3 Indonesia

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I. Introduction

The word Indonesia was coined from the Greek *indos* – for India and *nesos* – for island. Several of Indonesia's islands hosted powerful trading empires between the fifth and sixteenth centuries, namely: Srivijaya (Buddhist, 3^{rd}–14^{th} century), Majapahit (Hindus, 13^{th}-15^{th} century) and Mataram (Islamic, 15^{th}-16^{th} century). The Dutch took control part of the islands in the early 1600s and for three centuries profited from Indonesia's economy, largely at the expense of the local population. Growing Indonesian nationalism led to a declaration of independence on August 17, 1945, after three years of Japanese occupation (1942-1945). The Netherlands finally acknowledged Indonesia sovereignty in 1949 through Den Haag's Round Table Conference.

Indonesia is a democratic country which is governed by a presidential system. The philosophical foundation of Indonesia is Pancasila, which comes from two Sanskrit words: *Panca* meaning Five, and *Sila* meaning Principles. The motto of Indonesia is Bhinneka Tunggal Ika, which also derived from Sanskrit, translated as 'Unity in Diversity' – literally means '(although) in pieces, yet one'.

I.1 Geography

The Indonesian geographical names reflect a long history of human settlement because of its strategic position between two continents: Asia and Australia and two oceans: Indian and Pacific; thus on the traditional trading crossroads. Indonesia is a melting port of all races since the flux all races from the north (Malay), the Polynesian from the east and also the flux of races from the middle east and west, since the first century. It is reflected in the prevailing more than 300 ethnic languages, and hence, Indonesia is rich in the generic terms of geographical features.

The Republic of Indonesia is the largest archipelago country in the world, comprising 17,508 islands (which only about 6,000 are inhabited) stretching along 5,120 kilometers from east to west (94o45' to 141o05' east longitude), and 1,760 kilometers from north to south (06o08' north latitude to 11o15' south latitude). Five main islands and 30 smaller island groups are home to the majority of the population. The main islands are Sumatera (425,606 sq km), Kalimantan (539,460 sq km), Sulawesi (174,219 sq km), West Papua (421,981 sq km), and Java (129,187 sq km), which where the capital city Jakarta is located.

The archipelago of Indonesia belongs to the Austral-Asiatic tropical zone. Climatic and weather condition of the archipelago is characterized by an equatorial double rainy season. The east monsoon where dry winds blow from the southeast, arid continent of Australia, bring dry season from May to September; while the west monsoon where wet winds blow from the northeast, the humid continent of Asia, bring rainy season from December to March.

I.2 Population, Ethnic and Religion

Indonesia is the world's fourth most populous nation and the largest Islamic country – with 87 percent Muslim and the others are Protestant (6%), Roman Catholic (3%), Hindu (2%), Buddhist (1%) and other religions (1%). The Indonesian Constitution states "every person shall be free to choose and to practice the religion of his/her choice" and "guarantees all persons the freedom of worship, each according to his/her own religion or belief. The government, however, officially only recognizes six religions, namely Islam, Protestantism, Catholicism, Hinduism, Buddhism and Confucianism.

Indonesia estimated population reach 246,799,165 in 2006, with more than 114 million people living in island of Java. Age structure of the population is: 0-14 years (29.1%), 15-64 years (65.7%), and over 65 years (5.2%) – with average life expectancy of 68 years old. The population growth rate has declined from 1.8% in 2004 to 1.45% in 2005. There are more than 300 ethnic groups live with each others. The proportional populations of Indonesian ethnic groups are: Javanese (45%), Sundanese (14%), Malay (7.5%), Madurese (7.5%) and others (26%).

I.3 Natural Resource

In spite of having rich natural resources, unavoidably the country natural resource is increasingly degraded, leaving less for the state to exploit and less for the growing rural population to seek its livelihood from. Forests, as the result of illegal logging, are declining by as much as 1 million hectares per annum and currently Indonesia has already become an oil importer. Crude oil and natural gas are the most predominant mineral resources while others are: coal, bauxite, copper, gold, iron sands, nickel, silver and tin. Most of these minerals are highly localized and often difficult and costly to extract. In 2005, non-oil and gas sector contribute 89 percent of GDP, while oil and gas only contribute 11 percent of GDP.

I.4 Agriculture

Until it was overtaken by manufacturing in 1991, agriculture was the largest sector of the Indonesian economy in terms of output. It remains the most important sector in terms of employment, providing livelihoods for approximately 40 percent of workforce in Java. Indonesia is an important producer of crops including rice, rubber, palm oil, copra, coffee, tea, cocoa, sugar and tobacco. Most of these crops are grown on commercial plantations and are destined primarily for export.

Indonesia is the second largest producer of crude palm oil (CPO) in the world with exports of approximately 10.3 million tons in 2005 for US$4.5 billion. Indonesia is the world's second largest producer of rubber, exporting approximately 90 percent of its production, with total rubber exports exceeding US$3 billion in 2005. It is also the world's third largest producer of cocoa with 13 percent of the world's market, estimated 165,00 metric tons in 2005 with 88 percent being exported.

I.5 Industry and Manufacturing

The industrial sector accounts for an increasing share of gross domestic product (GDP) – 41 percent and employed about 14.2 percent of workforce in 2005. Basic industries are automotive and transportation manufacture, food processing, forest product processing, metal manufactures, oil and natural gas processing, and textiles, as well as such other industries as electronic goods, footwear, furniture, garments, and paper goods.

The development of the textile industry has been one of the government's major priorities, Textile products remain the largest non-oil, export-based contribution to national income. In 2005 exports reached US$7.3 billion, while over 1.2 million people are employed in the textile industry.

I.6 Politics

The first direct national election to the presidency in October 2004 marked a turning point in Indonesian history. The constitution has been changed to permit direct election of the president and vice president. To be elected president, a candidate is required to receive a clear majority plus at least 20 percent of the votes in more than half of the provinces. Susilo BambangYudhoyono, who served as a Coordinating Minister of Politic and Security in Megawati Soekarno Putri's cabinet until resigned to run for the presidency, beat the former President with 61 percent of the vote to 39 percent. The new president leads the new Democrat Party, which won only 10 percent of the seats in parliament. As the result, the cabinet formed was a "rainbow" Cabinet, since support from other political parties is needed. The first homework to be done is regarding a huge bill for fuel subsidies, which is highly sensitive issues, while other tasks -- political decentralization, terrorism threat, widespread of corruption -- are waiting.

Due to the lack of performance from a few ministers, especially in the economic sector, the President decided to reshuffle the cabine. The cabinet reshuffle announced in December 2005 was well received, as reflected by the positive response in financial markets. There is renewed hope that the new Coordinating Minister of Economic Affairs, Boediono, and the Finance Minister, Sri Mulyani Indrawati, would deliver more effective policies that will take the economy onto a stronger growth path. The government has since committed to 153 policy reforms, where taxation and customs issues are mostly predominant, aimed at streamlining infrastructure-related investment.

A remark that the government has achieved is successful negotiations for peace in Aceh -- the province after almost 30 years of strife and rebellion, and which had badly devastated after hit by the tsunami on December 2004.

II. Overview of Macroeconomic Activity and Fiscal Position

The year of 2005 witnessed both dynamism and challenges for the Indonesian economy. Indonesian economy posted 5.6% growth in 2005, surpassing the 2004 level of 5.1%. Despite being higher than during 2004, economic growth tended to slow due to stronger pressures on macroeconomic stability. Sluggish growth adversely affected consumption and investment in line with softness in consumer spending, escalating production costs and a non-conducive investment climate. Pressures on macroeconomic stability have risen since QII-2005 marked by a deteriorating external sectors, weakening exchange rates and a higher inflation rate.

Table 1 Selected Macroeconomic Indicators

(%)

Description	2003	2004	2005
Gross Domestic Product (GP) Growth	**4.7**	**5.1**	**5.6**
CPI Inflation	5.1	6.4	17.11
Core Inflation	6.9	6.7	9.75
Average Exchange Rate (Rp/$)	8,572	8,940	9,713
Bank Indonesia Interest rate (1month) since July 2005	8.31	7.43	12.75
Current Account/GDP	**3.4**	**1.2**	**1.1**
GDP by Expenditure			
Consumption	4.6	4.9	4.4
Gross Domestic Fixed Capital Formation	0.6	14.6	9.9
Export of Goods & Services	5.9	13.5	8.6
Imports of Goods & Services	1.6	27.1	12.4
GDP by Sector			
Agriculture	3.2	3.3	2.5
Mining and Quarrying	-1.4	-4.5	1.6
Manufacturing	5.3	6.4	4.6
Construction	6.1	7.5	7.3
Trade, Hotel and Restaurants	5.4	5.7	8.6
Transportation and Communication	12.2	13.4	13.0
Finance, Leasing and Corporate Services	7.2	7.7	7.1
Services	4.4	4.9	5.2
Unemployment Rate	**9.5**	**9.41**	**10.84**
Poverty Rate	**17.4**	**16.7**	**16.0**
Real GDP per Capita (Thousand Rp)	**7,391**	**7,673**	**7,985**
Real GDP per Capita ($)	**861.4**	**857.9**	**819.6**
Monetary Aggregate			
M2 Growth, end of period	8.12	8.14	16.42
M1 Growth, end of period	16.60	13.41	11.07
Base Money Growth - end of period (test date)	14.25	22.03	20.22
Interest Rate (%)			
Inter Bank Money Market (overnight)	8.18	6.86	10.03
Time Deposits (1 month)	6.62	6.43	10.43
Working Capital Credit	15.07	13.41	15.18
Investment Credit	15.68	14.05	14.92
Balance of Payments			
Debt Service Ratio (DSR) (%)	34.1	30.1	25.3
International reserves, in months of imports and official debt repayment	7.1	5.5	-4.4

Source: Bank of Indonesia, Annual Report 2005

The Government decided to reduce subsidy spending by raising fuel prices twice, namely in March and October 2005. To dampen the negative impacts of fuel price hikes, the Government determined to maintain peoples' purchasing power through the provision of the Direct Cash Transfer for the poor, village infrastructure development, health care and education incentive schemes.

After suffering sharp decline briefly to almost Rp12,000 to dollar in August 2005, the exchange rate stabilized and subsequently regained its value to Rp9,801 per dollar by the end of December 2005. On average, the rate stood at Rp 9,713 per dollar during 2005; 8.6% below the 2004 average.

CPI inflation in 2005 rose substantially to 17.1 % following the October hikes in fuel prices. This high CPI inflation was primarily driven by rising fuel prices and other administered prices, in particular transportation tariffs. In addition to high inflation expectations, the administered price increases and scarcity of fuel raised the prices of volatile foods due to a lack of supplies and disrupted distribution networks in various regions.

Growth in total exports remained high but weakened during the last quarter of 2005. In terms of the oil/gas sector, lower oil/gas export growth was due to lower productivity in Indonesia's oil wells accompanied by insufficient new exploration. Despite slower growth in volume, growth in non-oil/gas exports was partly ascribed to higher international commodity prices.

High growth in imports was reported during the first semester of 2005 but this weakened, thereafter, alongside sluggish growth in domestic demand. Lower imports were in line with slower investment, consumption and exports in QIV-2005 visible through lower consumer imports, raw materials and capital goods. This was closely related to weaker public purchasing power driven by rising fuel prices and exchange rate depreciation. Furthermore, exports also declined attributable to the high import content of Indonesian exports.

Banks' profitability, liquidity and capital were maintained securely and even improved over 2004. Up to December 2005, credit expanded by 22.7% with LDR of 64.7%, indicating that the targeted growth of 22-25%% was achieved comfortably. Credit to micro, small and medium enterprises (MSME) increased significantly reaching Rp354.9 trillion or 51 % of total bank credits. However, credit risks increased in line with the rising interest rates and real sector risk, pushing NPLs to 8.3%.

II.1 Macroeconomic Activity

II.1.1 International Environment

(1) Trade Balance

Concerning externalities, developments in the Indonesian Balance of Payments for 2005 were unfavorable. Weak growth in global trade volume, higher freight costs and the profit transfer of oil/gas companies exacerbated the current account balance throughout the reporting year. This is reflected in the declining current account surplus from $3.1 billion (1.2% of GDP) in 2004 to $3.0 billion (1.1 % of GDP). The declining surplus was primarily due to the oil sector which saw its imports increase substantially in line with higher fuel consumption. Greater imports and also a widened services account deficit were not offset by increases in oil exports, which were constrained by declining oil production; hence, reducing export volume. The official capital balance in 2005 recorded a significant surplus mainly due to debt moratorium following the tsunami disaster and rights issues of sovereign bonds, whereas the growing surplus in the private capital balance was attributable to the merger acquisition of a domestic company by a foreign partner. The overall capital balance recorded a net surplus of $6.3 billion, mainly supported by debt moratorium and sovereign bond issuance.

Throughout 2005 the balance of payments faced strong pressures and accordingly, recorded a deficit. The deficit was posted at $385 million after reporting a surplus of $309 million in the previous year with a decline in reserves to $34.7 billion or equivalent to 4.4 months of imports plus public debt service payments.

Table 2 Balance of Payment

Description	2004	2005
		Millions of $
I. Current Account	**3,108**	**2,996**
Goods Balance	**21,552**	**22,784**
Exports	72,167	86,640
Imports	-50,615	-63,856
Services	**-18,444**	**-19,788**
II. Capital Account	**2,612**	**6,254**
Public Sector	-1,777	1,184
Private Sector	4,389	5,070
Direct Investment	1,023	2,258
Portfolio Investment	3,136	3,221
Other Investment	231	-408
III. Total	**5,720**	**9,250**
IV. Errors and Omissions	**-5,411**	**-9,635**
V. Financing	**-309**	**385**
Change in International Reserves [1)]	674	1,492
Change due to Transactions		
IMF	-983	-1,107
Notes		
1. Foreign Assets (IRFCL)	36,320	34,724
Equivalent to imports and payments on government foreign debt (months)	5.5	4.4
2. Current Account/GDP (%)	1.2	1.1

Source: Bank of Indonesia Annual Report 2005

(2) Exports

During 2005 the value of total exports soared by 20.1 % reaching $86.6 billion, compared favorably with the previous year (12.6%). Both oil-gas and non-oil-gas exports contributed to the higher growth in exports. Growth in oil-gas exports was triggered by a surge in global oil prices, peaking at $69 per barrel by the end of August, which also raised other non-oil-gas commodity prices and, consequently, accelerated non-oil gas exports.

The upward trend of global oil prices raised oil-gas exports by 15.3% over the previous year to $20.4 billion. Oil exports contributed $9.2 billion; an increase of 9.9% over 2004. Despite being relatively high, the value of oil exports did not grow in line with the price, which is attributable to declining volume. The hikes in oil prices were followed by soaring gas prices; substantially increasing the value of gas exports by 20.1 % to $11.1 billion. However, the gas volume declined slightly. The higher growth of non-oil gas export mainly stemmed from higher commodity prices in the mining, agricultural and manufacturing sectors. However, the increases in agricultural and manufacturing prices were not as high as those of mining commodities.

Table 3 Development of Exports

Description	2004	2005	2005	
	Change (%)		Fob Value ($ millions)	Share (%)
Non-Oil and Gas Exports	11.5	21.6	66,257	76.5
Agriculture	-11.6	19.0	2,891	3.3
Mining	11.9	38.9	6,438	7.4
Industry	12.9	20.1	56,928	65.7
Oil and Gas Exports	16.1	15.3	20.384	23.5
Total	12.6	20.1	86,641	100.0

Source: Bank Indonesia and Central Bureau of Statistic (BPS) Indonesia

By commodity, the domination of price factor toward export growth did not occur in all commodities. Commodities that enjoyed higher prices include shrimp, nickel ore, footwear and cement. The increase in shrimp exports was fully attributable to the higher price as the volume declined. Higher chemical, coal and nickel ore exports were driven by both higher prices and slight increase in volume. A number of other commodity exports were driven by higher volumes but declining prices.

Table 4 Selected Non-Oil/Gas Export Commodities

Description	2004	2005	2005	
	Change (%)		Fob of value (millions of $)	Share (%)
Textiles and Textile Products	2.9	25	9,382	14.2
- Garments	5.2	21.5	5,301	8.0
Electrical Appliances	6.0	19.8	4,067	6.1
Wood-based Products	-2.6	14.5	3,622	5.5
- Plywood	-12.1	23.6	1,855	2.8
Crude Palm Oil	33.0	4.7	3,509	5.3
Coal	30.3	29.5	3,465	5.2
Rubber Products	34.1	18.6	3,412	5.2
Copper Ore	-8.8	55.5	2,729	4.1
Chemical Products	20.3	29.3	2,452	3.7
Paper	5.3	12.6	2,444	3.7
Metal Products	101.4	33.5	2,385	3.6
Shrimp	-13.6	11.8	897	1.4

Source: Central Bureau of Statistic of Ministry of Republic of Indonesia

By export destination, most Indonesian products were exported to five major countries, namely Japan (14.8% of total non-oil-gas exports), the US (14%), Singapore (10.6%), China (6%) and Malaysia (4.9%)These five destinations account for 50% of Indonesia's total exports; relatively unchanged from the previous year. These are considered the conventional market destinations for Indonesia's exports and Indonesia is highly dependent upon this market. As a consequence, however, Indonesian exports are vulnerable to economic instability in these countries. The major commodity exported to the five major destinations varies.

Table 5 Major Non-Oil/Gas Export Commodities by Country of Destination

No	Japan	United States	Singapore	China	Malaysia
1	Metal Ores and Metal By-Products (3.06%)	Garments (4.16%)	Electrical Machinery, Apparatus (2.65%)	Fixed Vegetable Oils and Fats (1.04%)	Fixed Vegetable Oils and Fats (0.51%)
2	Coal, Coke, and Briquettes (1.65%)	Telecommunications and Rep. App (1.24%)	Office Machinery and Automatic Data Processing (1.60%)	Organic Chemicals (0.92%)	Office Machinery and Automatic Data Processing (0.50%)
3	Wood, Lumber and Cork (1.23%)	Crude Rubber (1.22%)	Nonferrous Metals (1.12%)	Crude Rubber (0.5%)	Paper, Paperboard, and Mfd there of (0.32%)
4	Electrical Machinery, Apparatus (1.00%)	Fish, Crust. , Mollusks and Their Prep (0.88%)	Telecommunications and Rep. App (0.84%)	Nonferrous Metals (0.34%)	Coffee, Tea, Cocoa, Spices (0.31%)

Source: Bank of Indonesia Annual Report 2005

(3) Imports

In 2005, imports (C&F basis) rose by 26.4% on account of increase in oil-gas imports (42.9%) and non-oil-gas imports by 22.1 %. The rise in oil-gas imports were triggered by higher crude oil and fuel imports bill driven by soaring global oil prices. Oil imports continued to rise up to QIII but went down thereafter following the substantial hike in fuel prices by the Government in October 1, 2005.

Table 6 Development of Imports

Description	2004	2005	2005	
	Change (%)		C&F Value (Millions of $)	Share (%)
Non-Oil and Gas Imports	26.7	22.1	52,169	76.6
Consumer Goods	34.6	7.1	3,345	4.9
Raw Materials	21.8	21.8	38,071	55.9
Capital Goods	45.2	28.7	10,753	15.8
Oil and Gas Imports	42.6	42.9	15,944	23.4
Total	**36.3**	**26.4**	**68,113**	**100**

Source: Bank Indonesia and Central Bureau of Statistic (BPS) Indonesia

Imports of capital goods increased to a greater extent than other imported goods. The high growth in capital goods (28.7%) was sparked by higher demand amidst declining prices in the international market. Imports goods which enjoyed higher growth include transportation vehicles and non-transportation capital goods. Raw material imports rose by 21.8% over the previous year; driven principally by raw materials for manufacturing, spare parts and appliances. Imports of consumption goods increased by only 7.1 %; mainly due to imports of food and beverages.

