates, IMF International Survey on Revenue Administration.

Indonesia's tax administration has significant opportunities to enhance the effectiveness of its enforcement functions in collecting audit-generated tax liabilities. While warning letters and distress warrants are commonly utilized, there is potential to explore and streamline the use of more robust enforcement tools, such as account blocking, arrest, and prevention measures, to improve arrears recovery. Addressing internal procedures that may limit their use could unlock these tools' full potential. The increasing number of taxpayer disputes, particularly regarding VAT, highlights an opportunity to refine regulatory provisions and address ambiguities. This trend may also reflect improved taxpayer awareness of tax laws, presenting a chance to strengthen audit quality and build greater trust in the system.

Increasing access to information through third-party data and strengthening the regulatory frameworks can yield benefits across all three functions. The fragmented and confidential nature of third-party financial data hampers audit and enforcement efforts. Harmonizing bank secrecy, third-party data, and tax laws, while upholding privacy protections, can strengthen tax compliance. Currently, government institutions manage data separately under strict confidentiality, limiting the ability to collect accurate information on taxpayers' transactions. DG Tax's reliance on limited access through MOUs has proven insufficient for comprehensive and timely data sharing. Streamlining this data and making it accessible for audits could significantly boost compliance efforts. Lastly, the large volume of disputes highlights the necessity for strong regulatory measures that provide taxpayers with clear and consistent guidance. Updating tax regulations to stay aligned with changing business practices and economic conditions can prevent misinterpretations that lead to disputes.

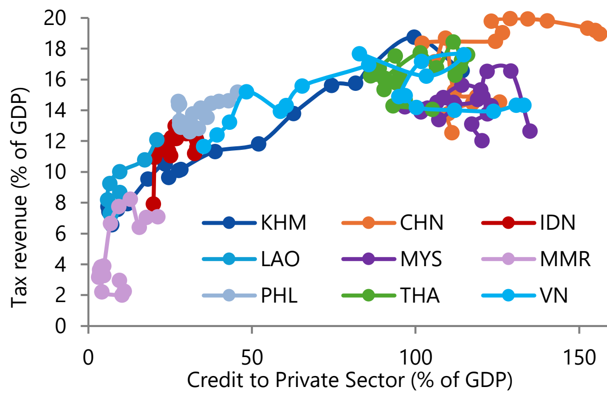
3.3 Underdeveloped financial markets

Cross-country evidence indicates that countries with more developed financial sectors tend to collect more revenues. Indonesia has low levels of both tax revenues and financial sector depth, while countries with higher financial system deposits and formal credit to the private sector (as a share of GDP) typically have higher tax ratios (Figure B.24). The connection lies in the formal financial system's role in tracking financial activities and supporting the accurate declaration of assets for collateral, which aids tax authorities in detecting non-compliance and discouraging tax evasion. Data supports this: businesses with access to credit lines, savings accounts, and other formal financial tools typically pay more in corporate income taxes (Figure B.25) than those without these resources. By expanding its financial sector, Indonesia can enhance access to finance for businesses to support growth while improving tax compliance through the digital trail left by financial transactions.

Formal finance is expected to discourage tax evasion. WBES results indicate that firms using bank funds to finance at least 50 percent of their working capital or investments find it more difficult to avoid VAT or corporate income taxes. Similarly, companies using electronic payment systems find tax evasion more challenging than those that do not.[31] This suggests that engaging with formal financial channels creates greater obstacles to tax evasion (Figure B.26 and B.27). Furthermore, a separate World Bank survey of Indonesian microenterprises reveals that many avoid banking transfers to evade taxes, driven by concerns that taxes paid through formal systems could be lost. This distrust reflects how a lack of confidence in the system can undermine tax morale and aligns with WBES findings, which highlight tax concerns as a key factor in keeping businesses informal (Figure B.28).

