Inside Indonesia

OCBC Bank

Going for Gold
How Indonesia could boost its tax amnesty program further

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- **Launched with much fanfare some time back, Indonesia's tax amnesty program has gotten off to a slow start, with barely 1.5% of its total targeted amount booked thus far. Even if the government target has been too lofty to begin with, the slow pace has brought a sense of anxiety to market players.**
- **While we remain cautiously optimistic that the pace of take-up will accelerate in the coming months, as participants figure out the program's details and sort out their legal and financial preparations, we also think more tweaks can be done to address some lingering concerns.**
- **Potentially, offering ways for participants to pay extra for additional features such as instalments of the penalty tax rates, instead of lump-sum, upfront payment now as well as a shorter lock-in period compared to 3 years currently could make a difference.**

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It ain't over till it's over

The Olympic Games may have drawn to a close, but that does not mean its spirit cannot live on. In particular, its motto of *"Citius, Altius, Fortius"* – Latin words for faster, higher, stronger – should be adopted by Indonesia's Finance Ministry at this point.

Despite hard work from officials there, the tax amnesty program has gotten off to a slow start, with IDR 57.1(~USD4.3bn) of assets declared thus far, comprising just 1.43% of the admittedly lofty target that the ministry had set itself. As they face pressure from within and beyond to show greater progress for the 9-month-long program, the idea that one can reach for the gold medal, because the race is still very much on and every little ounce of extra effort will still make a difference, can be a powerful one.

To that end, with Sri Mulyani's back at its helm, the Finance Ministry has launched a number of new regulations to further broaden the appeal of the tax amnesty program, as well as to clarify lingering uncertainties. Regulations 122 and 123 of August 8th, in particular, opened up a broad array of new asset classes in which repatriated money can be invested in during the 3-year lock-up period.

Apart from investments into bonds issued by Indonesia's sovereigns and SOEs, for example, the latest regulations allow for investments into companies, as long as they are domiciled in Indonesia, either through direct stakes or via VCs. For those with lower risk appetite or simply more comfortable with tangible and physical forms of wealth, the regulations allow for holdings of gold bullions and properties, as well.

Meanwhile, the government would also allow for withdrawal of returns and interests on the declared assets, and transfers between participating banks, as long as the initial principal sums stay the same for the 3-year duration.

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Highlights from recent Tax Amnesty regulations

Reg 122: Non-Financial Investments	
1	Infrastructure investment, in cooperation with state-owned companies
2	Real sector investment, based on government priorities
3	Property investment, be it land or buildings
4	Direct investment in Indonesia-domiciled corporations
5	Previous metal investment, in the form of gold bullions
6	Other non-financial investments deemed suitable by rules and regulations
Reg 123: Financial Investments	
1	Indonesia Government Bonds
2	Debt issued by SOEs
3	Debt issued by state-owned financing companies
4	Financial investment with Perception Banks
5	Debt issued by private companies, whose trade is regulated by OJK
Further details regarding allowable financial instruments	
1	Debt, including Medium Term Notes
2	Sukuk, Shares, Unit Trusts, REITs, Asset-backed securities
3	Fixed deposits, savings accounts and current accounts
4	Futures contracts that are traded in Indonesian futures exchange
5	Other capital market instruments, including investment-linked insurance products, financing companies, pension funds, venture capital that are approved by Financial Services Authority ("OJK")

Source: Ministry of Finance, OCBC.

Further Tweaks

The underlying philosophy of the latest initiatives appears to be flexibility, that as long as you participate to redress the old wrongs, the government is willing to listen to your concerns and work with you to find optimal ways out. The broadening scope of eligible assets in which repatriated money has to be parked in seems to be a response to the sense that they had been too narrow previously, particularly when set in contrast with the whole gamut of global investable universe that such money could have gone into if it stays in sophisticated offshore financial centers.

Viewed from that angle, we believe that the process of adjusting the regulations to better reflect concerns of would-be participants and thus boost the ultimate take-up rate has not ended. We will not pretend to have any particular insights into what exactly would constitute any further changes going forward, but we do think that the existing set of regulations could still be tweaked further, potentially, to boost the program's appeal even more.

Take the penalty tax rates, for instance. At as low as 2% for onshore and to-be-repatriated assets that are declared by end of September, it is hardly punitive to be sure, especially when compared with top-bracket rates of 25% for corporations and 30% for individuals. In fact, such low rates have invited criticisms from some observers, including an OECD official who argued that it is unfair to compliant taxpayers. (*Bloomberg, Aug 19th*)

Penalty tax rates under the Tax Amnesty program

Types of Previously Undeclared Assets		Period of Compliance		
		Q3 2016	*Q4 2016*	*Q1 2017*
Offshore assets that stay offshore		4%	6%	10%
Onshore assets and offshore assets that are repatriated		2%	3%	5%
Assets of companies earning gross income of less than IDR4.8bn (~USD360k) in the latest tax year	Stock of assets up to IDR10bn (~USD760k)	0.5%		
	Stock of assets above IDR10bn (~USD760k)	2%		

Source: Ministry of Finance, OCBC.