Table 7 Selected Non-Oil/Gas Import Commodities

Description	2004	2005	2005	
	Change (%)		Fob of value (millions of $)	Share (%)
Industrial Raw Materials (Processed)	26.8	23.2	23,228	44.5
Capital Goods, Except Transport Vehicles	30.5	19	8,104	15.5
Spare Parts and Fittings for Capital Goods	20.7	35.7	5,074	9.7
Spare Parts and Fittings for Transport Vehicles	9.6	18	3,766	7.2
Industrial Raw Materials (Primary)	19.2	10.1	2,882	5.5
Industrial Transportation	252.8	92.9	2,273	4.4
Food & Beverages (Primary), for Industry	13.9	-4.4	1,786	3.4
Food & Beverages (Processed), for Households	7.4	25.8	1,090	2.1
Food & Beverages (Processed), for Industry	-1.2	48	1,056	2
Non Durable Consumer Goods	37.5	-3.9	623	1.2
Food & Beverages (Primary), for Households	47.1	-15.9	400	0.8
Semi Durable Consumer Goods	28.8	-0.4	377	0.7
Passenger Cars	81.9	2.2	376	0.7
Durable Consumer Goods	84	8.9	351	0.7
Passenger Cars	108.4	-1.1	300	0.6
Fuels and Lubricants (Processed)	17.1	2	261	0.5
Non Industrial Transportation	179.9	411.1	179	0.3
Industrial Raw Materials (Processed)	26.8	23.2	23,228	44.5
Capital Goods, Except Transport Vehicles	30.5	19	8,104	15.5

Source: Bank Indonesia and Central Bureau of Statistic (BPS) Indonesia

By country of origin, the share of imports from the five major countries of origin shifted slightly. The highest share in imports still originated from Japan, of which its share increased slightly over 2004. China maintained the second highest import share. However, unlike China, the share of imports from the US declined continuously. Finally, imports from Thailand climbed, exceeding the import share from Singapore. The total share of imports from these five countries reached 53.3%; an increase over the previous year (50.5%). The imported products were used as capital and raw material inputs for production.

Table 8 Major Non-Oil/Gas Import Commodities by Country of Origin

No	Japan	United States	Singapore	C hi n a	Thailand
1	Motor Vehicles for Public Roads (3.49%)	Other Transportation (0.93%)	Organic Chemicals (1.64%)	Iron and Steel (1.84%)	Motor Vehicles for Public Roads (1.95%)
2	Iron and Steel (2.36%)	Industrial Machinery and Fittings (0.86%)	Plastic (0.61 %)	Industrial Machinery and Fittings (0.84%)	Sugar, Sugar Products, and Honey (0.82%)
3	Industrial Machinery and Fittings (2.11 %)	Specialized Industrial Machinery (0.8%)	Industrial Machinery and Fittings (0.57%)	Electrical Machines, Tools, and Fittings (0.71 %)	Organic Chemicals (0.76%)
4	Specialized Industrial Machinery (1.69%)	Motor Vehicles for Public Roads (0.58%)	Iron and Steel (0.4%)	Inorganic Chemicals (0.54%)	Industrial Machinery and Fittings (0.56%)

Source: Bank of Indonesia Annual Report 2005

(4) Current Account

Overall, current account performance during the reporting year deteriorated slightly as a result of the worsened oil-gas current balance. This was reflected in the declining surplus from $3.1 billion in 2004 to $3 billion in 2005. An unfavorable current account performance was also recorded in the oil-gas sector; from a surplus of $1.2 billion to a deficit of $2.6 billion. This deficit was partially the result of a narrowing surplus in the trade balance in which import growth was higher than that of exports and a swelling deficit in the oil-gas services balance. The weak current account performance was inherent with global oil price hikes.

Conversely, the performance of non-oil-gas current account improved due to significant growth in exports driven by higher commodity prices. Export volume, however, was little changed due to a number of constraints such as low export competitiveness and sluggish global economic growth. Non-oil-gas export accelerated by 21.6%, reaching $66.3 billion; much better than the previous year of 11.5% (Table). On the other hand, growth in non-oil-gas imports was 21.4%, much lower than the previous year (24.4%), reaching $47.9 billion.

Table 9 Current Account

Millions of $

Description	2004	2005
Current Account	**3,108**	**2,996**
Oil and Gas	1,237	-2,632
Non-Oil and Gas	1,871	5,628
Balance of Trade	**21,552**	**22,784**
Oil and Gas	6,526	4,439
Non-Oil and Gas	15,026	18,345
Exports	72,167	86,640
Oil and Gas	17,684	20,383
Non-Oil and Gas Imports	54,482	66,257
Imports	-50,615	-63,856
Oil and Gas	-11,159	-15,944
Non-Oil and Gas	-39,456	-47,912
Services	**-18,444**	**-19,788**
Oil and Gas	-5,289	-7,071
Non-Oil and Gas	-13,155	-12,717

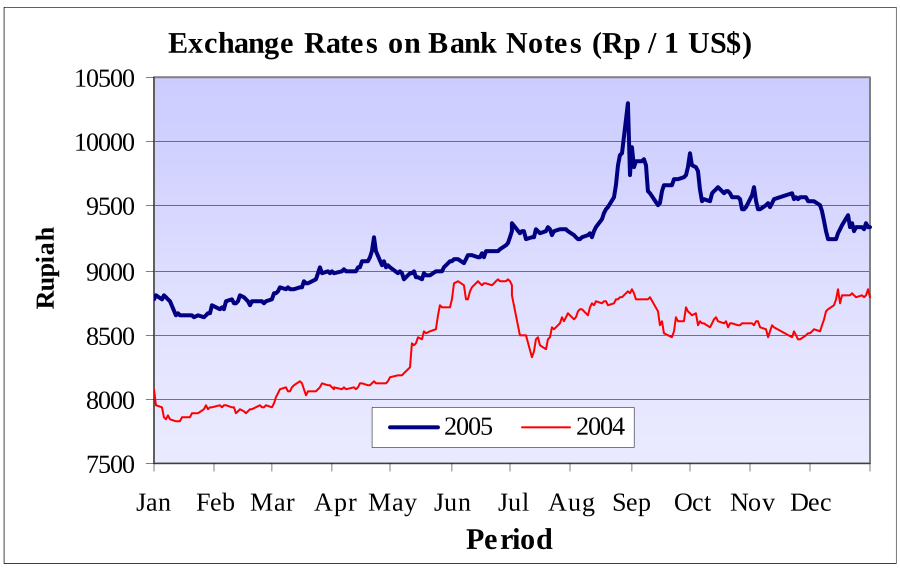
Source: Bank of Indonesia Annual Report 2005

(5) Exchange Rate and Exchange System

In 2005, Rupiah depreciated coupled with rising volatility. Rupiah depreciation was reflected in the Rupiah exchange rate against the dollar, which, on average, was 8.6% below the level in 2004. At year end, Rupiah was traded 5.9% below year end 2004. Volatility of 4.24% was marginally higher than for 2004 at 3.97%. Rising volatility was most evident in end of August 2005, corresponding to bullish sentiment surrounding the soaring global oil price (reaching approximately $70/barrel in August 2005) and dollar appreciation in the global market.

Rupiah depreciation in 2005 was extensively linked to external and internal shocks. External shocks stemmed primarily from the rising global oil price and the continuation of tight monetary policy in the US. These conditions put pressure on Rupiah in line with the deterioration of Indonesia's balance of payments and bearish exchange rate sentiment. Internal shocks, such as rising imports and foreign exchange demand to finance external debt repayments, also contributed to the weaker Rupiah The situation tended to deteriorate as the macroeconomic economy experienced shocks, evidenced by mounting inflationary pressure and an oversupplied Rupiah financial market.

Figure 1 Monthly Exchange Rate 2004-2005



Source: Bank Indonesia

(6) Foreign Direct Investment

The inflows of FDI during the reporting year were higher in year 2004. Total FDI inflows amounted to $6.9 billion; comprising of equities totaling $4.3 billion (increased from $1.3 billion in 2004) and loans totaling $2.6 billion. As a whole, FDI inflow was lower relative to the value of investment approved by the Coordinating Investment Board (BKPM), where in year 2005 foreign investment approved reached USD13.6 billion and fixed licensing issued by BKPM reached $8.9 billion.

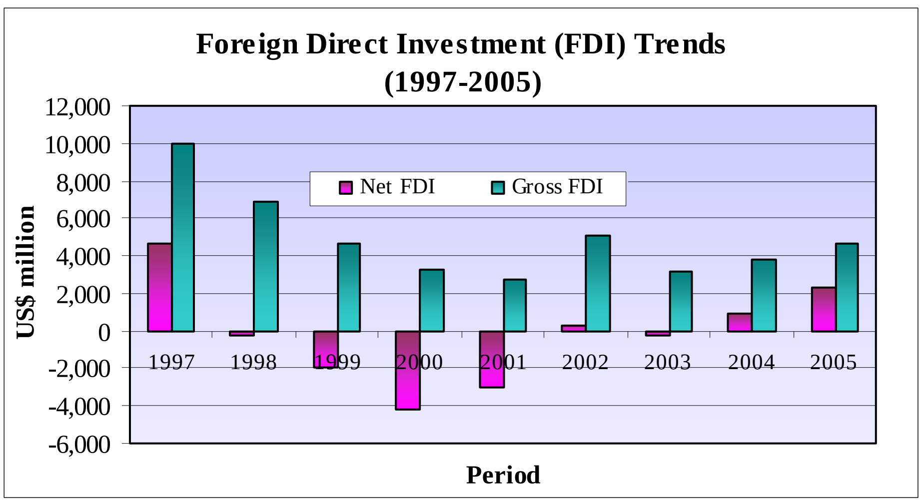
Table 10 Approved FDI Projects by Sector

(millions of US$)

Sectors	2001	2002	2003	2004	2005
Agriculture, forestry, and fishery	391.7	458.9	178.9	329.7	606.0
Mining	118.7	49.2	17.8	66.3	775.9
Manufacturing	5,144.4	.3,208.2	6,457.4	.6,334.3	6,028.0
Construction	47.6	287.7	787.7	954.0	1,777.2
Hotel	6,891.6	254.6	488.2	587.2	259.1
Transportation	373.3	.3,713.2	4,160.2	586.5	3,107.3
Real estate and office buildings	177.5	7.4	10.3	339.6	124.8
Other services	1,899.1	1,764.9	1,106.7	1,079.7	901.0
Total	**15,043.9**	**9,744.1**	**13,207.2**	**10,277.3**	**13,579.3**

Source: Bank of Indonesia

Figure 2 Foreign Direct Investment Trends



Source: Investment Coordination Board and Bank Indonesia

(7) Borrowing from Abroad

The official capital account improved marked by a high surplus over the previous year"s deficit. The surplus amounted to $1.2 billion from a deficit of $1.8 billion in the previous year. The improvement in the official capital account stemmed from debt moratorium and the issuance of international bonds by the Government. On one hand, debt moratorium eased the burden of foreign debt service payments and encouraged more economical use of reserves, but on the other hand the issuance of international bonds by the Government generated higher inflows to the official capital account, hence the overall official capital account enjoyed a surplus.

Debt moratorium extended by creditors under the Paris Club was associated with the tsunami disaster in Aceh and North Sumatra. This debt moratorium was imposed to allow postponement of foreign debt service payments, which could then be used for the reconstruction of disaster areas. The moratorium included both the principal and interest rate payments that due in 2005 and was treated differently from the general debt restructuring under the Paris Club. The moratorium did not link with the IMF program, the rating of Indonesian debt and the principal of comparability of treatment for commercial foreign debt. The total amount of moratorium was $2.7 billion comprising of the principal of $1.8 billion and interest payments of $0.9 billion. This debt repayment was postponed by 5 years with grace period of one year. As a result of this moratorium, the debt burden of the government declined significantly from $6.9 billion to roughly $4.2 billion.

Table 11 Indicators of External Vulnerability

Percentage (%)

Descriptions	2003	2004	2005
Current Account/GDP	**3.4**	**1.2**	**1.1**
Exports of Goods and Services/GDP	29.9	31.1	32.9
Non-Oil and Gas Exports/GDP	20.6	21.6	23.3
Foreign Debt Interest/GDP	2.3	2.2	1.7
Debt Service Ratio	32	30.1	25.3
Capital Flows/GDP	-0.4	1	2.2
Foreign Debt/Exports of Goods and Services	190.8	174.3	142.9
Foreign Debt/GDP	57	54.2	47
International Reserves/Debt Service	160	153.6	147.2
International Reserves/Foreign Debt	26.8	26.5	26
International Reserves/Imports and Government Foreign Debt Payments (months)	7.1	5.5	4.4
Foreign Debt ($ billions)	135,402	137,024	133,482
International Reserves ($) billions	36,296	36,320	34,724

Source: Bank of Indonesia Annual Report 2005

Inflows in the official capital account increased compare to the previous year. Throughout 2005, inflows from foreign borrowing disbursement totaled $4.8 billion. Unlike previous years, most inflows stemmed from international bond issuance; where the Government issued 3 series of sovereign bonds. The first series included Indo15 with a value of $1 billion in April 2005, falling due in 2015 with a coupon rate of 7.5%. In October 2005 the Government issued a further two series of sovereign bonds totaling $1.5 billion, namely Indo-16($0.9 billion) maturing in 2016 with a 7.5% coupon rate and Indo-35 ($0.6 billion) maturing in 2035 with 8.5% coupon rate.

Other inflows originated from creditors under the Consultative Group on Indonesia (CGI) forum. Disbursement under the CGI forum was lower relative to its pledge of $3.5 billion approved during the CGI conference in early 2005. The realized disbursement was only $1.3 billion; most of which came from the multilateral borrowing program. The disbursement from JBIC was $0.1 billion, ADB $0.8 billion and IBRD $0.4 billion. Constraints to disbursement were mainly related to budget management issues and changes in budget revision.

The low disbursement in both public and private borrowing has reduced outstanding foreign loans. Outstanding foreign debt declined from $137 billion in 2004 to $133.5 billion in 2005. This is most visible in government debt, which declined from $80.7 billion to $74.9 billion, whereas private sector debt dropped from $52.9 billion in 2004 to $51.9 billion. Outstanding domestic securities held by non residents soared from $3.4 billion to $6.6 billion. By share, official foreign debt was dominant (56%).

Table 12 Foreign Debt Outstanding

Millions of $

Description	2002	2003	2004	2005			
				Mar	Jun	Sep	Dec
Government	**78,324**	**80,910**	**80,734**	**77,675**	**76,770**	**75,254**	**74,893**
Private Sector	**55,212**	**51,942**	**52,929**	**52,448**	**55,948**	**55,609**	**51,943**
a.Financial Institutions	7,537	8,211	8,420	10,048	10,539	6,971	7,642
- Banks	4,316	3,906	4,037	5,913	6,239	4,834	4,870
- Non-Bank	3,221	4,306	4,383	4,136	4,300	2,137	2,772
b.Non-Financial Institutions	47,570	44,405	44,718	44,028	45,900	45,070	44,973
Securities	**1,634**	**2,550**	**3,361**	**4,239**	**3,571**	**4,873**	**6,646**
-Government	756	1,991	12,566	1,911	3,217	4,666	164
-Banks	-	4	4	5	9	15	-
-Non-Financial Institutions	1,794	1,367	1,670	1,656	1,648	1,965	1,470
Total	**135,170**	**135,402**	**137,024**	**134,362**	**136,290**	**135,736**	**133,482**

Source: Bank of Indonesia Annual Report 2005

By maturity, short-term foreign debt was relatively low at approximately $7.9 billion or 5.9% of total foreign debt. Most of this short-term foreign debt consisted of private foreign debt ($6.4 billion), whereas official foreign debt totaled only $1.5 billion. Against this backdrop, the burden of foreign debt service remained heavy, especially when considering the upward trend in the recent global interest rate.

Table 13 Foreign Debt Position by Maturity

Millions of USS

No	Maturity	December 2005					
		Government	Private Sector				Total
			Financial Institutions		Non Financial Institutions	Total Private Sector	
			Banks	Non Banks			
1	Short-Term	1,503	1,441	332	4,591	6,364	7,867
2	Medium and Long-Term	78,056	3,408	1,805	42,347	47,559	125,615
	Total	**79,559**	**4,849**	**2,137**	**46,937**	**53,923**	**133,482**

Source: Bank of Indonesia Annual Report 2005

II.1.2 Domestic Environment

(1) Economic Growth Rate

In 2005, the government launched a number of pro-growth policies targeting specific sectors and activities, including the following:

a) New tax and import duty incentives for capital investment, mining sector, automotive industry, and heavy equipment manufacturing to build a more conducive investment climate for investment and production.
b) Domestic fuel prices bought more into line with the market. Despite the added burden for the public and industry, in the longer term this policy will have a positive impact by promoting the development of alternative energy sources. This policy will also cut back the smuggling of fuel out of Indonesia.
c) Action to trim the high cost to the economy through simplification of licensing procedures, reduction in number of weighbridges, and revitalization of the coordinating team for streamlining processes for merchandise exports and imports. The government also took action to stimulate private sector interest in infrastructure investments by providing greater opportunity for public-private partnerships in infrastructure and more flexible project

tendering with the support of good governance practices. The issues of high costs in the economy and poor infrastructure are key factors that have hampered the investment climate.

d) Protection for domestic industry with new regulations governing imports of textiles and textile products (TPT) aimed at maintaining a conducive business climate for this sector on the domestic market and to prevent unfair trading practices disadvantaging the TPT industry and consumers.

e) Provision of direct cash transfers to the poor in compensation for the fuel price hike in order to sustain public purchasing power.

These policy actions will obviously not bring instant solutions to the complex array of economic issues. Nevertheless, the government economic institutions will work consistently towards improvement in economic structures and the business climate, which represents a prerequisite for sustainable growth.

Table 14 GDP by Sector

Billions of Rp

Sectors	Constant 2000 Market Prices		Current Market Prices	
	2004	2005	2004	2005
Agriculture, livestock, forestry, and fishery	248,222.8	254,391.3	331,553.0	365,559.6
Mining and quarrying	160,1 00.4	162,642.0	196,111.7	285,086.6
Manufacturing	469,952.4	491,699.5	639,655.0	765,966.7
Electricity, gas, and water supply	10,889.8	11,596.6	22,066.7	24,993.2
Construction	96,333.6	103,403.8	143,052.3	173,440.6
Trade, hotels, and restaurants	271,104.9	294,396.3	357,944.1	429,944.0
Transportation and Communication	96,896.7	109,467.1	142,292.0	180,968.7
Financial, rental, and business services	151,187.8	161,959.6	194,429.3	228,107.9
Services	152,137.3	159,990.7	234,620.4	275,640.9
Gross Domestic Product	**1,656,82 5.7**	**1,749,546.9**	**2,261,724.5**	**2,729,708.2**
Non-oil and gas	**1,506,605.5**	**1,604,224.1**	**2,060,635.0**	**2,427,591.8**
Oil and gas	**150,220.2**	**145,322.8**	**201,089.5**	**302,116.4**

Source: BPS-Statistic of Indonesia

Table 15 GDP Growth by Sector

Percent

Description	2002	2003	2004	2005
Total Consumption	3.2	3.1	3.3	3.0
Private Consumption	2.4	2.4	3.0	2.4
Government Consumption	0.9	0.7	0.3	0.6
Investment	1.0	0.1	2.9	2.1
Domestic Demand	3.6	2.9	7.3	6.1
Exports of Goods and Services	-0.5	2.2	5.1	3.5
Imports of Goods and Services	-1.3	0.4	7.4	4.1
Exports of Goods and Services (Net)	-0.8	1.8	-2.2	-0.5

Source: BPS-Statistic of Indonesia

(2) Inflation

The impact of sharp fuel price hikes; both first round and second round, provoked high inflation in 2005. The second fuel price hikes led to a two-digit inflation rate, from barely 9.06% (y-o-y) in September 2005 to 17.89% (y-o-y) in October 2005. The background of this domestic fuel hike was high global oil prices which dramatically raised the fuel subsidy borne by the government. Confronted by an array of fiscal difficulties and the plan to appropriately allocate fuel subsidies, the government opted to institute the thorny decision to cut fuel subsidies. The government raised the fuel prices on October 2005 by 126% on average. The first round fuel price hikes (on March 2005 by raising the price 26% on average) contributed to 3.47% inflation. Overall fuel price hikes contributed 5.54% to inflation in 2005, which raised transportation costs by 2.07%. The overall impact, implicitly and explicitly, of the fuel price hikes in 2005 totaled 6.87%. Furthermore, other administered price commodities which also recorded inflation in 2005 was LPG, tobacco, water and toll roads.