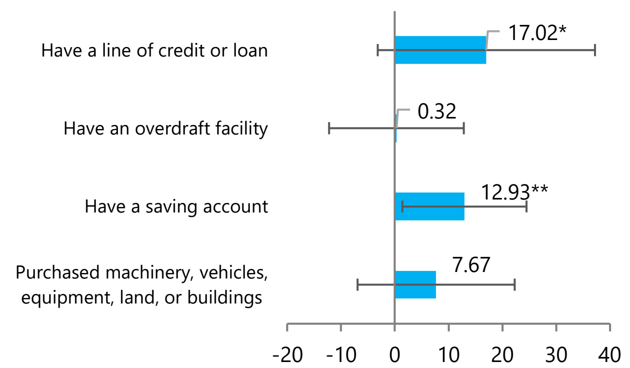
[31] Note that these findings are based on self-reported, survey information.

Figure B.24: Financial sector depth and government revenue



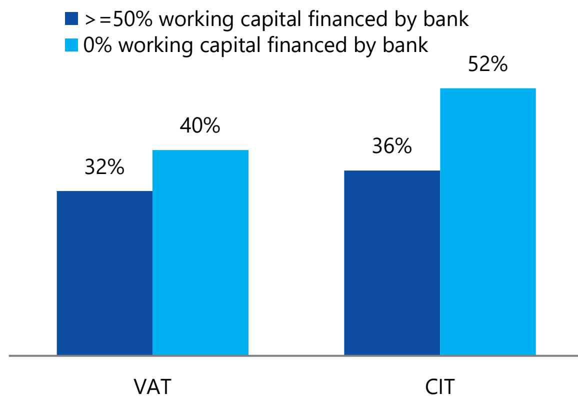
Source: World Bank staff calculation.

Figure B.25: Percentage of CIT paid (vs. various indicators of formal finance)



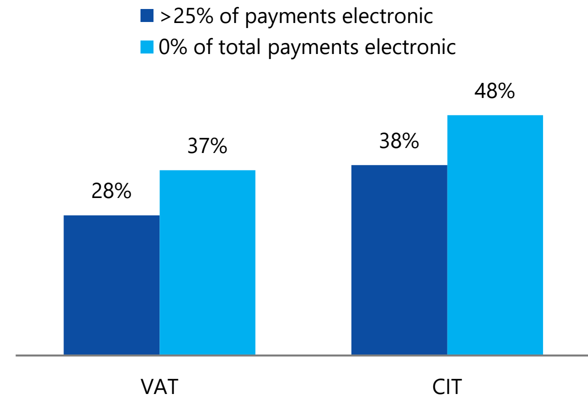
Source: World Bank staff estimates.

Figure B.26: Ease of avoiding taxes by use of bank finance
(percent that find it easy to avoid taxes)



Source: WBES, World Bank staff calculation.

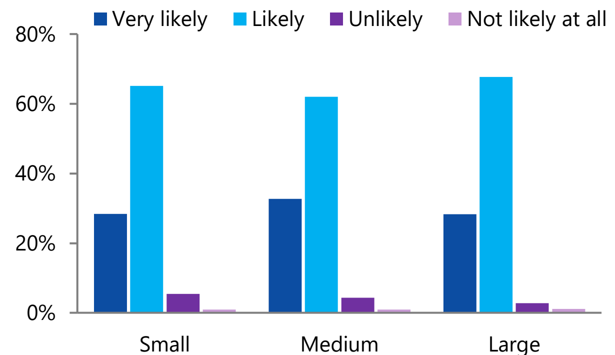
Figure B.27: Ease of avoiding taxes by use of electronic payments
(percent that find it easy or very easy to avoid)



Source: World Bank staff estimates.

Firms facing financial constraints are more likely to engage in tax planning to ease cash flow problems. The underlying intuition is that firms under financial pressure have a stronger incentive to engage in tax planning[32], which, if done aggressively, can border on tax evasion, to maintain necessary liquidity levels. Econometric analysis provides some evidence that financially constrained firms are more likely to engage in tax planning. These findings are robust even after controlling for various firm-specific factors, such as changes in pretax return on assets (PROA), sales, book-to-market ratio (BM), and leverage, which ensures that the observed effects are not driven by other variables.