Still, the reality is that, for those endowed with large sums of wealth, even such relatively low percentages make for hefty quantum of money to be handed over at one shot. For those less blessed, even if the sums amount to less, there is nevertheless the potentially tricky issue of liquidity needs. Even if the heart is willing in parting with money upfront to fulfil the amnesty requirements, the cash flow constraints that it may place could limit the enthusiasm, especially for smaller businesses running on thin margins with on-going working capital needs.

Hence, one way of making things more palatable for participants – and, thus, boosting the potential take-up rate – would be to offer the possibility of settling the tax liabilities in instalments rather than lump-sum, upfront payment as of now. The payments could perhaps be spread over the duration of the 3-year lock-up period. To retain the incentives for those who are able or willing to pay the penalty tax upfront to still do so, those opting for the protracted payment scheme could be made to pay additional interests on their unsettled liabilities, with rates tied to certain government bond yields, perhaps in half-yearly instalments. If they fail to pay these future tax liabilities for the particular period, the government should have recourse to withdraw the correct amount from the relevant accounts at the participating banks.

Meanwhile, the issue of 3-year lock up period has also often been highlighted as one reason for caution in repatriating funds home. No matter how broad the universe of investable assets the government can offer is, there remains some discomfort from not being able to have complete freedom over “your own money” in the time period. Here, there is perhaps space for another carefully designed adjustment. Here, the price of money, that is interest, can again be used as a clearing mechanism.

For those that indeed value free reins in the future so much over their money, the lock-up period could be shortened, perhaps halved to 18 months, but with the application of a higher penalty tax rate. Given that this particular category of participants falls between those with offshore assets but choose to repatriate and those who opt to keep them offshore, the tax rates can be a simple average of the two. Those who declare their assets in the first tranche ending September this year, for example, would thus pay 3%, the average of 2% and 4% payable by existing categories of participants. This can be done either upfront in lump sum, or, following our earlier discussion, paid in instalments with added interests during the 18-month period.

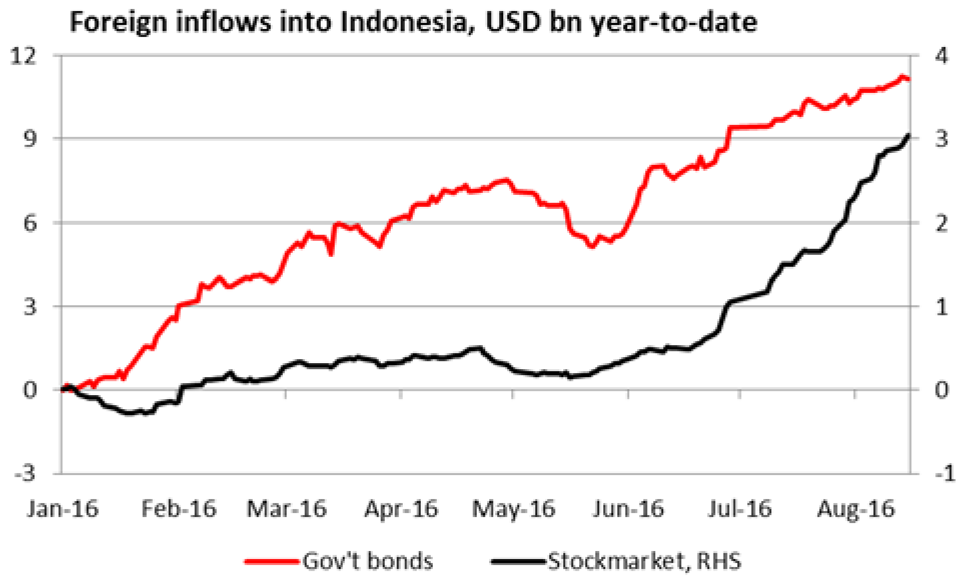
Enough carrots, where’s the stick?

To be sure, all the potential tweaks we touch on above can appear to be instruments for further mollycoddling of tax evaders on the surface. After all, with the tax amnesty program as it stands, they are already offered a magnanimous way out, a chance of getting a blank slate after years if not decades of evading their responsibilities as citizens. One vein of thinking would naturally be, why must the government go out of its way even more to accommodate the lingering concerns of these tax evaders, particularly when by 2018 there should be no place left for them to hide?

The answer is reality.