Table 16 First Round and Second Round Impact of Fuel Price Hike

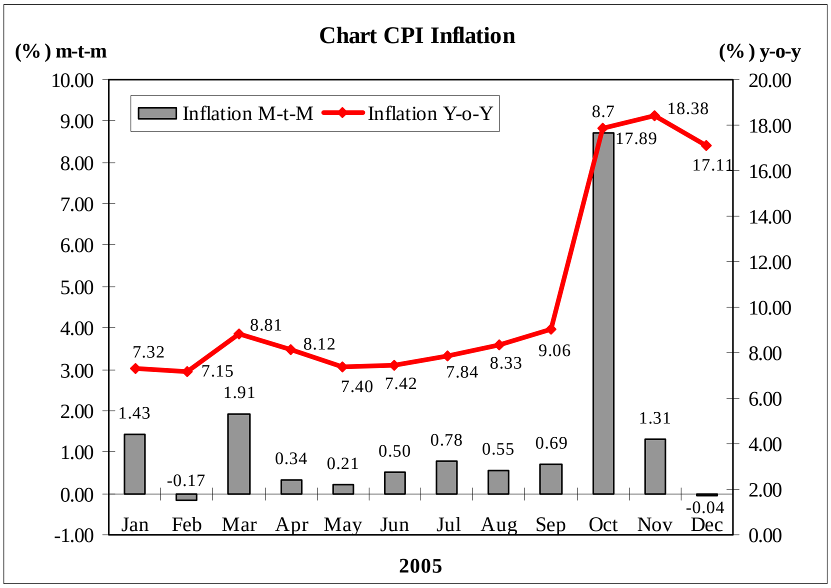
(Percent y-o-y)

Description	Weighting	March 2005		October 2005	
		Increase (%)	Contribution to Inflation (%)	Increase (%)	Contribution to Inflation (%)
First Round					
Kerosene	0.0118	0	0	115.51	1.4818
Automotive Diesel	0.0008	27.27	0.0226	104.79	0.1053
Gasoline	0.0197	29.99	0.561	79.45	1.8780
			0.5836		**3.4651**
Second Round					
Transportation Category			**0.7441**		**2.0739**
Urban Transportation	0.0353	19.96	0.6874	46.38	1.8376
Intercity Transportation	0.0046	11.35	0.056	35.9	0.1909
Taxi Fares	0.0009	1.02	0.0008	34.02	0.0316
Civil Aviation	0.002	-0.25	-0.0004	5.2	0.0100
Maritime Shipping	0.0004	0.83	0.0003	9.69	0.0037
Total			**1.3277**		**5.5390**

Source: Central Bureau of Statistic (BPS) – Indonesia

Overall CPI-inflation grew to 17.11% (y-o-y) in 2005, well above the inflation target of 6%+1% and inflation in 2004 of 6.4%. Furthermore, core inflation rose to 9.75%, higher than that in 2004 of 6.7%. Pressures emanating from the output gap were perceived as moderate.

Figure 3 CPI Inflation



Source: Central Bureau of Statistic (BPS) – Indonesia

In terms of inflation share, transportation and communications contributed significantly; around 6.25% primarily due to mounting fuel prices. Despite the newly established transportation costs in subsequent to fuel price hikes, prices in various regions continued to escalate appreciably. Rising fuel price hikes, particularly kerosene, increased inflation contribution of the housing category to 3.78%. Furthermore, raw foods category and processed foods group contributed 3.38% and 2.42% respectively to inflation. The profuse share of these commodities was closely related to supply shocks, hoarding behavior, and poor distribution of goods and services that came from fuel shortages in various regions. Fortunately, commodity groups such as clothing, health and education represented relatively more modest shares.

Table 17 CPI Components

Components	M-o-M	Y-o-Y
Food stuff	-1.34	13.91
Food, beverages, tobacco, cigarettes	0.64	13.71
Housing, water, electricity, oil/gas	0.35	13.94
Clothing	0.80	6.92
Health	0.59	6.13
Education, recreation, and sport	-0.02	8.24
Transportation, communication, financial services	0.04	44.75
Total	**-0.04**	**17.11**

Source: Central Bureau of Statistic (BPS) – Indonesia

An additional non-fundamental factor precipitating high inflation was disturbance in supply and distribution. This disturbance stemmed from fuel shortages in various regions and hoarding behavior that undermined distribution. The shocks are considered the prime cause for the escalation of volatile food prices by 15.51 % (y-o-y), with a share of 2.77% in CPI inflation.

CPI inflation in 2005 was considerably higher than in 2004, primarily as a result of non-fundamental factors. The relatively low inflation in 2004 (at 6.4% y-o-y) was due to contained administered prices and volatile food prices. In 2004, inflation of administered prices recorded 5.4% (y-o-y) with a share of barely 1.1 %. This is in line with government policy to sustain the prices of strategic commodities such as fuel and electricity. Furthermore, encouraging rice production in 2004 coupled with abundant supply and relatively smooth distribution attenuated inflation in volatile foods to 6.5% (y-o-y) with a share of 1.3%

Table 18 Contribution of CPI Inflation Components

Percent (y-o-y)

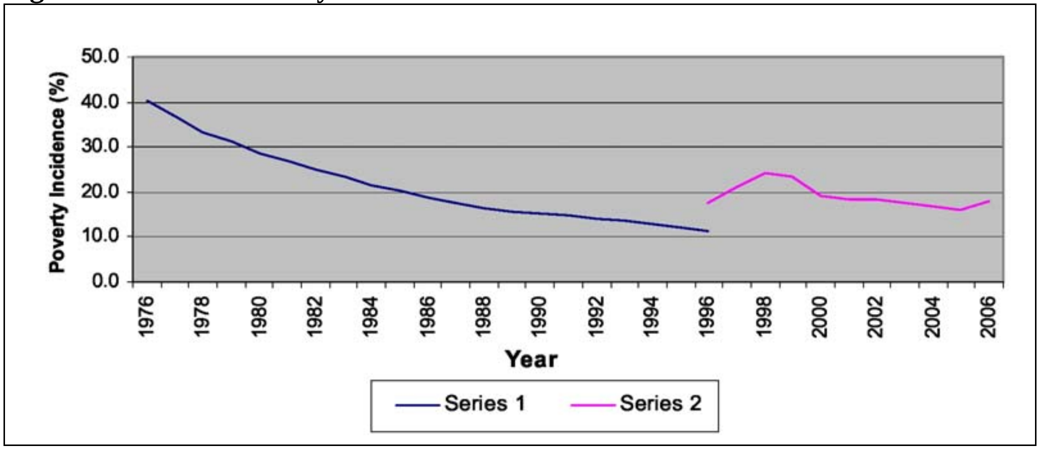
Desegregation of Inflation	Core Inflation		Volatile Foods Inflation		Administered Inflation		CPI
	Inflation	Contribution	Inflation	Contribution	Inflation	Contribution	
2001	10	6.2	12.4	2.9	23.5	3.4	12.6
2002	7	4.2	9.7	2.3	22.1	3.5	10
2003	6.9	4.1	-2.4	-0.6	9.1	1.6	5.1
2004	6.7	4	6.5	1.3	5.4	1.1	6.4
2005	9.8	6.1	15.5	2.8	41.7	8.1	17.1

Source: Central Bureau of Statistic (BPS) – Indonesia

(3) Poverty

The country poverty shows that the poverty incidence had declined to 16.7% in early 2005. In March 2006, however, it had increased again to 17.8%, following the effects of the fuel subsidy reductions in 2005. About 39.5 million people live below the poverty line. More than 50% of the population lives below $2/day and is highly vulnerable to shocks at all levels—micro or household (such as an illness in the family), meso or local (such as a natural disaster), and macro or national (such as an increase in fuel prices).

Figure 4 Trend in Poverty Incidence



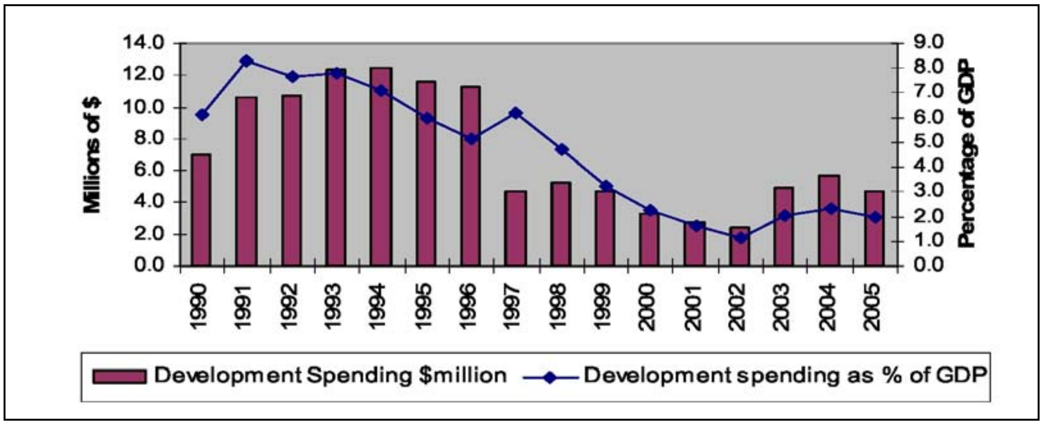
Source: Asian Development Bank

(4) Consumption

Government consumption in 2005 played a more expansive role, with expansion widening from 3.99% in 2004 to 8.06%. The rise in government spending was dominated by consumption and transfers. Expansion in government consumption became visible only in the second half of 2005, a result of administrative difficulties related to the implementation of a new budget system. The higher government consumption in 2005 took place largely to other expenditures, general allocation funds and revenue sharing funds, and increased personnel expenditures from the payment of 13th month salaries. Government spending expected to stimulate investment growth was hindered by the protracted project proposal mechanism and adjustment to the new state budget format.

Growth in consumption credit and non-bank financing slowed from the effect of rising interest rates in keeping with tightened monetary conditions. Disbursed consumption credit expanded 36.8% by during 2005, below the 38.1 % recorded in the preceding year. Growth in consumer financing fell more sharply from 44.9% to 21.6% in 2005.

Figure 5 Government Development Spending



Source: Asian Development Bank

(5) Investment

Investment grew by 9.93% in 2005, down from 14.68% in the previous year. This slowed performance resulted mainly from the steady drop in non-construction investments since early 2005 and the accelerated decline in the third and second quarter of 2005. Analyzed by fundamentals, investment growth was impacted by both external and internal pressures. Costs of production and investment mounted in response to soaring oil prices and the continued world monetary tightening cycle. The continued lack of a conducive investment climate, partly because delayed finalization of legal products and poor infrastructure, also hampered investment growth. Business perceptions of the slowing trend in consumption also had a dampening effect on private investment activity.

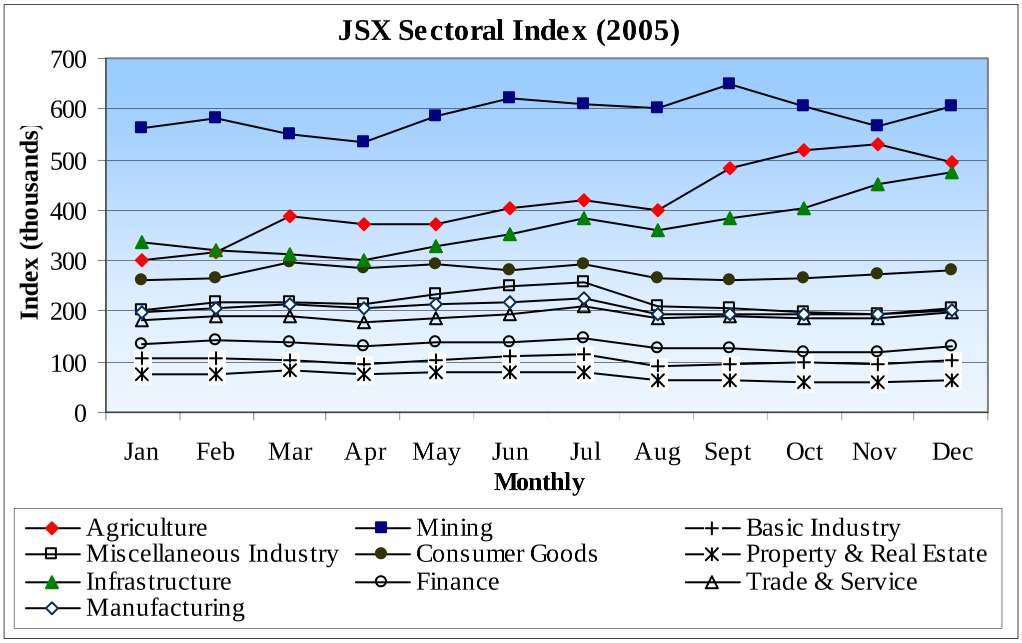
Despite expectations in 2005 for a boom in construction investment, the outcome was slightly lower growth. Construction investment, which widened 7.49% in 2004, registered only 6.17% growth in 2005. This slackened performance resulted not only from the deterioration in the business climate, but also rising production costs and low rate of infrastructure project implementation. The flagging investment growth in construction was confirmed by slower growth in cement sales, down from 9.7% to 4.7%

(6) Stock Market

On the stock market, the overall Jakarta Stock Composite Index (JSCI) rose during 2005. In addition to BI Rate increases, externalities such as the soaring global oil price also triggered corrections in the composite index in terms of a declining index in the global and regional stock exchanges. From an internal side, negative sentiment as a result of exchange rate depreciation and higher domestic interest rates propagated the pressures on the stock composite index. However, strong fundamentals, bullish sentiment and the improved condition of listed companies played a significant role in dampening further downward pressures on the index.

The Jakarta Stock Exchange Composite Index (JSCI) closed at 1,192.203 on August 3, 2005, the highest index in the history of the capital market in Indonesian. JSCI was closed at 1,162.635 at the end of the 2005 trading day. In the regional level, the Indonesian capital market demonstrated optimistic signs, in which, the JSCI rose by 16.24% which still higher, compare to those of Malaysia, Thailand, and even Hong Kong. If seen from the growth of trading value, the Indonesian exchanges showed a significant increase of 64.40%, which was came second place after that of the Philippines.

Figure 6 Jakarta Stock Exchange Sectoral Index



Source: Jakarta Stock Exchange

The rise in interest rates caused a number of firms to delay the initial public offering (IPO) of their stocks and bonds, while on the other hand companies took advantage of the ongoing economic condition to buy-back their debt securities. Compared to 2004, financing from the capital market has declined. Pertaining to stock financing, only 8 of the 30 issuances of IPO targeted by the Jakarta Stock Exchange were realized. In terms of corporate bond issuances, the rise in interest rates caused several corporations to delay bond issuances until the time was perceived as right.

Table 19 Capital Market Overview

In Trillion Rp otherwise stated

Description	2003	2004	2005
Initial Public Offerings	7.51	2.19	3.52
Right Issuance	2.46	4.34	6.23
Bond Issuance	26.02	19.17	8.25
Investment Fund/*Reksadana* (Net Asset Value)	69.48	104.04	29.41
Jakarta Stock Exchange (JSX)			
Market Capitalization	460.37	679.95	801.25
Annual Share Volume (million unit)	243,030	411,768	401,868
Annual Trading Value	125.44	247.01	406.01
Annual Share Price Index (unit)			
• Highest	693.03	1,004.43	1,192.20
• Lowest	379.35	668.48	994.77
• End	691.89	1,000.23	1,162.63
Surabaya Stock Exchange (SSX)			
Market Capitalization	397.81	605.39	695.56
Annual Share Volume (million unit)	8,323	18,735	15,546
Annual Trading Value	3.10	8.23	5.34
Annual Share Price Index (unit)			
• Highest	377.95	548.58	639.39
• Lowest	208.61	368.12	532.09
• End	375.02	545.62	620.042

Source: Indonesian Capital Market Supervisory Agency

Total corporate bond issues in 2005 mainly originated from 19 companies with a total value of Rp8.25 trillion. Value of shares floated in IPOs climbed from Rp2.19 trillion in 2004 to Rp3.54 trillion, despite a drop from 12 share issuers to only 8 in the year. During the same period, 18 listed companies also conducted rights issues valued at a total of Rp10.36 trillion, up significantly from only Rp4.34 trillion in 2004, which is a positive indication of improved access to financing on the capital market.

The market of *Reksadana* in 2005 experienced huge redemptions driven by market perceptions of marked to market practice, taxation against *Reksadana* interest earnings, and the rise in the BI Rate. This caused the net asset value of *Reksadana* to dramatically fall from Rp104.04 trillion to just Rp 29.41 trillion at the end of the year.

(7) Money Supply

In 2005, narrow money (M1) and broad money (M2) increased significantly, which average annual growth for M1 and M2 were 12.1 % and 13.9% respectively. Despite higher growth in nominal terms, the real growth of M2 was negative when CPI inflation was taken into account. At the end of 2005, M2 was recorded at Rp 1,168.3 trillion; an increase of Rp134.7 trillion over the previous year. On one hand, this was mainly contributed to by the expansion of rupiah quasi-money in the form of time deposits, foreign saving deposits and narrow money (mostly in the form of demand deposits). The rise in time deposits was driven by both the compound interest earning and shifting from savings to time deposits as a result of competition in offering a return to bank deposits amidst unattractive mutual fund investments.

Table 20 Money Supply

Trillion Rp

Description	2003	2004	2005				Growth (%, y-o-y)	
	Dec	Dec	Mar	Jun	Sep	Dec	2004	2005
M2	**955.7**	**1.033.5**	**1.020.7**	**1.073.7**	**1.150.5**	**1.203.2**	**8.1**	**16.4**
M1	**223.8**	**253.8**	**250.5**	**267.6**	**274.0**	**281.9**	**13.4**	**11.1**
Currency Outside Banks	94.5	109.3	98.6	106.1	115.0	124.3	15.6	13.8
Demand Deposits	129.3	144.6	151.9	161.5	159.0	157.6	11.8	9.0
Quasi-Money	**731.9**	**779.7**	**770.2**	**806.1**	**876.5**	**921.3**	**6.5**	**18.2**
Time Deposits in Rupiah	350.9	349.1	347.6	372.5	405.2	452.5	-0.5	29.6
Savings Deposits in Rupiah	241.8	295.0	283.0	282.5	279.3	279.8	22.0	-5.1
Foreign Currency Deposits	139.2	135.6	139.6	151.1	192.0	188.9	-2.6	39.3
in USD millions	*16.442*	*14.596*	*14.731*	*15.557*	*18.623*	*19.221*	*-11.2*	*31.7*
Factors Influencing M2	**955.7**	**1.033.5**					**8.1**	**16.4**
Foreign Assets (Net)	**271.8**	**263.6**	**268.5**	**256.1**	**280.4**	**313.1**	**-3.0**	**18.8**
Bank Indonesia	226.0	244.8	255.7	234.4	218.7	250.1	8.3	2.2
Commercial Banks	45.8	18.9	12.7	21.6	61.7	62.9	-58.8	233.5
Domestic Assets (Net)	**683.9**	**769.9**	**752.2**	**817.7**	**870.1**	**890.1**	**12.6**	**15.6**
Net Claims on Government	743.6	498.0	456.3	468.0	488.5	498.9	-33.0	0.2
Bank Indonesia	437.9	226.6	187.0	197.7	210.9	239.1	-48.3	5.5
Commercial Banks	305.7	271.4	269.2	270.4	277.6	259.8	-11.2	-4.3
Net Claims on Private Sector	466.8	615.8	640.7	687.4	737.8	738.8	31.9	20.0
Total Credit	437.9	553.5	576.4	622.6	673.2	689.7	26.4	24.6
Credit in Rupiahs	342.0	438.9	457.6	498.5	543.2	566.4	28.3	29.1
Credit in Foreign Currencies	95.9	114.7	118.8	124.1	130.0	123.2	19.5	7.5
in USD millions	*11.331*	*12.343*	*12.528*	*12.776*	*12.611*	*12.536*	*8.9*	*1.6*
Other Claims	28.9	62.3	64.3	64.8	64.6	49.2	115.5	-21.0
Other (Net)	**(526.6)**	**(343.9)**	**(344.8)**	**(337.7)**	**(356.2)**	**(347.6)**	**-34.7**	**1.1**

Source: Bank of Indonesia, Annual Report 2005

(8) Labor and Employment

Despite stronger economic growth, 2005 saw little improvement in the labor market, reflected among others in rising levels of open unemployment. The workforce in October 2005 totaled 106.9 million, having expanded by 2.9 million from 104.0 million in August 2004. During the same period, 1.6 million entrants to the workforce found jobs; leaving 1.3 million unable to start work and bringing total unemployment to 11.6 million. With this increase in total unemployed, open unemployment climbed to 10.84% from the previous year's level of 9.86%.