Figure B.28: Likelihood of taxes being the main reason for competitors to remain informal
(percent of respondents)



[32] Examples of tax planning: (i) Taxpayers can reduce their taxable income by taking advantage of deductions e.g., deducting expenses related to operations, such as salaries, rent, and equipment costs; (ii) Tax credits directly reduce the amount of tax owed e.g., a company might receive a tax credit for investing in renewable energy or research and development; (iii) Companies can apply deferrals, which delays the recognition of income or accelerating the recognition of expenses to push tax liabilities to future periods e.g., a business might postpone invoicing until the next tax year to defer income; (iv) Through income shifting companies can move income or expenses between different entities or tax jurisdictions to take advantage of lower tax rates e.g., a company might shift profits to a subsidiary in a country with a lower tax rate.

3.4 High prevalence of informality

A significant portion of Indonesia's firms operates informally, particularly among micro-enterprises. A 2023 World Bank Informal Sector Enterprise Survey conducted across six Indonesian cities highlights the prevalence of informality. On average, around two-thirds of firms are informal, with notable variations across cities: 67 percent of firms in Makassar operate informally, while this figure rises to 78 percent in Jakarta (Figure B.29). Interestingly, over 70 percent of informal firms recognize the importance of paying taxes, indicating a general awareness of tax obligations. However, this agreement tends to be lower in cities with higher levels of informality. Additionally, 60 percent of informal firms believe that business registration does not apply to them, revealing a widespread misconception. This misunderstanding is especially pronounced in Surabaya (81 percent) and Denpasar (75 percent). These findings suggest that targeted tax education and awareness campaigns could play a critical role in addressing misconceptions about tax registration and encouraging formalization.

Given the characteristics of informal firms and the high threshold for standard tax rates, the foregone revenue from the informal sector is likely to be small. First, the distribution of firms in the informal sector is heavily skewed toward very small enterprises (Figure B.30). These firms typically lack the capacity to comply with standard tax regimes, as evidenced by the fact that only 14 percent of firms prepare a profit and loss statement at least once a year. Second, the annual sales of informal firms (Figure B.31) are notably low and fall significantly below the current tax threshold of IDR 4.8 billion for standard VAT and CIT. While formalizing these micro firms may not generate substantial tax revenue in the short term, it holds the potential to broaden the tax base in the long run. Formalized firms could benefit from opportunities to do business with other formal enterprises, gain access to credit at lower interest rates, and take advantage of government programs that incentivize investment and innovation. These benefits not only support the growth of individual firms but also contribute to overall economic development.

Figure B.29: Share of informal firms that report registration does not apply to them by city