The reality is that, the only major stick that the government can wield remains the 2018 Automatic Exchange of Information framework. Given that it is not yet in place, the government can only really brandish a potential weapon, not an actual one at this point. Eventually, Indonesia’s tax department will have what it takes to take what taxpayers have. For now, however, because the stick cannot yet work optimally, the onus is thus on providing carrots that are as enticingly sweet and tender as possible. As discussed above, these had already brought about regulatory changes that allow for greater choices in captive investments. It may yet bring about further changes including ways for participants to pay extra for what they deem important, either via instalment schemes or options for shorter lock-in period.

A lot is riding on the success of the tax amnesty program. It used to be more unequivocally a bonus for the country, a good thing to have if it takes place but not too big a deal if it does not. With so much expectation built into it, the scheme risks increasingly becoming a baseline necessity, however. While we remain cautiously optimistic that the take-up rate would accelerate once participants better understand the operational details of the program and have enough time to make the necessary legal and financial preparations, we think more could be done still.



Source: Bloomberg, OCBC.

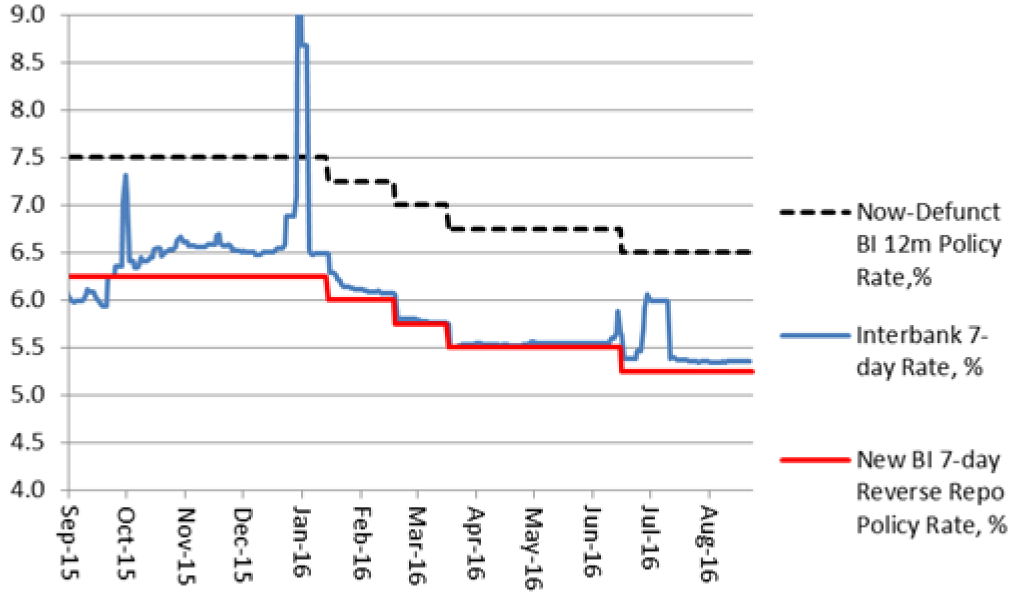
Partly because of the anticipation for a successful program, Indonesia has received substantial chunks of portfolio inflows across both equity and government bond areas. Flows into the latter, in particular, are inching towards the USD12bn mark, boosted further by a pathetically low-yielding global environment. The risk of disappointment in tax amnesty leading to portfolio outflows thus cannot be dismissed totally, especially if it coincides with another sudden reversal in sentiment towards emerging markets.

Already, Bank Indonesia appears to have been acting cautiously on its monetary policy front of late. Last week’s decision to keep policy rate on hold, despite substantial room given by relatively muted inflation, illustrates that. Indeed, we are of the view that, even though BI is still keen on easing further, with at least one policy rate cut to go by year-end, the central bank is still going to wait for more substantial pick-up in tax amnesty participation before acting. The last thing it wants is to be forced to suddenly double back and hike its policy rates to safeguard Rupiah stability a la Taper Tantrum of 2013.

For now, the central bank is going to focus on making sure that its monetary policy framework adjustment, of using the 7-day Reverse Repo rate as the benchmark rate, will continue to proceed smoothly. Thus far, that has indeed been the case, with the interbank market rate hugging the new policy rate closely and helping to develop the country’s money market and therefore transmission of monetary policy decision onto lending rates charged by banks.

All in all, we retain the view that Indonesia has a lot more potential positive catalysts to offer investors than negative ones. We just wish to see more active participation of tax amnesty in the coming months for us to be more certain that, ultimately, the program will have seen much faster rate of participation, much higher amount of declared assets, resulting in a much stronger footing for the Indonesian economy to face what may come on the global front.

Bank Indonesia policy rate and interbank rate movement



Source: Bloomberg, OCBC.

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