The workforce remains heavily concentrated in agriculture (44.6%), trade (20.1 %), industry (12.4%), and services (11.3%) While overall economic growth has improved, the slowing growth in agriculture and manufacturing contributed to low employment creation during 2005. Labor productivity measured by output per worker increased from 17.7 in 2004 to 18.6 in 2005. Productivity was up mostly in the electricity (30.34%), mining (26.71 %), and financial sectors (16.68%).

II.2 Fiscal Position

II.2.1 Government Expenditure

The 2005 State Budget faced heavy pressure beginning early in the reporting year. This took place immediately after the tsunami disaster in Nanggroe Aceh Darrusalam (NAD) and Nias provinces in December 2004. In addition, global oil prices accelerated to $69.81 per barrel, far off the price assumption for Indonesian crude oil used in the State Budget at the beginning of the year of $24 per barrel and the substantial rupiah depreciation. This, consequently, threatened fiscal sustainability due to the huge funds required to rehabilitate NAD and Nias provinces, estimated around $5.8 billion, and fuel subsidy spending. The year following the tsunami, around $4.4 billion committed by various sources of financing was allocated for projects, especially to meet the basic needs in most sectors.

The realization of the 2005 State Budget, in general, was lower than the target. The implementation of a new state budget format caused a delayed and protracted preparation of budget document by ministries and government agencies. As a result, by the end of 2005, not all projects could be fully realized; hence state budget expenditure realization was not optimal. Up to November 2005 the realized budget remained surplus before recorded a deficit of Rp13.97 trillion (0.5% of GDP) on 30th December 2005, which was lower than the target in the second State Budget Revision (APBN-PII) 2005 of Rp24.9 trillion (0.9% of GDP). The 0.5% deficit ratio originated from the realization of state revenue and grants, which accounted only 92% of the target in APBN-PII 2005, and the realization of state expenditure which reached 90% of the target in APBN-PII 2005. The lower realization of state revenue and grants was mainly associated with oil and gas revenue, which only achieved 75% of the target in APBN-PII 2005. The low realization of state expenditure was mainly caused by government spending on goods, capital, social aid, and others which only arrived at around 70-80% of the targeted amount in APBN-PII 2005.

Facing this external and internal pressure, in 2005, fiscal consolidation was consistently pursued to maintain fiscal sustainability. Efforts were also made to consolidate the 2005 State Budget related to revenue, expenditure, and financing aspects; all of which were directed to restore confidence and certainty in the national economy. Policies regarding revenue were mainly in the form of optimization of non-tax revenue from non-oil and gas sector; those concerning expenditure were in the form of reductions and reallocations of reductions of fuel subsidy spending; and those pertaining to financing were in the form of government debt principal moratorium. Through such policies, fiscal sustainability could be maintained, which is reflected in the declining state budget deficit to GDP ratio and the outstanding government debt to GDP ratio. The budget deficit ratio in second revision of 2005 state budget (APBNP-II 2005), as approved by Law No. 9/2005, was 0.9% of GDP, lower than the previous year's deficit ratio of 1.3% of GDP3. The outstanding government debt to GDP ratio for 2005 was also predicted to slide to 49.6%, lower than that in the previous year of 56.1 %

Table 21 Summary of Government Financial Operation

Description	2004				2005	
	Preliminary		Budget		Revised Budget	
	Nominal	% of GDP	Nominal	% of GDP	Nominal	% of GDP
A. Total Revenues and Grants	**407.9**	**17.7**	**380.4**	**14.9**	**540.1**	**20.4**
I. Taxation Revenues	**280.9**	**12.2**	**297.8**	**11.6**	**352.0**	**13.3**
1. Domestic Taxes, etc	**268.1**	**11.6**	**285.5**	**11.2**	**334.4**	**12.6**
a. Income Tax	134.9	5.9	142.2	5.6	180.2	6.8
b. VAT/Luxury Goods Tax	87.6	3.8	98.8	3.9	102.7	3.9
c. Land and Building Tax	11.8	0.5	10.3	0.4	13.4	0.5
d. Property Transfer Tax	2.9	0.1	3.2	0.1	3.7	0.1
e. Excise	29.2	1.3	28.9	1.1	32.2	1.2
f. Other Taxes	1.8	0.1	2.0	0.1	2.2	0.1
2. Taxes on International Trade	**12.7**	**0.6**	**12.4**	**0.5**	**17.6**	**0.7**
II. Non-Tax Revenues	**126.7**	**5.5**	**81.8**	**3.2**	**180.7**	**6.8**
1. Natural Resources Revenues. etc.	**91.4**	**4.1**	**0.9**	**2.0**	**144.4**	**5.4**
Oil and Natural Gas	85.3	3.7	47.1	1.8	138.6	5.2
2. Profit Share from SOEs	**9.8**	**0.4**	**10.6**	**0.4**	**12.0**	**0.5**
3. Other Non-Tax Revenues	**25.5**	**1.1**	**20.3**	**0.8**	**24.3**	**0.9**
III. Grants	**0.3**	**0.0**	**0.8**	**0.0**	**7.5**	**0.3**
B. State Expenditures	**437.7**	**19.0**	**397.8**	**15.5**	**565.0**	**21.3**
l. Central Government Expenditures. etc.	**308.1**	**13.4**	**266.2**	**10.4**	**411.6**	**15.5**
Interest Payments	62.4	2.7	64.1	2.5	61.0	2.3
Subsidies	85.5	3.7	31.3	1.2	119.1	4.5
Incl. Fuel Subsidy	69.0	3.0	19.0	0.7	89.2	3.4
II. Regional Expenditures	**129.7**	**5.6**	**131.5**	**5.1**	**153.4**	**5.8**
1. Fiscal Balance Funds	**122.9**	**5.3**	**124.3**	**4.9**	**146.2**	**5.5**
a. Revenue Sharing Funds	36.7	1.6	31.2	1.2	52.6	2.0
b. General Allocation Funds	82.1	3.6	88.8	3.5	88.8	3.3
c. Special Allocation Funds	4.1	0.2	4.3	0.2	4.8	0.2
2. Special Autonomy	**6.8**	**0.3**	**7.2**	**0.3**	**7.2**	**0.3**
C. Primary Balance	**32.5**	**1.4**	**46.7**	**1.8**	**36.1**	**1.4**
D. Budget Surplus Deficit	**(29.9)**	**(1.3)**	**(17.4)**	**(0.7)**	**(24.9)**	**(0.9)**
E. Financing	**29.9**	**1.3**	**17.4**	**0.7**	**24.9**	**0.9**
I. Domestic Financing	**52.9**	**2.3**	**37.6**	**1.5**	**29.8**	**1.1**
1. Domestic Banking System	**26.8**	**1.2**	**9.0**	**0.4**	**4.3**	**0.2**
2. Domestic Non-Bank	**26.1**	**1.1**	**28.6**	**1.1**	**25.5**	**1.0**
a. Privatization	3.5	0.2	3.5	0.1	3.5	0.1
b. Asset Sales	15.8	0.7	4.0	0.2	5.1	0.2
c. Government Bond Sales, net	6.9	0.3	22.1	0.9	22.1	0.8
d. Government Equity Participation	-	-	(1.0)	0.0	(5.2)	(0.2)
II. Foreign Financing (Net)	**(23.0)**	**(1.0)**	**(20.2)**	**(0.8)**	**(4.8)**	**(0.2)**
1.Drawing of Foreign Loans (Gross)	**23.5**	**1.0**	**26.6**	**1.0**	**35.5**	**1.3**
a. Program Loans	5.1	0.2	8.6	0.3	11.3	0.4
b. Project Loans	18.4	0.8	18.0	0.7	24.3	0.9
2. Installments on Debts Principal	**(46.5)**	**(2.0)**	**(46.8)**	**(1.8)**	**(40.4)**	**(1.5)**

Source: Bank of Indonesia, Annual Report 2005

II.2.2 Public Borrowing

For the most part during 2005, domestic sources of financing played a major role in Indonesia»s economic growth. According to the flow of funds account data, this was reflected among others in the high value of domestic financing allocated to non-financial investment. Regarding investment financing in particular, the sizable role of domestic financing was also matched by extensive use of external funds.

Data on the flow of funds account confirms the major role of domestic financing, as reflected in net non-financial investment financing and sources of financing. On the non-financial investment financing side, this role is reflected in the flow of funds account interim data for 2005, which indicates a Rp 36 trillion surplus in net loans to other domestic sectors. This indicates that for the year overall, investment financing for other domestic sectors, which consist of households, business, state enterprises, and non-banking finance institutions, was in aggregate financed by savings and incomes held and earned by those sectors. This reinforced by the quarterly figures for the flow of funds account, which indicated a sizeable Rp 18.7 trillion deficit in QIII-2005 in contrast to the Rp 69 trillion surplus in QIV-2005, consistent with the slow trend in economic growth during that period.

Table 22 Saving – Investment Gap

		2001	2002	2003	2004	2005
Government	Saving	31.1	48.7	76.4	57.9	76.3
	Investment	71.6	72.2	111.5	85.8	90.3
	Deficit/Surplus	-40.5	-23.6	-35.1	-27.8	-14
Private Sector	Saving	363.6	378.2	379.3	462.7	546.3
	Investment	252.3	281.8	274.8	407	509.5
	Deficit/Surplus	111.3	96.5	104.5	55.6	36.8
Total	Saving	394.7	426.9	455.7	520.6	622.6
	Investment	323.9	354	386.2	492.8	599.8
	Deficit/Surplus	70.8	72.9	69.5	27.8	22.8
		Ratio to GDP (%)				
Government	Saving	1.8	2.6	3.7	2.6	2.8
	Investment	4.2	3.9	5.4	3.8	3.3
	Deficit/Surplus	-2.4	-1.3	-1.7	-1.2	-0.5
Private Sector	Saving	21.6	20.3	18.5	20.5	20
	Investment	15	15.1	13.4	18	18.7
	Deficit/Surplus	6.6	5.2	5.1	2.5	1.3
Total	Saving	23.4	22.9	22.3	23	22.8
	Investment	19.2	19	18.9	21.8	22
	Deficit/Surplus	4.2	3.9	3.4	1.2	0.8
Notes:	GDP (Trillions of Rp) baseline year 2000	1,684.30	1,863.30	2,045.90	2,261.70	2,729.70
	Current Account (Millions of $)	6,901	7,822	8,106	3,108	2,996
	Average Exchange Rate (Rp/$)	10,256	9,318	8,572	8,940	9,713

Sources: BPS-Statistic Indonesia. Ministry of Finance. Bank Indonesia

In the flow of funds account data for 2005, rupiah credit was a strong financing source for other domestic financial sector investment at 43.6%. This dominant role of bank lending is consistent with the high 22% expansion in bank credit during 2005. In addition to credit, economic growth was also financed from equity held by the business sector, as reflected in the net deficit in financing sources for long-term securities.

Table 23 Estimated Investment Needs and Financing Sources

	2004		2005	
Economic Growth (%)	**5.05**		**5.6**	
Investment Growth (%)	**14.43**		**9.93**	
	Value (Tril Rp)	**Share (%)**	**Value (Tril Rp)**	**Share (%)**
Nominal Investment Financing Sources:	**493**	**100.0**	**600**	**100.0**
1. Government	126	25.6	149	24.9
2. Bank Credit	117.9	23.9	135.1	22.5
3. External	237.6	48.2	303.5	50.6
a. FDI Inflows	82.8	16.8	150.4	25.1
b External Fund Inflows (non-Gov't)	154.9	31.4	153.2	25.5
4. Others	11.2	2.3	11.8	2.0

Source: Bank Indonesia

This financing of economic growth was complemented by external financing raised by the private sector. Capital inflows from foreign direct investment (FDI) reached Rp 150.4 trillion, up from Rp 82.2 trillion in 2004. The FDI role in 2005 is also reflected in increased realized FDI (issue of Permanent Investment Licenses) compared to 2004. Capital inflows in other forms, such as portfolio investments and private sector foreign borrowings, were also high at Rp 153.2 trillion.

II.2.3 Domestic Revenue

In terms of revenue, the realization of both tax and non-tax revenues in 2005 was below target, mainly as a result of changes in macroeconomic assumptions such as the oil price, economic growth and the exchange rate.

Table 24 Composition of Domestic Revenue

Fiscal Year	Tax		Non Tax		Total
	billions of Rp	(%)	billions of Rp	(%)	billions of Rp
1994/1995	44.442,1	66,9	21.975,9	33,1	66.418,0
1995/1996	48.686,3	66,7	24.327,6	33,3	73.013,9
1996/1997	57.339,9	65,4	30.290,4	34,6	87.630,3
1997/1998	70.934,2	63,2	41.341,3	36,8	112.275,5
1998/1999	102.394,4	64,8	55.648,0	35,2	158.042,5
1999/2000	125.951,0	61,6	78.481,6	38,4	204.432,6
2000	115.912,5	56,5	89.422,0	43,5	205.334,5
2001	185.540,9	61,7	115.058,6	38,3	300.599,5
2002	210.087,5	70,4	88.440,0	29,6	298.527,5
2003	242.048,1	71,0	98.880,2	29,0	340.928,3
2004	280.897,6	68,9	126.684,4	31,1	407.582,0
2005	351.973,6	66,1	180.697,4	33,9	532.671,0
2006	416.313,2	67,0	205.292,3	33,0	621.605,4

Source: Ministry of Finance

II.2.4 Tax Revenue

In fiscal year 2005 Income Tax Revenue contributed 51.2% of total tax revenue, with non-oil and gas revenue contributed Rp 143,017.4 billion (79.3%) and oil and gas revenue contributed only Rp 37,235.5 billion (20.7%) of income tax revenue. While, VAT and Sales on Luxury Goods revenue contributed 29.2% of total tax revenue (the second largest revenue).

Table 25 Tax Revenue

Billions of Rp

Fiscal Year	Domestic Tax					International Trade Tax		Total	GDP	Ratio (%)
	Income Tax	Value Added Tax	Land and Building Tax	Excises	Other Tax	Import Duties	Export Tax			
1994/1995	18,764.1	16,544.8	1,647.3	3,153.3	301.9	3,900.1	130.6	44,442.1	365,750.9	12.2
1995/1996	21,012.0	18,519.4	1,893.9	3,592.7	452.8	3,029.4	186.1	48,686.3	433,110.4	11.2
1996/1997	27,062.1	20,351.2	2,413.2	4,262.8	590.7	2,578.9	81.0	57,339.9	511,365.4	11.2
1997/1998	34,388.3	25,198.8	2,640.9	5,101.2	477.8	2,998.7	128.5	70,934.2	633,520.5	11.2
1998/1999	55,944.3	27,803.2	3,565.3	7,732.9	413.0	2,305.6	4,630.2	102,394.4	947,659.8	10.8
1999/2000	72,729.0	33,087.0	4,107.3	10,381.2	610.9	4,177.0	858.6	125,951.0	1,138,115.8	11.1
2000	57,073.0	35,231.8	4,456.1	11,286.6	836.7	6,697.1	331.2	115,912.5	971,502.6	11.9
2001	94,576.0	55,957.0	6,662.9	17,394.1	1,383.9	9,025.8	541.2	185,540.9	1,467,654.8	12.6
2002	101,873.5	65,153.0	7,827.7	23,188.6	1,469.3	10,344.4	231.0	210,087.5	1,610,565.0	13.0
2003	115,015.6	77,081.5	10,905.3	26,277.2	1,654.3	10,884.6	229.7	242,048.2	1,786,690.9	13.5
2004	134,903.8	87,567.3	14,680.0	29,172.5	1,832.2	12,444.2	297.6	280,897.6	2,303,03 1.0	12.2
2005	180,252.9	102,670.5	17,036.7	32,244.8	2,198.3	16,590.5	979.9	351,973.6	2,651,157.6	13.3
2006[1)]	210,713.6	128,307.6	21,008.0	36,519.7	2,772.8	16,572.6	418.9	416,313.2	3,040,771.7	13.7

[1)] Proposed Budget
Source: Ministry of Finance

III. Tax Structure: Institutions and the Reality

III.1 Overview of the Role of Taxation in Indonesia

Since the economic crisis began, the Indonesian government has faced the real challenge to assure its fiscal sustainability in the short and longer term. Financial revenue from oil and gas sector can no longer be relied on, since a gradual decline of them already started in the 1990s.

Simultaneously, the government's commitment to gradually reduce the budget reliance on foreign debt also gives rise to deteriorate government budget funding. As a result, efforts should be made particularly to mobilize funding and to increase the efficiency of government expenditure. At the revenue side, the government has no other option but to effectively boost revenue from taxes. This reality cannot be doubted, seeing the large increasing amount of tax revenue loaded to Directorate General of Taxes (DGT) start since a few years back. Taxes have a great potential to be the main source of government funding. Increasing tax revenue can be achieved through improved taxation administration, by expanding tax base, and/or by increasing tax rates. Nonetheless tax implementation up to 2004 shows that there is still opportunity to increase tax revenue by expanding tax base, without necessarily increasing current tax rates. There are number of indicators that support this:

1. The number of registered tax payer in Indonesia is still relatively low. From more than 220 million potential individual taxpayers, only 2.5 million registered as individual taxpayers until 2004;
2. Tax return filing ratio (ratio of taxpayers who file tax return with total number of taxpayers registered) is below 40% in FY 2004;
3. The distribution of tax revenue is still concentrated on too few taxpayers. The fact that has been revealed for almost a decade; one thousand largest taxpayers contribute almost

61% of national tax revenue, which demonstrate that tax-intensification dominates more than tax-extensification;

Increase the number of potential taxpayers

With total population more than 220 millions including 50 million households, the ratio of tax filers to the total population is extremely low – only 2.5 million people registered as individual taxpayers, with ratio less than 2%.

On October 2005, DGT launched *10 million taxpayers* program by sending taxpayers number to individual who supposed should be registered as a tax payer in district tax office but failed to do so. The program is constructed by using the third-party sources such as registered vehicle and property assets. In some cases, since the change of information is not continuously, assets might have already been sold or transferred to other entity and resident's addresses are not up to date. However those taxpayers still have to explain the source of income to posses the assets and required to pay the final tax (Income Tax article 4(2)) for selling properties and/or vehicles.

The total number of individual taxpayer itself is still under verification since the person who received the tax payer number may object with reason he/she has: already register as a taxpayer (in the different address), not required to register (having annual income under the threshold level) or already deceased.

Table 26 Registered Taxpayers

Types of Tax	Per 31 Dec 1999	Per 31 Dec 2000	Per 31 Dec 2001	Per 31 Dec 2002	Per 31 Dec 2003	Per 31 Dec 2004
Income Tax Art. 21	808.617	873.437	845.283	879.927	1.241.210	1.327.550
Income Tax Art. 22	135.338	142.571	22.509	37.938	244.942	268.849
Income Tax Art. 23	598.783	635.008	666.325	729.880	919.122	993.151
Income Tax Art. 25 Individual	1.311.582	1.320.157	1.552.816	1.896.987	2.337.817	2.504.520
Income Tax Art. 21 Corporate	607.066	660.736	738.326	886.247	979.975	978.052
Value Added Tax	392.515	419.002	464.471	520.432	569.403	574.626

Source: Directorate General of Taxes, Annual Report 2004

Increasing the compliance of taxpayers

The main cause for low tax revenues includes problems in the tax structure and also the question of proper tax compliance and audit.