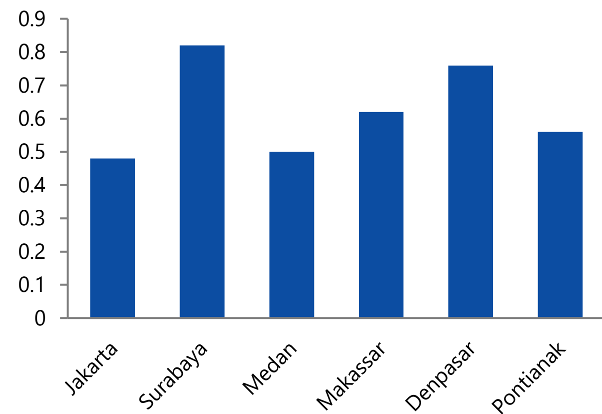


Figure B.30: Firm size distribution in informal sector

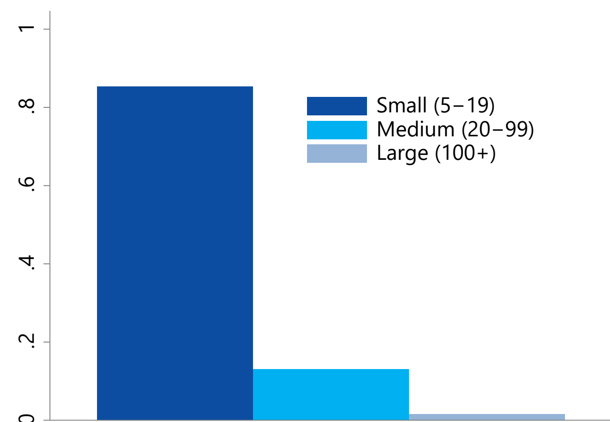
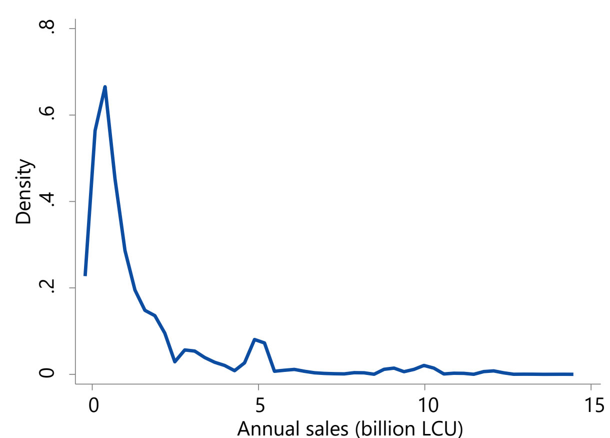


Figure B.31: Annual sales distribution in informal sector



4. Recommendations to increase development financing

4.1 Updating tax policies to widen the tax base

To simplify CIT and boost revenue, Indonesia can consider withdrawing special treatments and concessional schemes. Removing special treatments for the construction services sector, publicly listed firms, and MSMEs can help close the CIT policy gap and potentially generate considerable revenue. Construction services, which have been under a final tax regime, need to be reintegrated into the standard CIT system to align tax collections with the sector's GDP growth. Similarly, the ongoing tax preferences for publicly listed firms can be abolished, as the Indonesia Stock Exchange has become a mature market that no longer requires tax incentives to attract listings. The concessional CIT scheme for MSMEs, which is overly complex and creates horizontal inequities,[33] could also be replaced with a simpler, more permanent regime.

Tax holidays could be made more strategic and systematically evaluated to achieve better outcomes. While tax holidays are commonly used by countries to attract foreign direct investment (FDI), promote innovation, and support key sectors or regions, international evidence suggests they are often inefficient. They tend to benefit already-profitable projects rather than encouraging new investments. Additionally, tax incentives are not a major factor in attracting foreign investors and can lead to substantial revenue losses. A more effective approach would be to replace tax holidays with horizontal policies that reduce the overall cost of doing business. This includes lowering regulatory barriers, improving access to finance, supporting labor mobility and reskilling, and investing in infrastructure to reduce logistics costs. In the short term, conducting a comprehensive assessment of the costs and benefits of existing tax incentives would help identify any redundancies. Best practices for granting tax incentives involve using cost-based incentives, ensuring that all tax incentives are time-bound and performance-based.

The VAT tax base can be expanded substantially by reducing the registration threshold and exemptions. Reducing the VAT registration threshold from IDR 4.8 billion to IDR 0.5 billion would help to capture more businesses in the tax net, fostering formal business interactions between small and large firms.[34] Additionally, removing exemptions for various sectors, such as the extractive industry, imports of machinery, basic food, and private healthcare, can help align Indonesia's VAT system with international best practices. Simplifying the VAT system in this manner would broaden the tax base and help with compliance.

Tax rates hikes will lead to higher revenue when compliance challenges are addressed at the same time. Indonesia's VAT rate, even with the scheduled increase to 12 percent, will still lag peer countries. There is room for further increases in the VAT rate to align with the average rates of other lower-middle and upper-middle-income countries. To ensure that revenue gains from these rate increases are not undermined by poor compliance, tax administration needs to be strengthened, incorporating more third-party data to enforce compliance. Additionally, zero-rating for non-exports and the final VAT regime for hard-to-tax sectors could be eliminated, as they complicate the system and create opportunities for tax evasion.