Table 27 Submission of Annual Tax Return

Types of Tax	2000	2001	2002	2003	2004
Income Tax Art. 25 Corporate	39,0%	37,1%	35,6%	36,2%	34,1%
Income Tax Art. 25 Individual	32,5%	33,5%	35,2%	35,8%	35,3%
Income Tax Art. 21	43,1%	38,8%	38,6%	36,3%	36,2%

Source: Directorate General of Taxes, Annual Report 2004

III.1.1 Indonesian Tax Reform

After Indonesia became independence in 1945, the tax provisions in Indonesia can be divided in two periods: Ordinance Period and post-1983 Reform Period. The law reform of specific taxes described in the figure below. Tax reform was based on the intention to improve the underlying law for collecting taxes, which was colonial inheritance, to become tax collection that leads to people participation. Tax compliance is the basic requirement in order to encourage people to pay taxes properly. The importance to improve tax compliance was the ground of simplification: the type of taxes, tax rate and tax collection method in 1983.

Table 28 Tax Simplification in 1983 Tax Reform

<table>
<tr><th rowspan="2">No</th><th rowspan="2">Old Law
(which has been withdrew)</th><th colspan="2">Number of</th><th rowspan="2">New Law</th><th colspan="2">Number of</th></tr>
<tr><th>Article</th><th>Tariff</th><th>Article</th><th>Tariff</th></tr>
<tr><td>1</td><td>Company Tax
(Ordinance PPs 1925)</td><td>55</td><td>32</td><td rowspan="4">Income Tax
(Law No.7/1983)</td><td rowspan="4">36</td><td rowspan="4">3</td></tr>
<tr><td>2</td><td>Revenue Tax
(Ordinance PPd 1944)</td><td>54</td><td>20</td></tr>
<tr><td>3</td><td>MPS/MPO (Law No.8/1967)</td><td>5</td><td>10</td></tr>
<tr><td>4</td><td>Tax on Interest, Dividend and Royalty (Law No. 10/1970)</td><td>28</td><td>4</td></tr>
<tr><td>5</td><td>Sales Tax</td><td>50</td><td>9</td><td>Value Added Tax on Goods and Services and Sales Tax on Luxury Goods (Law No.8/1983)</td><td>21</td><td>3</td></tr>
<tr><td>6</td><td>Stamp Duty (Regulation 1921)</td><td>149</td><td>167</td><td>Stamp Duty (Law No.13/1985)</td><td></td><td></td></tr>
<tr><td>7</td><td>Household Tax Ordinance 1908</td><td>14</td><td>3</td><td rowspan="7">Tax on Land and Buildings
(Law No.12/1985)</td><td rowspan="7">31</td><td rowspan="7">1</td></tr>
<tr><td>8</td><td>Indonesia Verponding Ord. 1928</td><td>22</td><td>2</td></tr>
<tr><td>9</td><td>Verponding Ordinance 1928</td><td>60</td><td>2</td></tr>
<tr><td>10</td><td>Wealth Tax Ordinance 1932</td><td>73</td><td>1</td></tr>
<tr><td>11</td><td>Road Tax Ordinance 1942</td><td>13</td><td>1</td></tr>
<tr><td>12</td><td>Emergency Law No.11/1957 concerning Regional Tax General Regulation Law</td><td>43</td><td>3</td></tr>
<tr><td>13</td><td>Law No. 11/PRP/1959 concerning PHB/IPEDA</td><td>21</td><td>16</td></tr>
<tr><td></td><td></td><td></td><td></td><td>General Provisions and Taxation Procedures
(Law No.6/1983)</td><td>50</td><td></td></tr>
</table>

Source: The Indonesian Tax in Brief

Until now, 1983 Tax Laws have been continually amended to keep up with the society dynamics. First amendment was in 1991 on Income Tax Law, followed by the second amendment in 1994 on General Provisions and Taxation Procedures, Income Tax Law, VAT, Luxury Sales Tax, Tax on Land and Buildings.

Third amendment was in the year 2000, which generated tax laws currently applicable. Those are Law No.16/2000 about General Provisions and Taxation Procedures, Law No. 17/2000 about Income Tax Law, Law No.18/2000 about VAT and other Indirect Taxes, Duties on the Acquisition of Title to Land Buildings (Law No.20/2000) and Tax Collections through Distress Warrants (Law No.19/2000), which applied starting on January 1, 2001.

In addition to modifying tax laws and regulations, 1983 tax reform has also fundamentally changed the paradigm of tax collection by changing the way of tax collection system. Before 1983 (ordinance period), the underlying of tax collection system was official assessment system. Under such a system, the amount of tax that taxpayers owned in a fiscal year was fully determined by tax officers. Therefore, the success of the tax collection depended on the tax officers' performance and integrity. In 1983, along with tax reform, tax collection system was totally changed to self assessment system, in which taxpayer will be given trust and responsibility to calculate, to pay and to report their tax.

Table 29 Cost of Tax Collection Ratio

Year	Cost Incurred (billion Rp)	Tax Revenue (billion Rp)	Ratio (%)
2000	334.1	97,484.8	0.34
2001	516.8	158,579.8	0.33
2002	1,031.3	176,323.5	0.58
2003	930.4	204,656.7	0.45
2004	1,082.5	238,983.4	0.45

Source: Directorate General of Taxes, Annual Report 2004

Tax Arrears

The activities of tax collection are focused on the program for decreasing tax arrears. Part of the program focus on: monitoring tax collection of one hundred biggest delinquent taxpayers, implementing tax audit for delinquency audit, persuasive tax collection for grouping cooperative or non-cooperative delinquent taxpayers, law enforcement for non-cooperative delinquent taxpayers by prohibition for going abroad and detaining taxpayers.

To expand the implementation of law enforcement, DGT has performed coordination with law institutions by establishing Memorandum of Understanding (MoU), namely Police Department, Centre of Reporting and Analysis of Financial Transaction (PPATK), Commission of Corruption Combating (KPK) and the MoU will be followed with other law institutions to uncover tax delinquency and tax avoidance.

Table 30 Tax Arrears

Year	Total Arrears (Rp million)	Growth from Previous Year (%)
1999	14,800,516	30.30
2000	13,358,845	(9.74)
2001	17,305,249	29.54
2002	18,581,648	7.38
2003	25,556,978	37.54
2004	25,894,949	1.32

Source: Directorate General of Taxes, Annual Report 2004

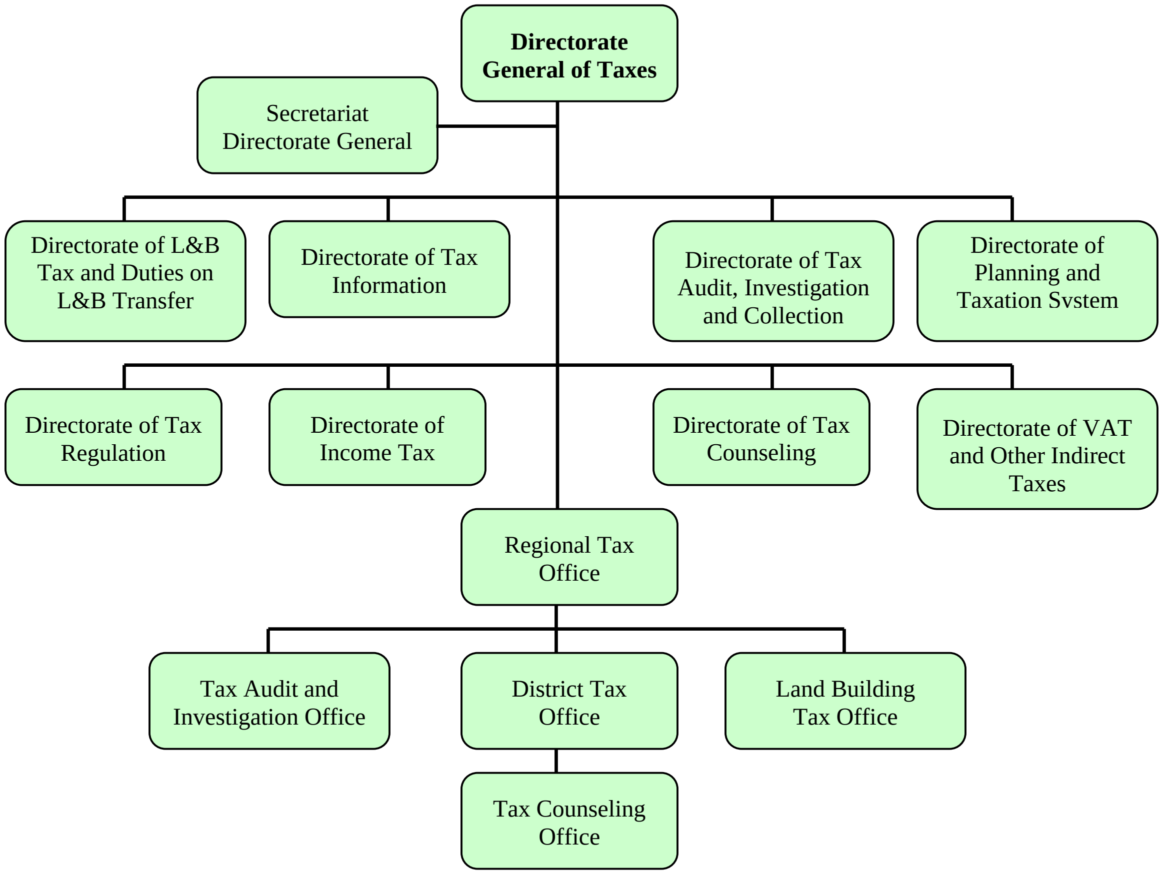
III.1.2 Organization Structure

The design of the tax office was adjusted with the applied tax collection system. When the official assessment was used, the tax office organization was more directed to the function of assessment and monitoring by the tax office. After 1983, when the system self assessment was applied, the District Tax Office was designed to accommodate the objective of applying self assessment system.

When the 1983 tax laws where applied, the design of subordinate units of the DGT still referred to the provisions applied in the period of official assessment and focused more on the assessment and monitoring. Finally at the end of the 1980’s, there were major changes happened in the organization of the DGT subordinate vertical units by which the formation of section were based on type of taxes.

The formation of subordinate units in the DGT referred to three pillars of tax administration functions: counseling, services, and monitoring. The accommodation of these pillars was accomplished by establishing Tax Counseling Office (KP4), District Tax Office (KPP) and Tax Audit and Investigation Office in 1989.

Figure 7 Organization Chart of Directorate General of Taxes



The major modification of subordinate units in the DGT was initiated in 2002, with the formation of Modern Region and District Tax Office through the Tax Administration Modernization Program. The main characteristics of the Modern District tax Office are: (i) the merge of Tax Audit and Investigation Office and Land and Building Tax Office into one District Tax Office; (ii) the segmentation of taxpayer administration into Large Taxpayer Office (LTO/*KPP Wajib Pajak Besar*), Medium Taxpayer Office (*KPP Madya*), and Small Taxpayer Office (*KPP Pratama*); (iii) function-based system of both Regional and District tax Office; and (iv) service paradigm, which focuses on assisting taxpayer to perform their tax obligation by expanding some facilities.

III.1.3 Human Resources Development

Modern administration-based tax offices require human resources management that is different from the current existing tax offices. The differences include recruitment system, performance measurement, compensation improvement, and employees' ethic code practice. The entrance recruitment to become staffs in the modern tax offices is competitive, since only a few numbers of staffs will be placed gradually in the modern administration-based office. The selection test is arranged by the professional third-party. This test is conducted for echelon 4 level officer, Account Representative (AR), and auditors. The compensation offered is much higher than at the old system tax office; however the rewards are balance with the tasks and responsibilities. The reward and punishment system hopefully can minimize the misconducts which probably arise in the line of duty.

The Directorate General of Taxes new employee recruitment in fiscal year 2004 was 1.744 persons. The number of employees until the end of 2004 with echelon and function with level of education described below.

Table 31 Directorate General of Taxes Human Resources

Echelon	Number	Function
I	1	Director General of Taxes
II	35	Secretary of Directorate General, Director, and Head of Regional Tax Offices
III	508	Deputy Director, Head of Division, Head of Department, Head of Tax District Offices, Head of Tax Audit and Investigation Offices, Head of Land and Building Tax Offices
IV	3.334	Head of Section, Head of Sub Department, Head of Tax Counseling Offices
V	6.697	Staff Coordinator
---	16.254	Coordinator
---	2.685	Functional Staff (Tax Auditor, Land and Building Tax Appraiser, Programmer)
Total	**29.514**	

Source: Directorate General of Taxes, Annual Report 2004

III.1.4 Tax Administration Modernization

The Directorate General of Taxes (DGT) continuously extends the tax reform measures that have been implemented in the previous years. The tax reform measures, such as the establishment of the Large Tax Payer Office and the Modern Tax Offices, the implementation of the latest technology in providing service to the taxpayers, the development of the DGT bank data, the tax awareness campaign, and other programs show satisfying results which gain positive interest from the taxpayers.

DGT has declared a *blue print* tax policy as guidance in order to collect tax revenue effectively and efficiently within the scope of good corporate governance. The blue print stated that DGT main agenda for fiscal year 2001 is taxpayer canvassing, knowing your taxpayers (2002), uphold tax law (2003), National Bank Data and Single Identification Number (2004) and Indonesia Synergy (2005). The main goal of these programs is to strengthen the taxpayer data.

(1) Information Technology

Besides formation offices and implementation modern system, modernization is marked by applying advanced information technology in taxation service, such as:

- Portal intranet site of DGT, which becomes internal communication device and a door-way to enter tax application program;
- Input Tax-Output Tax application, as a tool to compare Input Tax Invoice of Buying and Output Tax Invoice of Selling for Taxable Entrepreneur (VAT purpose);
- Tax report and Payment Monitoring (MP3) application has a function as on-line device to monitor and to supervise the tax payment from taxpayers through perception banks;
- e-registration (e-reg) application, which is a society means for conducting on-line application to register as a taxpayer and to get taxpayer identification number (NPWP);
- e-filing application, which a service to provide taxpayers with on-line return filing;
- e-SPT program, which a service to file Tax Return (SPT) via electronic devices;
- Geographical Information System (GIS) which has been developed as a “Smart Map” to map information related to Land and Building Tax Object Number (NOP).

(2) National Bank Data

Bank Data is collections of data or information about taxpayers from the third parties, that given to the DGT through the memorandum of exchange information. These data is kept in the master file record (database server) of the head office under maintenance and monitoring of Directorate of Tax Information through the portal-intranet system. Tax authority staffs were given user login and password to access the application system, thus they have to be responsible for the data they access. These data is required in conducting tax audit to be cross checked and compared with the filing tax returns by the taxpayers.

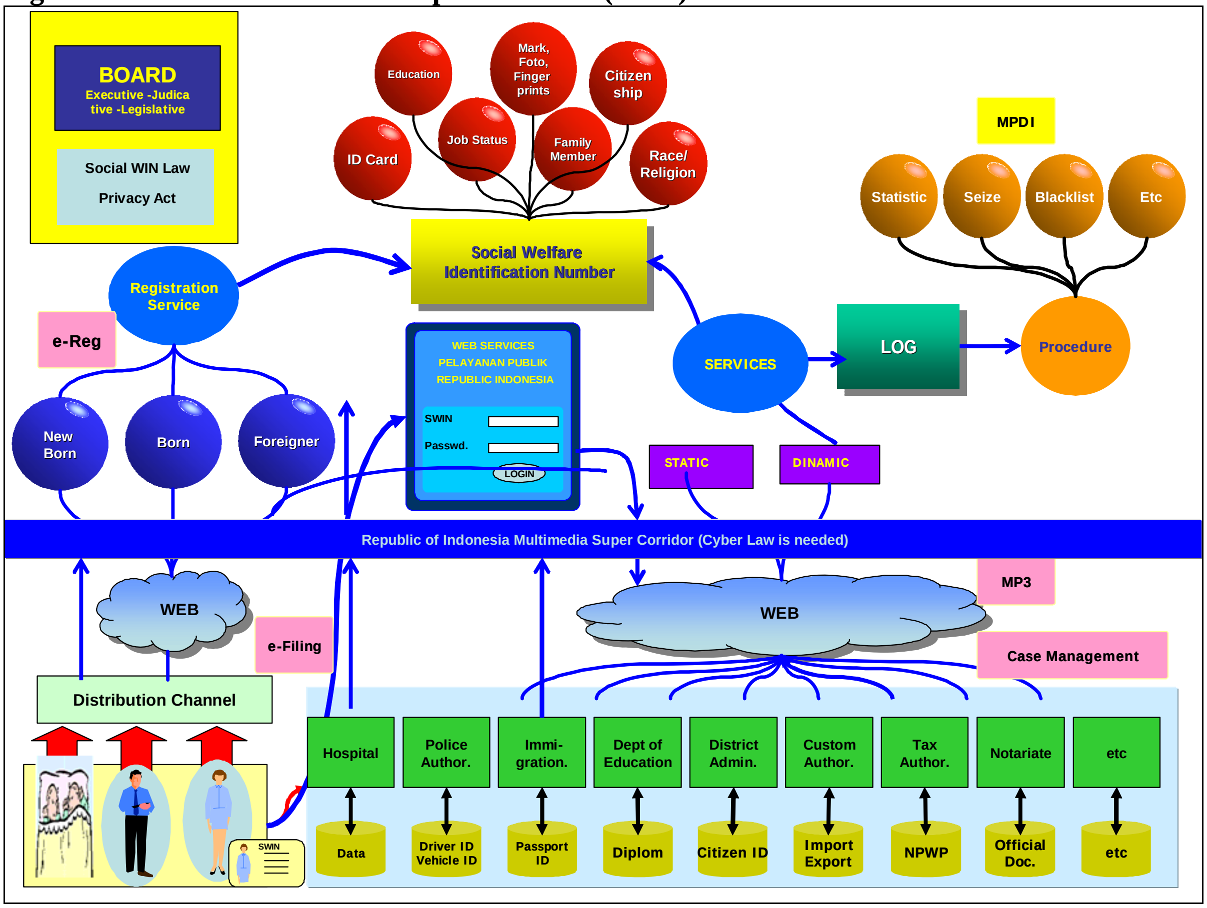
(3) Single Identification Number (SIN)

Judicial law product President Instruction No. 72/2004 has stipulated DGT to administer the SIN and ordered other government institutions to exchange information that can be valuable for tax purpose to increase the revenue. President Decree will automatically be legal provision for the DGT to collaborate with some departments, directorates, and other institutions in order to obtain the required data. Since SIN is very important, the Ministry of Communication and Information has clarified that SIN, which is developed by the DGT is mentioned as *e-Indonesia*. SIN will be accessible to all relevant government bodies and can be used for business licenses and industrial permits.

Although it is already stipulated in the law, the exchange of information among government departments/institutions does not perform smoothly. DGT has signed Memorandum of Understanding (MoU) with other government agencies and institutions, i.e.: Police authorities, Department of Trade and Industry, Local Governments, Investment Coordinating Board, etc. But the information exchange typically “halted” in the mid-management level of the institution for some reasons: a good system of database is unavailable (most transactions are in paper and not recorded well) and reluctance to exchange information with the tax authorities.

DGT realizes that the task scope is huge especially when people ‘trust’ to the tax authority are still low. The alternative solution is to have a special body that administer the information and exchange flows from any government agencies. This body, so called Indonesia Multimedia Super Corridor, should be directly under the authority of the President of Republic Indonesia. SIN itself is schedule to run out in year 2006. SIN also assists the government in increasing the tax revenue because such data can be retrieved by extensification and intensification program to increase the tax revenue which can be spent on routine budget, establishments and society welfare. Finally, the Social Security Number (SSN) which improves the society welfare will be created subsequently if the government capability has been improved.

Figure 8 Indonesia Multimedia Super Corridor (MSC)



III.2 International Taxation

The issue of international taxation has continually developed through the mechanism for taxes avoidance. From legal issue, such as e-commerce to illegal issues, namely transfer pricing, tax avoidance facilitated by tax heaven countries, and money laundering practices. Standard Operating Procedures (SOP) must discourage the incompliant taxpayers, and encourage the compliance taxpayers to use many available facilities, such as Advance Pricing Agreement (APA). Indonesia has concluded tax treaties with these following countries:

Table 32 Tax Avoidance of Double Taxation Agreement

Country	Effective date	Dividend		Interest		Royalty		Branch Profit Tax
		Portfolio Investment	Substantial Holding	General	Specific Case	General	Specific Case	
Australia	1-7-1993	15	15	10	--	15	10	15
Austria	1-1-1989	15	10	10	--	10	--	12
Belgium	1-1-1975	15	15	15	10	10	--	15
Bulgaria	1-1-1993	15	15	10	--	10	--	15
Brunei Darussalam	1-1-2002	15	15	10	--	10	--	15
Canada	1-1-1980	15	10	10	--	10	--	15
China	1-1-2004	10	10	10	--	10	--	10
Czech	1-1-1997	15	10	12.5	--	12.5	--	12.5
Denmark	1-1-1987	20	10	10	--	15	--	15
Egypt	1-1-2000	15	15	15	--	15	--	15
Finland	1-1-1990	15	10	10	--	15	10	15
France	1-1-1981	15	10	15	10	10	--	10
Germany	1-1-1992	15	10	10	--	15	10.75	10
Hungary	1-1-1994	15	15	15	--	15	--	10
India	1-1-1988	15	10	10	--	15	--	10
Italy	1-1-1996	15	10	10	--	15	10	12
Japan	1-1-1983	15	10	10	--	10	--	10
Jordan	1-1-1999	10	10	10	--	10	--	20
Kuwait	1-1-1999	10	10	5	--	20	--	10
Luxembourg	1-1-1995	15	10	10	--	12.5	10	10
Malaysia	1-1-1987	15	15	15	--	15	--	12.5
Mauritius	1-1-1999	15	5	10	--	10	--	10
Mexico	1-1-2004	10	10	10	--	10	--	10
Mongolia	1-1-2001	15	10	10	--	10	--	10
Netherlands	1-1-1971	15	10	10	--	10	--	9
New Zealand	1-1-1989	15	15	10	--	15	--	20
Norway	1-1-1991	15	15	10	--	15	10	15
Pakistan	1-1-1991	15	10	15	--	15	--	10
Philippines	1-1-1983	20	15	15	10	15	--	20
Poland	1-1-1994	15	10	10	--	15	--	10
Portuguese	1-1-2005	10	10	10	--	10	--	10
Romania	1-1-2000	15	12.5	12.5	--	12.5	10	10
Russia	1-1-2001	15	15	15	--	15	--	15
Saudi Arabia[1]	1-1-1989	-	-	-	--	-	--	-
Seychelles	1-1-2001	10	10	10	--	10	--	20
Singapore	1-1-1992	15	10	10	--	15	--	15
Slovakia	1-1-2002	10	10	10	--	15	--	10
South Africa	1-1-1991	15	10	10	--	10	--	10
South Korea	1-1-1990	15	10	10	--	15	--	10
Spain	1-1-2000	15	10	10	--	10	--	10
Sri Lanka	1-1-1995	15	15	15	--	15	--	20
Sudan	1-1-2001	10	10	15	--	10	--	10
Suriname	1-1-2002	15	15	15	--	15	--	15
Sweden	1-1-1990	15	10	10	--	15	10	15
Switzerland	1-1-1990	15	10	10	--	12.5	5	10
Syria	1-1-1999	10	10	10	--	20	15	10
Taiwan	1-1-1996	10	10	10	--	10	--	5
Thailand	1-1-1983	15	15	15	--	15	10	20
Tunisia	1-1-1994	12	12	12	--	15	--	12
Turkey	1-1-2001	15	10	10	--	10	--	15
UAE	1-1-2000	10	10	5	--	5	--	5
United Kingdom	1-1-1976	15	10	10	--	15	10	10
Ukraine	1-1-1999	15	10	10	--	10	--	10
USA	1-2-1991	15	10	10	--	10	10	10
Uzbekistan	1-1-1999	10	10	10	--	10	--	10

Venezuela	1-1-2001	15	10	10	--	20	10	10
Vietnam	1-1-2000	15	15	15	--	15	--	10

[1] limited to both countries "air line companies"
Source: Directorate General of Taxes (DGT) Republic Indonesia: Tax Treaties

Foreign Tax Relief

A credit is allowed for tax paid or due overseas on income accruing to an Indonesian company, provided it does not exceed the allowable foreign tax credit. The allowable foreign tax credit is computer per country basis.

III.3 Indonesian Tax Laws

III.3.1 Income Tax Law

Income tax is a tax which is imposed on individuals and corporations that receive or earn income in a taxable year. The individuals and organizations that receive or earn income are known as tax subject. Tax subject includes individual, corporation and permanent establishment (PE).

PE defined as an establishment regularly used to carry business in Indonesia by individual does not present in Indonesia for more than 183 days in any twelve month period, or by an organization or enterprise not set up or domiciled in Indonesia, i.e. in the form of a branch office, a representative office, a factory, an office building and a dependant agent. PE's income includes:

1. Income derived from business activities and from the assets possessed by it;
2. Headquarters' income derived directly from business activities in Indonesia, not through its PE, that similar to those of its PE's. Such type of income must be assumed to be PE's income since, basically, the business activities can be conducted by its PE in Indonesia;
3. Income in the form of dividend, interest (including premium and discount and compensation related to the guarantee payment of the debt), royalties, rents (other compensation related to the usage of assets), compensation related to professional service, prizes or awards, pension or another annuities received or earned by the headquarter from Indonesia, as long as there is an effective relationship between its PE and those assets or business activities from which the income derived.

Tax Residence

Based on taxpayers' domicile, there are two types of income tax subject: resident and non-resident (foreigner) tax subjects. Resident tax subjects must pay taxes if they receive or earn income, meanwhile non-resident tax subjects are automatically liable for paying taxes upon incomes they derived from Indonesia or through their PE in Indonesia.

Table 33 Treatment between Resident and Non-Resident Taxpayers

Resident Taxpayers	Non-Resident Taxpayers
1. Taxed on income originated both from Indonesia and from foreign countries	1. Taxed imposed on income originated from Indonesia
2. Taxed on the net income	2. Taxed imposed on gross income
3. Applying general tax rate (Art. 17 Income Tax Law)	3. Applying final tax rate (Art. 26 of Income Tax Law)
4. Have obligation to file the Tax Return	4. Do not have obligation to file the Tax Return

Source: the Indonesian Tax in Brief

A. Corporate Income Tax

A corporation defined as: (i) resident if it is setup or domiciled in Indonesia, i.e. in the form of limited corporation, limited partnership, other corporation, state-owned firm/local-government-owned firm, partnership, cooperative, pension fund, consortium, association, foundation, mass-organization, political organization, or similar organization, institution, and others; (ii) non-resident if it is neither setup or domiciled in Indonesia.

Companies incorporated or domiciled in Indonesia are subject to income tax on worldwide income. A credit may be obtained for income taxed overseas.

(1) Rates of Tax

Corporate income tax rate is progressive as describe below:

Taxable Income	Corporate Tax Rate
Up to Rp. 50 million	10%
Over Rp 50 million to Rp 100 million	15%
Over Rp 100 million	30%

Source: Republic of Indonesia Law Number 17 Year 2000 on Income Tax Article 17

(2) Tax Deductions

Deductions of gross income are all taxpayers' expenses in conducting their business, namely the cost of acquiring, collecting, and maintaining income which is directly related to the business activities. Taxpayers are generally able to deduct from gross income expenses to the extent that they are incurred in earning taxable income. Similarly to income, expenses are recognized on an accrual basis. Taxes other than income tax are deductible. If employee income taxes are borne by an employer, a grossing-up calculation can be made to claim the expense as a deduction from gross profit.

A business may also deduct the following expenses:

- depreciation and amortization, in accordance with specific rates;
- contribution to approved pension funds;
- losses from the sale of property or rights used in a business;
- foreign-exchange losses;
- cost of research and development (R&D) performed in Indonesia;
- scholarship, apprenticeship and training cost;
- 50 percent of the cost of automobiles provided to employees;
- office refreshments provided to all employees.

The following expenses may not be deducted:

- provisions or reserves, with exceptions for certain industries;
- premiums for employees' life and health insurance, unless paid by the employers and treated as income taxable to the employees;
- benefits-in-kind provided to employees, including housing;
- gifts, support and donations;
- personal expenses of shareholders
- salary paid to a member of an association, partnership or a limited partnership whose capital is not divided into shares;
- income tax and administrative sanctions in the form of interest, fines, surcharges, and criminal sanctions in the form of fines in connection with provisions of the tax laws;
- foreign business losses

(3) Loss Carry Forward

Accumulated loss in any taxable year can be carried forward to the next taxable year's profit, continuously for the next five years. For certain taxpayers, accumulated loss can be carried forward more than five years, with the maximum of ten years. A carry-back of losses is not possible. Tax consolidation is not available.

(4) Depreciation

Expenditures incurred in relation to assets with a beneficial life of more than one year are categorized and depreciated from the month of acquisition by consistently using either the straight-line or declining-balance method as follows:

Physical (Tangible) Asset	Useful Life (Years)	Method of Calculation	
		Straight Line	Double Declining Balance
I. Non Building :			
Group 1	4	25 %	50 %
Group 2	8	12.5 %	25 %
Group 3	16	6.25 %	12.5 %
Group 4	20	5 %	10 %
II. Building :			
Permanent	20	5 %	
Non Permanent	10	10 %	

Source: Republic of Indonesia, Law Number 17 Year 2000 on Income Tax Article 11

(5) Amortization

Intangible property or costs, including the cost of extending building use rights, rights for business use, rights for use and land and building transfer duty on land rights with a useful life of more than one year, should be amortized on the following bases:

Non-Physical Asset	Useful Life (Years)	Method of Calculation	
		Straight Line	Declining Balance
Group 1	4	25 %	50 %
Group 2	8	12.5 %	25 %
Group 3	16	6.25 %	12.5 %
Group 4	20	5 %	10 %

Source: Republic of Indonesia, Law Number 17 Year 2000 on Income Tax Article 11A

Specific amortized rates are applied to the following:

1. Costs incurred for acquiring the right to oil and natural gas concessions having a beneficial life greater than one year are amortized using the production-unit method.
2. Costs incurred for acquiring mining rights, forest concessions, and other rights to exploit natural resources and natural products with a beneficial life of more than one year are amortized using the production-unit method but not exceeding 20% per annum.

(6) Tax Incentives

Tax incentives may be granted to newly-established resident companies investing in certain types of businesses or regions. A government regulation has yet to be announced to specify the types of industries and regions qualifying for the incentives. The tax incentives include the following:

a) accelerated depreciation and amortization;
b) tax-loss carry forward period of 10 years;
c) a reduced dividend withholding tax rate of 10 percent unless the rate provided in a relevant tax treaty is lower;
d) an investment allowance of 5 percent per year for a period of six years.

(7) Corporate Restructuring

Tax-neutral restructuring is available for taxpayers undergoing mergers, consolidations, and certain expansions with the following requirements:

a) the taxpayers have paid all outstanding tax debts;
b) for taxpayers that will transfer and utilize the balance of the tax losses carried forward to the surviving company in a merger or consolidation: all fixed assets will be revalued, the taxpayer has an active business prior to the merger or consolidation, and the taxpayer receiving the transferred

property is actively running the business for at least two years after completion of the merger or consolidation process.

Based on DGT specific approval, transfers of assets at book value are allowed under the following situations:

- Conducting a tax-neutral merger or consolidation

Tax losses of the dissolved companies can be transferred to the surviving company provided that the dissolved companies' assets are revalued. The companies involved can offset their receivables and payables against each other without incurring any tax implications. Transferors are exempt from land and building right transfer tax for qualified mergers or consolidations. Additionally, subject to specific DGT approval, duty for the acquisition of land and building rights (DALBR) may be reduced up to 50%.

- In case of business expansion constitute part of an initial public offering (IPO) plan

Within one year of the DGT approval, the company concerned must have an effective declaration about registration for an IPO with the Capital Market Supervisory Board. For complications beyond the company's control, the period can be extended by the DGT up to 3 years.

(8) Golden Taxpayers

Golden Taxpayer is a particular taxpayer who appointed by the DGT as a taxpayer who fulfills certain criteria, which eligible to get preliminary refund of overpaid tax without being audited. In the year of 2000, the Ministry of Finance consigned the criteria of Golden Tax Payers who deserves tax facilities in line with the regulations. The golden taxpayers have the right to get a preliminary refund of overpaid tax without being audited, not later than: three months, in the case of income tax; and one month, in the case of VAT, as from the date of receipt of complete application for refund. Furthermore, to provide the best service to taxpayers, the DGT issues a Circular Letter Number SE-05/PJ.33/2001 that request the head of district tax offices to issue the decision on preliminary restitution of overpaid tax, not later than:

i. 2 (two) months, in the case of income tax;
ii. 7 (seven) days, in the case of VAT;

which start from the date of receipt of complete application, after examine the application or request.

The requirements for the Golden Taxpayers include:

a) submitting tax returns on time for previous two years;
b) for the latest year, a periodical tax return that is filed beyond the time limit covers no more than three tax periods for all kind of taxes, and is not continued;
c) the periodical tax returns that are filed beyond the time limit are not submitted beyond the time limit for the following periodical tax return;
d) not having delinquent tax for any kind of taxes:
    - unless the taxpayer has been permitted to install or postpone tax payment;
    - tax assessments issued for the last two tax periods.
e) not having been sentenced or criminal tax case-related offenses for the last ten years;
f) in case that taxpayers' income statement is audited by a public accountant or BPKP, it must receive an unqualified opinion, without additional paragraphs or with additional paragraphs as long as they do not affect the fiscal profit/loss.

In case that the taxpayer's income statement is not audited by a public accountant, the taxpayer must propose a written application not later than three months before the year end, to be stipulated as a Golden Taxpayer. The taxpayer has to meet all the requirements from point (a) to (e) above, and has to perform bookkeeping as stipulated in the Tax Law. Moreover, if the taxpayer has been audited for the last two years, fiscal correction for all forms of tax liability should not exceed 10%.

(9) Taxable Benefits-in-Kind

Benefits-in-kind are not taxable in the hands of the employee, except if provided by:

- Mining companies and production sharing contractors (PSC) which are subject to tax under the 'old' tax laws;
- Representative offices of offshore companies not constituting taxpayers;
- Final-taxed companies; or
- Deemed profit companies.

(10) Deemed Profit Margins

The following businesses have deemed profit margins for tax purposes:

Descriptions	On gross revenues	Effective income tax rate
Domestic shipping operations	4%	1.2%
Domestic airline operations	6%	1.8%
Foreign shipping and airline operations	6%	2.64%
Foreign oil and gas drilling service operations	15%	-
Certain Ministry of Trade representative offices	1 % of export value	0.44%

(11) Tax Facilities

Based on specific presidential decrees, the following tax facilities can be granted to limited liability companies (PT) pursuant to their investments in certain business areas considered a high national priority or if in certain remote regions:

- A reduction in net income of up to 30% of the amount invested, prorated at 5% for 6 years provided that the assets invested are not transferred within 6 years;
- Acceleration of fiscal depreciation;
- Extension of tax loss carry-forwards up to 10 years; and
- A reduction to 10% in the withholding tax on dividends paid to nonresidents.

The same tax facilities can be granted by the specific approvals from DGT to companies conducting business in an Integrated Economic Development Areas (KAPET). Currently there are approximately 25 areas designated as “KAPET”s. If the company has a bonded-zone status, the tax facilities will also include those typically enjoyed by a bonded-zone company such as:

- VAT and sales tax on luxury goods are not collected on certain transactions;
- Exemption from prepaid income tax (Income Tax Law Article 22) on the importation of capital goods and other equipment directly related to production activities;
- Postponement of import duties on capital goods and equipment and goods and materials for processing;
- Exemption from import duties for 4 years on machinery and certain spare parts.

B. Individual Income Tax

Resident individual taxpayers who receive or earn annual income exceeding the annual non-taxable income threshold (PTKP) must register with the Indonesian Tax Office and file annual income tax returns (form 1770). The personal tax return should report all of the individual's income, including compensation from employment, investment income, capital gains, overseas income and other income as well as summary of the individual assets and liabilities (starting from year 2001).

(1) Tax Rates

Resident individual’ income is subject to income tax at the following general tax rates:

Taxable Income (Rp.)	Individual Tax Rate
Rp 20 million or less	5%
Over Rp. 25 million to Rp. 50 million	10%
Over Rp. 50 million to Rp. 100 million	15%
Over Rp. 100 million to Rp. 200 million	25%
Over Rp. 200 million	35%

Source: Republic of Indonesia, Law Number 17 Year 2000 on Income Tax Article 17

(2) Deductions

To determine the taxable income of permanent full-time employee (Income Tax Article 21), gross income is reduced by the following amounts:

Table 34 Annual non-taxable income (PTKP) for resident individuals:

Description	Amount (Rp.)
Taxpayer	12,000,000
Spouse	1,200,000
Each dependent (max. of 3)	1,200,000
Occupational expenses	1,296,000
Employee contribution to Jamsostek for old age security savings (2% of gross income)	Full amount
Pension expenses (5% of gross income, max Rp. 108,000/month)	432,000

Source: Republic of Indonesia, Law Number 17 Year 2000 on Income Tax Article 17

C. Withholding Taxes

Indonesian income tax is collected mainly through a system of withholding taxes. These withholding taxes are commonly referred to by the relevant article of the Income Tax (PPh) Law.

(1) Income Tax Article 21 – Employment Income

Taxable income of an employee includes wages, salary, commissions, bonuses, pensions, director's fees and other compensation for work performed. Compensation-in-kind for work or services is not taxable income for the employee and is not a deductible expense for the employer. However, this treatment does not apply to employees of a representative office or to employees of companies subject to the final tax regime.

An Indonesian taxpayers' income is aggregated with the taxable income of their spouse. They are thus taxed as a single taxpayer, unless they have an agreement to have separate asset ownership, in which case, taxed as separate taxpayers.

(2) Income Tax Article 22 - Imports

Article 22 Income Tax is applicable in the following events:

a) Import of goods;
b) Sales of goods to the government calling for payments from the State Treasury, the State Budget ;
c) General Directorate, and certain state-owned companies;
d) Sale/purchase transactions of steel, automotive, cigarettes, cement, and paper products.

The tax rates for the designated events are as follows:

Description	Tax Rate (%)	Tax Base
1. Import of goods – using an Importer Identification (API)	2.50	Import value, i.e.: CIF values + duties payable
2. Import of goods – without API	7.50	Import value, i.e.: CIF values + duties payable
3. Sales of goods to the government calling for payment from the State Treasury and certain state-owned companies	1.50	Selling prices
4. Purchases of steel products	0.30	Selling prices
5. Purchases of automotive products	0.45	Selling prices
6. Purchases of paper products	0.10	Selling prices
7. Purchases of cement	0.25	Selling prices
8. Purchases of cigarettes	0.15	Retail selling prices

Payments from the State Treasury and certain state-owned companies such as: PT Telkom, Pertamina, BPPN, Bulog, Bank Indonesia, PLN, PT Indosat, PT Garuda Indonesia, PT Krakatau Steel and state-owned banks, for goods are also subject to Article 22 tax at 1.5%, which is deducted by the State Treasury state-owned companies. Payments from industries and exporters for plantation, forest, fishery goods are also subject to Article 22 Income Tax at 0.5%. Final-taxed companies are not subject to Article 22 tax if they have a certificate of exemption from the Tax Office. Subject to certain requirements, a certificate of exemption may also be granted by the Tax Office provided the taxpayer can show that the estimated corporate tax liability will show an overpayment position.