4.2 Enhancing tax administration to increase compliance

Enhance compliance risk management (CRM) could improve detection and deterrence of tax evasion. The Indonesian tax authority can strengthen its CRM process by gaining access to high-quality third-party data, such as financial and transactional records, to better identify and manage taxpayer compliance risks. Increased accuracy in detecting tax evasion will lead to more accurate tax assessments from audits and more successful enforcement. Achieving this will require aligning bank secrecy laws with tax regulations to ensure that relevant financial data can be shared without compromising privacy rights. Additionally, integrating

[33] Firms and sectors with higher profit margins receive larger benefits.
[34] With an exceptionally high threshold, most small firms are exempt, which may discourage large firms' purchases from these small businesses (as large firms are not allowed to claim VAT credits on their inputs bought from exempt small businesses).

fragmented data across various government agencies and making it easily accessible to the DGT will improve audit accuracy and help reduce tax evasion.

Clarify and strengthen VAT regulations to help reduce tax disputes. The government can simplify and clarify VAT regulations to minimize disputes between taxpayers and tax authorities. Clearer guidelines and more consistent application of VAT rules will help prevent misunderstandings, improve compliance, and reduce the administrative burden on both taxpayers and the tax authority. Strengthening VAT regulations is essential to providing taxpayers with confidence and reducing litigation, ultimately improving audit outcomes and closing the tax compliance gap.

4.3 Addressing structural constraints to further facilitate compliance

Continue strengthening the financial sector to further improve financial inclusion and economic growth while also facilitating tax compliance. The government has made significant strides in addressing the challenges in Indonesia's financial sector, most notably through the adoption of the Financial Sector Omnibus Law (2023). These efforts align with the World Bank's framework for financial sector development, which emphasizes expanding the funding base, increasing access to finance, improving resource allocation efficiency, and maintaining financial stability. By maintaining a strong commitment to these priorities, the government can further strengthen the sector. A more efficient financial sector, with better credit information systems and formalized savings, will reduce information asymmetries and provide the tax authority with better data, ultimately leading to increased revenue collection.

Enhance third-party data sharing from the financial sector with the tax authority to enhance accuracy of CRM. The government can prioritize improving third-party data availability, particularly from the financial sector, to enhance tax compliance. This can be achieved by aligning regulations to encourage data sharing, establishing clear memorandums of understanding with financial institutions, and investing in IT systems for automated data reporting. These steps will allow tax authorities to verify income declarations more effectively, reducing the tax gap and promoting fair taxation across the economy.

Formalizing micro firms could support firms' growth and raise revenue in the long term. To raise tax awareness and promote formalization among micro firms, governments can simplify tax systems, offer education and outreach programs, and highlight the tangible benefits of formalization, such as access to credit, government programs, and new market opportunities. Reduced registration costs and phased tax obligations can further encourage compliance. Providing support services, leveraging technology for easy registration and filing, and partnering with local organizations can make the transition more accessible. Building trust through transparent use of tax revenues and showcasing the impact of taxes on community development is crucial for long-term success.

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Table B.3: Summary of Recommendations to Raise Tax Revenue

Objective	Recommendation	Additional Information
Broaden the tax base	Reduce the registration threshold for VAT, which also applies to the temporary final tax regime for MSMEs.	Ideally to IDR 500 million which is more aligned with international averages for middle income countries. For firms below the threshold, institute a permanent final tax regime for MSMEs.
	Remove special treatments and concessional schemes	Remove special treatments for construction services, publicly listed firms for CIT, and remove non common VAT exemptions.
	Rationalize tax incentives	Make tax incentives more strategic, time bound, and systematically evaluated.
Increase compliance	Enhance compliance risk management	Strengthen CRM by accessing high-quality third-party data and integrating fragmented data across government agencies.
	Clarify and strengthen VAT regulations	Simplify VAT regulations to reduce disputes and reduce administrative burden
Address structural constraints to facilitate compliance	Expand the reach, depth, and efficiency of the financial sector	Expand the funding base through digital access and the growth of institutional investors. Increase access to finance to individuals and SMEs. Improve efficiency of financial resource allocation with digital finance, increasing competition, and enhancing financial infrastructure (better credit information systems, collateral registries, insolvency framework, and consumer protection laws). Strengthen supervision of financial conglomerates, legal protections for regulatory staff, and crisis management coordination.

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