(3) Income Tax Article 23

Article 23 Income Tax is tax withheld on income in whatever name and form which is source from capital, service rendered or other activities other than being withheld under Article 21 Income Tax. Resident companies, PEs, representatives of foreign companies, organizations, and appointed individuals are required to withhold tax from the following payments to other residents:

a. 15% tax rate on gross amounts of:

- dividends ;
- interest, including premiums, discounts, remuneration (with debt claims), and loan guarantee fees;
- royalties; and
- prizes and rewards other than being withheld under Article 21 Income Tax.

b. varied rate on estimated net income (ENI):

Description	ENI	Rate (% of Gross Amounts)
1. Rentals other than land and/or buildings		
• rental of land transportation vehicles	20%	3%
• others (payments under finance leases are not subject to withholding tax)	40%	6%
2. Fees for services		
• professional services and consulting services	50%	7.5%
• construction contracting services, including installation and maintenance services provided by licensed construction companies	13.33%	2%
• construction planning services and construction supervisory services	26.67%	4%
• technical and management services; design services; intermediary services	40%	6%
• accounting and bookkeeping services	50%	7.5%
• installation and maintenance/repair services,	40%	6%

• support services in flight services and airport, including catering support	40%	6%
• custodial/storage/consignment services (excluding those provided by KSEI and storage rental which is already subject to final tax)	40%	6%
• securities trading services except those provided by BEJ, BES, SEI and KPEI	40%	6%
• technology information, telecommunication and computer software services	40%	6%
• waste treatment and disposal, forest felling services, including land clearing	40%	6%
• drilling and support services in mining (excluding drilling services in oil/gas provided by PEs); mining and support services in non-oil/gas mining industry	40%	6%
• appraisal and actuarial services	50%	7.5%
• film dubbing/mixing services; toll manufacturing ("maklon"); recruitment/manpower supply services	40%	6%
• services other than the above the payments for which are borne by government budgets (APBN and APBD)	10%	1.5%

(4) Income Tax Article 26

Article 26 Income Tax is income tax levied or withheld on income derived from Indonesia source-income or earned by non resident taxpayer other than PE in Indonesia. Residents of tax treaty countries generally can obtain a lower rate of withholding tax (subject to Tax Treaty provisions). Resident taxpayers, organizations, and representatives of foreign companies are required to withhold tax from the following payments to non-residents:

a. 20% tax rate on gross amounts of:

- dividends;
- interest, including premiums, discounts (interest), swap premiums, and guarantee fees;
- royalties, rents and payments for the use of assets;
- remuneration in respect of work, services and activities;
- prizes and awards;
- pensions and any other periodic payments; and
- the notional annual distributions of after-tax profits of a branch or PE.

b. varied rate on estimated net income (ENI):

Description	ENI	Rate (% of gross amounts)
Insurance premiums paid to non-resident insurance companies:		
• by the insured	50%	10%
• by Indonesian insurance companies	10%	2%
• by Indonesian reinsurance companies	5%	1%
Sale of non-listed shares by non-residents	25%	5%

After-tax profits of a PE will be exempt from withholding tax if they are reinvested in Indonesia in the form of equity participation in a company established and domiciled in Indonesia for which the PE acts as the founder or one of the founders, if meet the following requirements:

a. the re-investment is carried out in the form of capital participation on such company established and domiciled in Indonesia as founder or members of founders;

b. the re-investment is carried out in the current year or not later than ensuing year;

c. it is not allowed to capital repatriation at least 2 (two) years after the invest company started business operation.

Where the recipient is resident in a country which has a tax treaty with Indonesia, the withholding tax rates may be reduced or exempted.

(5) Article 4 – Final tax

One of underlying consideration for final tax imposition is the simplicity principle. Final tax is not a prepayment of income tax and cannot be credited against tax payable on other source of income. The costs of used for generating, collecting, and maintaining the income are not deductible items. Resident companies, PEs, representatives of foreign companies, organizations, and appointed individuals are required to withhold tax from the following gross payments to residents:

Description	Tax Rate	Tax Base
1. Transfer of title of land and/or building (except Real Estate companies):		
• Normal housing :	5%	gross value
• Low cost housing :	2%	gross value
2. Rentals of land and/or buildings	10%	gross value
3. Fees for the services of "small construction companies" that have obtained a "small-scale entrepreneur's certificate" issued by an authorized institution and has a contract of not more than Rp. 1 billion:		
• Construction contracting :	2%	gross income
• Construction planning :	4%	gross income
• Construction supervision :	4%	gross income
4. Income from shipping business:		
• Resident taxpayers :	1.2%	gross income
• Non-resident taxpayers :	2.64	gross income
5. Income tax on interest earned on bonds sold on Indonesian stock exchanges (exempted for Banks operating in Indonesia, Government approved pension funds and mutual fund companies registered with the Capital Market Supervisory Board within 5 years of their establishment) :		
• Resident taxpayers :	20%	gross income
Non-resident taxpayers (lower if subject to tax treaty):	20%	gross income
6. Securities traded on stock exchange:		
• Stock trading	0.1%	gross transaction
• Additional tax on company founder's stock traded	0.5%	gross transaction
7. Difference between the fair market value and the tax book value of the revalued assets	10%	net gain
8. Income on prizes from lotteries	25%	gross income

III.3.2 Tax Law on VAT and Sales Tax on Luxury Goods

A. Value Added Tax (VAT)

VAT is levied at 10% on imported and locally produced goods, on most services and also at the retail level, including disposals and transfers of assets not originally intended for resale whose input VAT paid at the time of purchase could be credited. VAT is also levied on deliveries of goods from a head office to branches or between branches and on deliveries to intermediaries, except for companies allowed or required to centralize their VAT reporting.

In principle, input VAT on purchases related to a taxpayer's business may be credited against output VAT due on sales with some exceptions, most notably VAT on expenditures associated with making exempt supplies and employee benefits-in-kind. Input VAT on imports paid by an importer on a customs underpayment assessment issued by the Customs Office may also be credited against output VAT.

Companies registered under the Special Regional Tax Office, namely Foreign Investment Tax Office, Foreign Corporate and Individual Tax Office, Go Public Tax Office, Large Taxpayer Office (LTO), and Middle Taxpayer Office (MTO) are required to centralize their VAT reporting and to file tax returns in digitalized form (e-tax return).. Other companies can only centralize their VAT reporting based on special DGT approval.

(1) VAT Base

Generally, tax imposition base (DPP) is the sales price or compensation paid. Luxury sales tax is not included in the tax imposition base (DPP) for importers or manufacturers.

(2) VAT Exemptions

The following goods and services are not subject to VAT:

Goods	Services	Strategic Goods
a. mining or drilling products extracted directly such as crude oil, natural gas, geothermal energy, sand and gravel, coal before being processed into coal briquettes, iron ore, tin ore, copper ore, gold ore, silver ore and bauxite ore; b. basic commodities needed by society – rice, salt, corn, sago and soya beans; c. food and drink served in hotels, restaurants and the like; and d. money, gold bars and securities	a. medical health services; b. social services such as orphanages and funeral services; c. mail services with stamps; d. banks, insurance, and finance leasing services; e. religious services; f. educational services; g. commercial art and entertainment services which are taxed under regional entertainment tax; h. broadcasting services for advertising; i. public transportation on land and water and international air transport; j. manpower services; k. hotel services; and l. public services provided by the Government	On the import and delivery of: a. certain machinery and factory equipment used to manufacture taxable goods (excluding spare parts) b. agricultural, plantation and forestry products, animal husbandry products, including hunting and trapping, and cultivation or fishery products, including the catching and cultivation of fish produced by farmers; c. electricity, except household electricity exceeding 6,600 watts; d. piped water, or through drinking water tankers; e. cattle, poultry and fish feed, and the raw materials for manufacturing cattle, poultry and fish feed; and f. seeds and seedlings for agricultural, plantation, forestry, farm and animal husbandry products.

(3) Special Rates of VAT

Special VAT rates apply to certain goods and services, such as:

a. services rendered by a travel agent are levied at 1 % of invoice value;
b. cigarettes sold by manufacturers are levied at 8.4% of invoice value;
c. courier services are levied at 1 % of invoice value;
d. independent construction (self-building) is levied at 4% of total costs incurred or paid, exclusive of the acquisition price of land;
e. factoring services is levied at 0.5% of the total fee, including service fees, provisions, and discounts;
f. sales of second-hand motor vehicles by motor vehicle dealers is levied at 1 % of total sales value;
g. redemption of VAT on "paid" stickers on audio tapes and video recordings;
h. own use and free gifts of taxable goods and/or services are levied at 10% of the cost of sales.

(4) VAT Collectors

During 2004 only the State Treasury qualified as a VAT collector. This situation continued up to 1 February 2005 when PSC contractors were reappointed as VAT collectors. Since then VAT collectors have comprised the State Treasury and PSC contractors. Given the change, the ordinary input - output mechanism should be applicable for any transaction involving VAT except those requiring payments from the State Treasury and PSC contractors.

(5) VAT Invoices

VAT invoices must contain the following information:

a. the name, address and tax ID number of the taxpayer delivering the taxable goods or services;
b. the name, address and tax ID number of the purchaser;
c. the type of good or service, the quantity, the sales price or compensation and any discounts;
d. the VAT that has been collected;
e. the sales on tax on luxury goods that has been collected (if any);
f. the code, serial number and date of issuance of the invoiced; and
g. the name, position and signature of the authorized signatory to the invoice.

Documents that can be considered VAT invoices are:

a. import declarations (PIBs) together with tax payment slips or tax collection slips issued by Customs;
b. export declarations (PEBs);
c. instruction letters for the distribution of milled flour from National Logistic Bureau (Bulog);
d. Pertamina (State Own Enterprise Oil and Gas company) delivery invoices;
e. telephone/telecommunications service bills, electricity bills, airway bills, or delivery bills issued for domestic air transportation services; and
f. sales invoices issued for deliveries of port services.

(6) Crediting Input VAT

Where input VAT exceeds output VAT, a refund of input VAT can be requested on a monthly basis; or the excess amount can be credited against the output tax in the future period (the Indonesian term for this procedure is called compensation, instead of refund). An input tax credit must be claimed in the same period within the period of output products are sold. However, it is allowed to claim the respective input tax later, as long as not more than three months after the end of the respective tax period. Beyond this limit, the credit can still be claimed, only by submitting an amended VAT return. An input VAT invoice issued late for more than 3 months, is considered as an invalid tax invoice, cannot be credited.

(7) VAT Refund

In principle, input VAT on purchases related to a taxpayer's business may be credited against output VAT due on sales with some exceptions, most notably VAT on expenditures associated with making exempt supplies and employee benefits-in-kind. Input VAT on imports paid by an importer on a customs underpayment assessment issued by the Customs Office may also be credited against output VAT. Any excess of output VAT over input VAT must be paid to the Tax Office by the 15th of the following month. The approval periods for refunds are determined as follows:

a) Certain qualifying taxpayers (golden taxpayers) will receive approval within 1 month;
b) Exporters and suppliers to VAT collectors who do not qualify for the 1 month approval will receive approval within 2 months
c) Other taxpayers will receive approval within 6 months;
d) If the Tax Office elects to audit all taxes, the refund in all cases must be determined within 12 months.

Except for (a), VAT refunds are subject to the tax authority's audit / examination before payment. An input tax credit must be claimed not later than three months after the end of the tax period in which it should have been claimed. If this deadline is missed, the credit can still be claimed, but only by submitting an amended VAT return for the period when it should have been claimed.

(8) Administrative Penalties

An administrative penalty of 2% of the tax imposition base (DPP) is applied in the following circumstances:

a. A qualified taxpayer has not registered as a VAT enterprise ("PKP").
b. A taxpayer issues VAT invoices without being confirmed as a VAT enterprise.
c. A VAT enterprise does not issue VAT invoices or issues incorrect, late, or incomplete VAT invoices.

If a tax overpayment is incorrectly used as an offset or the 0% rate was incorrectly applied, a 100% penalty will be imposed in addition to the tax itself.

(9) VAT in Batam

Batam is an island in the Riau Islands province of Indonesia with 415 sq km land area. The island is located about 20 kilometers south of Singapore. Batam has been treated as a special bonded zone with more VAT facilities than those granted to ordinary bonded zones. A bounded zone is a facility for encouraging exports by exempting imported duty, provided at least 66% of the production value of finished goods (or 50% in the case of semi-finished products) is exported. After several times of deferment, certain steps have finally been taken to turn Batam into an ordinary bonded zone. Starting from 1 January 2004 VAT and luxury sales goods tax (LST) has been applied in Batam as follows:

a) Starting 1 January 2004 VAT shall be imposed on deliveries of automotive, cigarette and liquor products;
b) Starting 1 March 2004 the list of taxable goods shall be extended to include electronic products;
c) No more goods and services have been added to the list of taxable goods and services after 1 March 2004 despite the original target to extend the list every 6 months.
d) There is an exception for companies qualifying for a bonded zone status.

B. Sales Tax on Luxury Goods

Luxury Sales Tax (LST) is levied at from 10% to 75% on imported and domestically produced luxury goods as stipulated by the Minister of Finance. Sales tax is collected at the import and manufacturing levels, not at the end-consumer level. Taxable items include the following items:

(No) Taxable Rate	Items
(1) 10%	• fermented cream or milk, nuts or cocoa, yoghurt, kephir, whey, cheese, butter • bottled/packaged fruit or vegetable juices • bottled/packaged non-alcoholic drinks including soda water • certain household utensils, coolers, heaters, and certain TV receivers • equipment and accessories for sports • air conditioners • visual recording or reproducing apparatuses, radio receivers • photography, cinematography apparatuses and their equipment • motor vehicles with more than 10 to 15 seats using petrol, diesel or semi-diesel motor vehicles with less than 10 seats, except sedans and station wagon with 4x2 wheel drive, using petrol, diesel or semi-diesel fuel with a cylinder capacity of less than 1500 cc
(2) 20%	• certain household utensils, coolers, certain heaters, except those under (1) • luxury apartments, condominiums, town houses • air conditioning units, washing machines, dryers, electromagnetic instruments, and musical instruments • perfumes • certain carpets, except those made from choir, silk or wool, or animal fur or feathers • motor vehicles with less than 10 seats, except sedans and station wagons with 4X2 wheel drive, using petrol, diesel or semi-diesel with a cylinder capacity of 1500 cc to 2500 cc motor vehicles with double cabin
(3) 30%	• ships, vessels and water vehicles, dugouts, canoes, except those for government and public use • equipment and accessories for sports, except those under (1) • motor vehicles in the form of sedans/station-wagons, using petrol diesel or semi-diesel with a cylinder capacity of up to 1500 cc • motor vehicle, beside sedans and station wagon
(4)	• certain alcoholic beverages

40%	• goods made of leather or imitation leather • silk or wool carpets • goods made of crystal for table, kitchen, home or office decoration • goods made of precious metals and/or precious metals or combinations thereof • ships, vessels, and water vehicles, except those for government and public use and those under (3) • balloons and private aircraft • bullets and other weapons, except those for government use • footwear • household and office furniture and fittings • goods made of porcelain, land, Chinese land or ceramic • goods made of stone • motor vehicles, besides sedan and station wagons using petrol with 4X2 wheel drive and having a cylinder capacity of 2500 to 3000 cc • motor vehicles with 4X4 wheel drive using petrol and having a cylinder capacity of 1500 cc to 3000 cc • motor vehicles using diesel or semi-diesel in the forms of sedan or station wagon, and beside sedan or station wagon using petrol with 4x2 wheel drive and having a cylinder capacity of 1500 cc to 2500 cc
(5) 50%	• carpets made of animal fur or feathers • aircraft, except those under (4) and except those for government and public use • equipment and accessories for sports, except those under (1) and (3) • weapons and shooting equipment, except those for government use • all motor vehicles used as golf carts
(6) 60%	• 2-wheeled motor vehicles with a cylinder capacity of 250 cc to 500 cc • special motor vehicles used for the snow, beach, mountain and the likes.
(7) 75%	• Alcoholic beverages, except those under (4) • goods made of precious metal, precious stones, pearls or combinations thereof, except those under (4) • luxury yachts, except those for government and public use • motor vehicles with less than 10 seats using petrol and having a cylinder capacity of more than 3000 cc or using diesel or semi-diesel and having a cylinder capacity of more than 2500 cc • 2-wheeled motor vehicles with a cylinder capacity more than 500 cc • trailers and semi-trailers for caravans for camping or home use.
(8) Exemption from LST	• motor vehicles used as ambulances, police vans, fire-engines, hearses, and public transportation • motor vehicles used for the official duties of State protocol c) motor vehicles with more than 10 seats using diesel or semi-diesel of all cylinder capacities used for the official duties of the Indonesian Armed Forces/State Police

III.3.3 Import Duty

Import duty is payable at rates from 0% - 170% on the customs value of imported goods. Customs value is calculated of the cost, insurance and freight level (CIF).

Group	Good	Rate (%)
Automobiles	Passenger and commercial vehicles	25 to 80
Automobile parts		15
Electronic Goods		
Footwear		10 to 15
Ethyl Alcohol & Alcoholic Drinks	Ethyl alcohol, beer, wine, spirits	30 to 170
Agricultural Products	Animal & vegetable products	Mostly 5
Other	Chemicals, pharmaceutical products, rubber, etc.	Mostly 5

III.3.4 Land and Building Tax

The tax object shall be land/or buildings with the territory of Indonesia. Land shall be the surface of land and the body of land underneath. Building shall be technical construction which is planted and installed permanently on land/or water.

Indonesian law on property encompasses several classes of land title:

- The right to build *(Hak Guna Bangunan)* allows construction and ownership of buildings on land for up to 30 years, which may be extended for a further 20 years;
- The right to use *(Hak Pakai)* allows use of land owned by the state or others for a specific purpose for up to 25 years, which may be extended for a fuether 20 years;
- The right to exploit *(Hak Guna Usaha)* allows cultivation of land for a variety of purpose, including agriculture, fisheriesm and cattle breeding for up to 35 years, which may be extended for a further 25 years.

Land and building (L&B) tax rate is specified to be 5%, the actual tax due for a particular piece of L&B is calculated by applying the tax rate to the *taxable sale value* (NJKP) of the L&B. "NJKP" is a predetermined proportion of the *sale value of the tax object* (NJOP) of a particular L&B, with amount stipulated as follow:

1. For the plantation, forestry and mining: "NJKP" is 40% of the real sales value.
2. For other tax object:

- "NJKP" is 40% of the sales value if the sales value of the tax object is Rp 1 billion or more;
- "NJKP" is 20% of the sales value if the sales value of the tax object is less than Rp 1 billion.

The government can increase the "NJKP" rate up to 100% of the "NJOP". The sales value is the average value of the arm's length transaction. If it is not, the sales value is stipulated trough the price comparison with the other similar object, or new acquisition value, or the replacement sales value. Objections to assessments may be submitted to the Head of the L&B Tax Office in the area where the property is located, who has 12 months to make decision. L&B tax is payable annually pursuant to n official assessment issued by the DGT.

III.3.5 Duty on the Acquisition of Land and Building Transfer (DAL&BR)

A transfer of land and building (L&B) rights will typically give rise to a liability of the Duty on the Acquisition of Land and Building Transfer (DAL&BR) to the party receiving or obtaining the rights. DAL&BR is to be based on the *Tax Object Acquisition Value* (NPOP), in most cases being the higher f the market (transaction) value or the "NJOP" of the L&B rights concerned. The tax due to for a particular event is determined by applying the applicable tax rate (5%) to the relevant "NPOP" minus an allowable non-taxable threshold, which is varies by region: the maximum being Rp. 60 million, except for inheritance which may reach Rp. 300 million. With a government regulation, the government may change the non-taxable threshold.

At the request of a taxpayer, the DGT may grant a DAL&BR reduction up to 50% in respect of L&B right transfers in business or mergers or consolidation at book value as well as L&B rights obtained as compensation for the release of L&B rights for a public-interest governmental project. In certain non-business L&B right transfers, at the request of a taxpayer, the DGT may also grant DAL&BR at either 25%, 50% or 75% of the tax due.

A number of exemptions or reductions apply, including:

- Transfers to diplomatic representatives and certain international organizations;
- Transfers intended for general government activities or in the public interest;
- Rights conversions without changes in the name of ownership;
- *Wakaf* (religious donations);
- Transfers for religious purposes;
- Where the land or buildings are used for social or educational activities that are non-profit-seeking – 50% reduction;
- Grants to blood relatives in a straight line, either one step above or below – 75% reduction;
- Where the land and/or buildings are transferred in connection with a merger – 50% reduction;

- Where the land or buildings are auctioned and the purchase price is lower than the "NJOP" – reduction equal to the difference between the transfer duty according to the "NJOP" and the transfer duty according to the auction price.

A notary is prohibited from signing a transfer of title deed until duty payment has been made.

III.3.6 Stamp Duty

Stamp duty is a tax imposed on document which is used by the society for any activities, related to the law. The nominal is either Rp. 6,000 or Rp. 3,000 on certain documents.

Object	Tariff (effective on May 1, 2000)
1. Letters of agreement and other letters (i.e. authorization letters, letters bestowing gifts, declarations) drawn up with the purpose to be used as means of evidence regarding factual acts or occurrences of a civil nature	Rp.6,000
2. Notarial deeds including their copies	Rp.6,000
3. Deeds prepared by the Land registry Official (officers who are responsible for the preparation of land deeds), including their copies	Rp.6,000
4. A letter covering an amount of money or nominal price o foreign currency which stipulates the following the receipt of money, the bookkeeping of money or keeping of money in an account in a bank, the information regarding the account balance in the bank, an acknowledgement that the entire cash debt has been settled in its entirely or partly or has been offset; 5. Negotiable instruments such as money order, promissory note and IOU; 6. Bonds in any shape of forms; For (4), (5), and (6) the rate is subject to its nominal price, if: • its nominal price is in excess of Rp 1,000,000 • its nominal value is more than Rp 250,000 but does not exceed Rp 1,000,000 • its nominal value does not exceed Rp 250,000	 Rp.6,000 Rp.3,000 Not subject (free)
5. Ordinary letters and household letters; letters which originally are not assessed Stamp Duty pursuant to its intent. In the event, it I used for other objectives or used by somebody else, other than its original intent; on documents to be used as proof of evidence in court	Rp.6,000
6. Check	Rp.3,000

III.3.7 Tax Return Filing

Tax liabilities for a particular period or year are typically to be paid to the State Treasury through a designated tax-payment bank and then accounted for to the DGT office by filing the relevant tax returns. The tax payments and tax return filing for a particular tax must be undertaken monthly, annually, or both (monthly and annually), which can be described in the table below:

Table 35 Monthly Tax Obligations

Type of Tax	Tax Payment Deadline	Tax Return Filing Deadline
1. Article 21/26 Income Tax	The 10^{th} of the following month	The 20^{th} of the following month
2. Article 23/26 Income Tax	The 10^{th} of the following month	The 20^{th} of the following month
3. Article 25 Income Tax	The 15^{th} of the following month	The 20^{th} of the following month
4. Article 22 Income Tax – Tax Collector	The 10^{th} of the following month	The 20^{th} of the following month
5. Article 4(2) Income Tax	The 10^{th} of the following month	The 20^{th} of the following month
6. VAT and LST – Taxable Enterprise	The 15^{th} of the following month	The 20^{th} of the following month
7. VAT and LST – VAT Collector	The 15^{th} of the following month	The 20^{th} of the following month

Table 36 Annual Tax Obligations

Type of Tax	Tax Payment Deadline	Tax Return Filing Deadline
1. Corporate Income Tax	The 25th of the third month after the book year end	The end of the third month after the book year end
2. Individual Income Tax	The 25th of the third month after the book year end	The end of the third month after the book year end
3. Article 21/26 Income Tax	25 March of the following year	31 March of the following year
4. Land and Building (L&B) Tax	6 months after the receipt of a *Tax Due Notification Letter* ("SPPT") from the DGT office	N/A
5. Duties on the Acquisition of L&B Rights	On the acquisition date	N/A

Tax Penalty (Late Filing)

Late payments will incur an interest penalty at 2% per month, part of month (e.g. 1 day) being considered to be a full month. Late filing of a tax return will incur an administrative penalty of Rp. 50,000 for each particular monthly tax return and Rp. 100,000 for each particular annual tax return.

III.3.8 Fiscal Exit Tax

An exit tax is Income tax that must be paid by each individual who will travel abroad. The rate is: Rp. 1,000,000 per exit from Indonesia by plane, Rp. 500,000 by ship and Rp. 250,000 by land. If the exit tax is borne by an employer and the overseas trip was for business purposes, the amount paid is a prepayment of the employer's income tax, otherwise the exit tax can be credited against the individual's income tax.

III.3.9 Tax Audit and Assessment

The Indonesian tax system is based on the principle of self-assessment. Though, DGT has the right to issue an assessment within a 10-year limitation period (statute of limitation), if, after an audit, it considers that the taxpayer has not self-assessed the correct amount or if no tax return has been lodged. An additional assessment can be issued after expiry of the 10-year limitation period if the taxpayer has committed a criminal act, in which case an administrative (interest) penalty of 48% is applied to the additional assessment in addition to the above surcharge.

Tax Penalty (Assessment)

Where a tax assessment had been issued, an interest penalty is chargeable on tax not paid by the due date until it is paid. The rate of interest is 2% per month for a maximum of 24 months. Administrative surcharges levied on underreported tax:

- 50% of the income tax not paid or underpaid in a tax year if a tax return is not filled or not filled within the special period as started in the reminder letter issued by the Tax Office.
- 100% of the income tax not withheld or under withheld, not collected or under collected, or not deposited or under deposited.
- 100% of any VAT or sales tax on luxury goods not deposited or under deposited.

Within 2-year limit after the tax is due or after the end of tax period or tax year, a taxpayer may correct its own tax return. If the result is that the tax owed increase, a penalty in the form of 2% interest per month is applied to the total tax underpayment (to a maximum of 48%), calculated from the end of the filling date until the date of payment arising from the corrected tax return.

Even though a tax return has been corrected or after the 2-year limit has passed, a taxpayer may declare an error in the tax return as long as the Tax Office has not issued a tax assessment and the revision results in a higher taxable profit or a lower tax loss. Any tax underpaid and the administrative surcharge of 50% of the tax underpaid should be paid before the tax return is submitted.

III.3.10 Tax Dispute

There is an aspect which may not be forgotten when discussing tax administration organization, which is the organization of Tax Court to settle the disputes between taxpayers and tax administration.

(1) Tax Court

The tax reform, especially Law No.6/1983 about General Provisions and Tax Procedures, states for tax disputes settlement alternatives: (a) reduction and cancellation of tax assessment; (b) reduction and cancellation of penalties; (c) correction on assessment, (d) objection; and (e) appeal. Of the five tax disputes settlement alternatives, only appeal (e) that was settled out of the DGT (in Tax Court/MPP).However, the regulation changed under Law No. 5/1986 about State Administration Court, that MPP decision is not final anymore and taxpayers can request for an appeal to the State Administration Court, and even propose a judicial review to the Supreme Court.

Tax Dispute Settlement Agency (BPSP) was established based on Law No.17/1997, addressing a tax dispute settlement. The BPSP structure is outside the Supreme Court management and its authorities are dependent -- outside the District Court and State Administration Course. The BPSP decision is final and permanent. The role of BPSP then was changed into a Tax Court, an institution which performs judgmental authorities in tax dispute, objection and appeal whether for central government or local taxes. Law reform based on Law No.14/2002 regulated BPSP to be under the authority of State Administration Court and Supreme Court management.

(2) Objections

A taxpayer may object to an assessment or an additional assessment within 3 months of its date of issue. The Tax Office has one year in which to issue a decision. The Tax Office may reduce the assessment, confirm it, or even increase it. Failure to issue a decision means the taxpayer's objection is deemed to be accepted. Upon a partially or fully successful objection, the tax already paid based on a tax underpayment assessment (SKPKB) and/or additional tax underpayment assessment (SKPKBT) will be returned to the taxpayer plus compensation of 2% interest per month up to a maximum of 24 months.

(3) Appeals

A taxpayer may appeal to the Tax Court (BPSP) against a decision of the Tax Office on the taxpayer's objection. This appeal must be made within 3 months of receiving the decision but requires that at least 50% of the assessed tax has to be paid first.

A taxpayer may also file a law suit with the Tax Court in relation to the tax collection process for tax assessment decisions other than those against which an objection can be filed and any correction decision issued by the Tax Office with respect to a tax collection letter.

Lawsuit and appeal decisions must be issued within 6 and 12 months respectively, but may be extended by an additional 3 months under certain circumstances. If the conflicting parties are not satisfied with Tax Court decision, request for judicial review can be made to the Supreme Court within 3 months of discovery of one of the following conditions:

a) if the decision is considered to be based on perjury or deception on the part of the opposing party or based on evidence that is subsequently found to be invalid by a criminal court judge.
b) if there is new very important written evidence that could alter a decision if it had been discovered in an appeal or a law suit.
c) if a decision clearly does not conform with prevailing tax regulations.

Upon a partially or fully successful appeal, the tax already paid based on tax underpayment assessment (SKPKB) or additional tax underpayment assessment (SKPKBT) will be returned to the taxpayer plus compensation of 2% interest per month up to a maximum of 24 months even if one of the disputing parties files a request for reconsideration with the MA.

IV. Country Specific Fiscal Issue

GDP growth has picked up in recent years, from 3.8% in 2001 to 5.6% in 2005. Other indicators have improved commensurately: the fiscal deficit has narrowed to below 1% of GDP and public debt has declined to 52% of GDP, down nearly 30 percentage points over the last four years. The continuing recovery in 2005 was noteworthy because it was achieved in the face of several major difficulties, including the aftermath of the December 2004 earthquake and tsunami, changes in budgetary procedures, a slump in the rupiah, a sharp increase in domestic fuel prices; and a surge in inflation and interest rates.

Bank Indonesia raised its 1-month policy interest rate by 4 percentage points to 12.75% between September and December to support the rupiah and damp inflation. These moves restored investor confidence, but they also ramped up inflation and slowed consumer spending. Rising interest rates hurt the banking sector. Loan growth decelerated and the net nonperforming loan (NPL) ratio rose from 1.9% to 5.0% during the year. Banks' capital-adequacy ratio (CAR) declined from 21.7% to 19.6%. The banking sector still dominates the financial system with almost 80% of total assets. Private commercial banks posted NPL ratios of 3.4%, while state-owned banks NPL ratio of around 15.1%, generating concern about their governance and risk management. State-owned banks cannot take haircuts, or discounts, on sale of their NPL and that has limited NPL resolution.

A comprehensive reform program has commenced, including substantial decreases in fuel subsidies in March and October 2005. The Government initiated a major anticorruption drive and launched infrastructure reforms beginning with the Indonesia Infrastructure Summit in early 2005. The anti-corruption campaign continued with a growing number of prosecutions (and convictions) for corruption. The Anti-Corruption Commission (KPK) is playing a leading role in this area and in broader reform, including, most recently, taking the lead in a proposal for fundamental civil service reform. The Supreme Audit Agency continued breakthrough audits (including dissemination of results) on government agencies and public enterprises.

A. Proposed Tax Law Amendment

The government submitted amendments in the following tax laws to the State Secretary on August 2005, which cover: (i)) General Tax Provisions and Procedures, (ii) Income Tax, (iii) Value Added Tax and Luxury Sale Tax. Based on the reaction of various parties, including the Indonesian Chamber of Commerce (*Kadin*), other business associations and the Indonesian tax authorities, the draft tax law will be further amended. The final amended tax law will be effective at the earliest on January 1, 2007.

The amendments will include the following features: increase the income-tax thresholds and reduce the highest marginal rates. The government focused on the goal of the amended law to simplify personal and corporate income tax tariffs and change administrative procedures to ease matters for taxpayers. The purpose of the amendments is to improve legal certainty and broaden the tax base. This will be achieved by:

1. *Simplifying Tax Rate Structure*. The maximum rate for personal income tax will be reduced by 2 percent points to 33 percent in 2007 and 30 percent in 2010. There will be a single corporate tax rate at 30 percent in 2006 which will be reduced to 28 percent in 2007 and 25 percent in 2010.
2. *Improving Tax Administration and Service Delivery*.
3. *Increase in accepted transfer pricing methodologies and increase in the type of transactions subject to Indonesian transfer pricing or "anti avoidance" provisions*.
4. *Speeding Up Tax Refund.* Significant delays in Value Added Tax (VAT) refunds continue to be an ongoing constraint to investment. According to the draft proposal, companies with

a good tax record (defined as compliant taxpayers), will be able to claim refunds in one month, although it will continue to take 12 months for other taxpayers. However the exact criterion for compliant taxpayers is still to be decided.

5. *Giving wider access to data and information by DGT, with appropriate safe guards in place*. DGT is facing difficulties lack of accessibility to have data of taxpayers' tax returns since there is no access: (i) to the bank with the intention of identifying taxpayers' account; (ii) to the traffic report of foreign exchange; (iii) to money laundering report; (iv) to deposit account, (v) credit card holder; and (vi) banks' debtors.
6. *Imposing stiffer sanctions on delinquent tax payer on those who have not registered.* Higher taxes will be imposed for those without taxpayer registration number (NPWP). In order to broaden the tax base, income tax for non-NPWP holders will be raised by twenty to one hundred percent.

The initial reaction to the draft amendments by the business community is mixed and there are concerns about its revenue neutrality and the potential introduction of a Tax Amnesty. In particular the business community is concerned that these tax proposals increase the power of tax authority without addressing concerns of taxpayers about the abuse of tax assessment, audit and collection procedures. Without supporting administrative reforms, these amendments could end up hurting the investment climate and threaten fiscal sustainability.

B. Oil Subsidy Compensation Program

The policy to rise up the domestic oil price is applied by government to reduce the oil subsidy -- in line with the international oil price grows up continuously. The removal of fuel subsidies led to a spiraling of inflation to above 18% in October 2005 and is likely to result in slower growth in the short term; however it has reduced a major distortion in the economy. As a result, the Government is estimated to have generated a "fiscal space" of about $5 billion in 2005 and about $10 billion in 2006. To deal with the adverse impacts of inflation on the poor, the government launched one of the largest cash transfer programs by targeting 15.5 million poor households to receive about $32 per household per quarter. The Oil Subsidy Compensation Programs decided by government includes a direct cash transfer, incentives for education, health care, village infrastructure and rice provision to the poor amounting to a total of Rp23.5 trillion.

No	Programs	Allocated Fund (Rp trillions)
1	Direct Cash Transfers	5
2	Education	6.3
3	Health	3.9
4	Rural Infrastructure	3.3
5	Rice for the Poor	5
	Total	**23.5**

Source: Ministry of Finance

C. Indonesia Infrastructure Summit

The first summit on infrastructure was organized in January 2005, known as Indonesia Infrastructure Summit (IIS) 2005. The summit was intended to attract foreign investors to finance and develop infrastructure in Indonesia, as a boost for economic development, and a remedy to high rates of unemployment and poverty. The government unveiled a list of 91 projects with an estimated value of US$ 22.5 billion that would be offered for tender in early March 2005 as well as its plans for infrastructure development over the next five years. The goal of the summit is to start spending on infrastructure, which has slumped following the 1997 Asian financial crisis.

Of the 91 infrastructure projects on offer by the government only 5 projects entered the construction phase. A further 28 projects were still undergoing preparation for tendering and 15 projects received the green light to proceed. Factors contributing to the low implementation rate for infrastructure projects include the lack of a legal framework, with some legal products finalized only at the end of 2005.

No	Sector	No of Project	Total Value (million US$)
1	Gas pipelines	6	2,888
2	Electricity	12	5,897
3	Telecommunications	1	1,600
4	Railway	1	77
5	Seaport	4	1,485
6	Airport	5	709
7	Water	24	386
8	Toll Road	38	9,428
Total		**91**	**22,469**

One of the major issues that have prevented foreign investment in large infrastructure projects is the long and costly process of land acquisition, especially for long linear projects such as toll roads, transmission lines or pipelines. Unlike in most other countries, the costs and risks for such processes in Indonesia have been put on the developer. However, the government promise to be accountable that land should be acquired before a project is tendered. A decree later has been released by Ministry of Finance state that investors may receive funds or have operating concessions extended, if they face a delay in clearing land for approved projects. A long-awaited committee to coordinate infrastructure is operational, the government is nearing completion of the government regulation on a public private partnership and there is a commitment to develop a risk-sharing framework at the Ministry of Finance.

Government has learned the lesson from IIS 2005 by making some improvements and developments on the second IIS (held on November 2006) focus on three main strands: (i) identifying 120 regulations needed to ensure legal certainty and boost investor confidence; (ii) focusing on 10 “model” projects valued at US$ 4.5 billion and (iii) providing any information to the interested investors during the summit event.

V. Conclusion: Where We Stand and Where We Go?

The Government has formulated the Medium-Term Development Plan (RPJM) for 2005–2009, which focuses on poverty reduction through higher growth rates with job creation and environmental sustainability, and activities and investments to achieve the Millennium Development Goals (MDGs).

The near-term outlook faces several risks that inflation could remain in double digits for longer than expected, keeping interest rates high and discouraging consumption and investment. The banking sector is vulnerable to currently rising rates of NPLs. The RPJM targets halving the percentage of those below the poverty line to 8.2% by 2009 through programs to improve food security, water supply and sanitation, access to basic health and education services, and shelter. The macroeconomic targets by 2009 include an increase in economic growth from 5.5% to 7.6%, a reduction in open unemployment from 9.7% to 5.1%, annual average GDP growth of 6.6%, halving both the poverty incidence to 8.2% and the unemployment rate to 5.1%. A key priority is to spur investment in manufacturing and infrastructure to generate jobs.

The Government aims to reduce debt to 31.8% of GDP by 2009 by maintaining a conservative fiscal stance. At the end of 2005, public foreign debt was $65.6 billion, combined domestic and foreign debt was 47% of GDP, with debt servicing requirements over 2004–2005 averaged 25%

of the overall budget, and 144 loan-funded projects under implementation had an undisbursed balance of $8.3 billion. Of the outstanding foreign debt, $9.4 billion in principal and interest is due in 2006, representing about 14% of export earnings and one third greater than debt repayments in 2005. The Government has embarked on a program of loan cancellations, debt swaps in the case of bilateral loans, and more prudent borrowing for new projects; and has estimated it needs to attract $65 billion foreign direct investment by 2010.

In the subsequent years, taxation will again be the dominant component of state revenues. Tax receipts are targeted to reach 13.7% of GDP in 2006, up from about 12% of GDP in 2005. Oil and natural gas revenues are also expected to rise because of higher crude oil prices. The increase in revenues is based on the underlying assumptions used in 2006 budget, that economic growth will reach 6.2% and world crude oil prices will average US$57 per barrel. On the expenditure side, interest payments on debt are predicted to rise as a result of the substantial debt financing of the budget deficit in 2005 and 2006. However, the decision to cut subsidies in 2005 will reduce the subsidy burden in 2006 amid expectations of even higher oil prices. In regard to the financing of the deficit, the main sources like in 2005 will be Government Bonds and use of the government account at the central bank, while privatization and recovery of bank assets will be minimal and foreign borrowings represent a net outflow because of the sizable installment payments in debt principal. The Government plans to meet the financing needs by issuing new bonds (about $5.7 billion) by seeking concessional project and program lending assistance (about $3.6 billion).

Production of oil had declined over a decade to around 1 million barrels per day (bpd) in 2005; compared to 1.4 million bpd in 1991. The decline in production reflects the relatively low level of investment in exploration since the late 1990s and the fact that the major share of oil is produced from fields which are in decline. The country's known oil reserves are currently estimated at approximately 4.2 billion barrels. Domestic consumption of oil, encouraged by the fuel subsidies, rose to above 1.2 million bpd. Nevertheless since the subsidies were cut, the demand has declined by more than 20%.

There is a need to discover new reserves and better exploit better marginal areas. Without the discovery and development of significant new reserves, Indonesia with rapidly growing internal energy demands will inevitable become a *permanent* net oil importer Though it still remains as a net energy exporter because it supplies about a quarter of the world's liquefied natural gas (LNG) from fields in Aceh and Kalimantan. An agreement reached in March 2006 between state-owned oil company Pertamina and Exxon Mobil to develop the large Cepu oil field, after years of negotiations, would might improve the investment climate and boost the country's oil production by 2009.

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