Inside Indonesia

OCBC Bank

Worth the Wait

Indonesia’s tax amnesty law is enacted, finally

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- **This is a story about second chance. All about forgiveness on past trespasses, in the spirit of reconciliation for a better future together. No, this is not about remedial Brexit referendum.**
- **Rather, we are referring to the passage of tax amnesty law in Indonesia today. It has been deliberated on for so long that its significance may be discounted by the market. To do so, however, would be a mistake.**
- **To us, this law is a potential game-changer, a boost to tax receipt immediately and to tax base in the long run. Bank Indonesia sees USD42bn of funds getting repatriated, and delivering a 0.3ppt kicker to growth.**

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What is this Tax Amnesty thing all about?

It’s a one-time offer by the Indonesian government to delinquent taxpayers to come clean about their undeclared or under-declared assets that are sitting either onshore or offshore. By paying a penalty tax on these assets, they will be forgiven of these past mistakes. The penalty rate depends on when the individual or corporation comes clean. The sooner they do it, the more attractive it is, even if they can opt to join the scheme as late as Q1 next year.

Meanwhile, for assets that are sitting overseas, the applicable tax rate also depends on whether they will be repatriated onshore or remain offshore. The latter category incurs double the tax rates. Returning offshore funds will have to be invested in government-approved funds including infrastructure bonds for at least three years.

Also, the new law allows for an extremely favourable way for smaller companies to come clean. Those earning less than USD360k of gross income last year can pay half a per cent to bring their assets to light, as long as these are under USD760k in aggregate. Above that amount, and they can do so at a still-attractive penalty rate of 2%. Unlike in the case of individuals, these low rates apply throughout the amnesty period lasting until March 2017.

Fig 1. Penalty tax rates under tax amnesty law

<table>
<tr><th colspan="2" rowspan="2">Types of Previously Undeclared Assets</th><th colspan="3">Period of Compliance</th></tr>
<tr><th>Q3 2016</th><th>Q4 2016</th><th>Q1 2017</th></tr>
<tr><td colspan="2">Offshore assets that stay offshore</td><td>4%</td><td>6%</td><td>10%</td></tr>
<tr><td colspan="2">Onshore assets and offshore assets that are repatriated</td><td>2%</td><td>3%</td><td>5%</td></tr>
<tr><td rowspan="2">Assets of companies earning gross income of less than IDR4.8bn (~USD360k) in the latest tax year</td><td>Stock of assets up to IDR10bn (~USD760k)</td><td colspan="3">0.5%</td></tr>
<tr><td>Stock of assets above IDR10bn (~USD760k)</td><td colspan="3">2%</td></tr>
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Source: Various news outlets, OCBC.

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Any takers?
We believe a combination of factors will lead to a relative success of this program. For offshore assets, in particular, the carrots dangled by today's amnesty could soon contrast with the sticks presented by a global timeline for authorities to share information about bank accounts across borders by 2018. There must be at least some moneyed folks who thought it wiser to take a bite at these Indonesian carrots than to risk being clobbered by the global sticks down the road.

The fact that they are not forced to repatriate their assets – even if they are incentivized to do so via the tax rate differentials – is also an attractive point for those thinking of the safety angle that comes from geographical diversification. There is also the consideration that the global market sentiment now is so dour now that it is not as if there are countless attractive investment opportunities out there anyway. Why not come clean on at least some assets, right when the potential investment returns are puny elsewhere, and park them back home for three years and see what happens thereafter?

Predicting the eventual take-up rate is not easy. One has to take a stab at first estimating how much undeclared wealth there is out there to begin with. Going by estimates from Global Financial Integrity database, there had been over USD180bn of undocumented outflows from Indonesia between 2004 and 2013 alone. Finance Minister Bambang Brodjonegoro mentioned that up to USD200bn is sitting in just one single foreign country. If these estimates are anywhere close to reality, then we are dealing with a chunky sum of more than USD200bn. Whatever the actual number is, Finance Ministry talked about as much as USD150bn coming home. Bank Indonesia has in mind USD42bn. The central bank's estimate may be more conservative than what the Finance Ministry has in mind, but nonetheless is a tidy sum amounting to more than 40% of foreign reserves it has now.

Would it matter to the economy?
Yes, it will make a difference. Enough for us to lift our GDP growth forecast of this year from 5.1% to 5.2%. (It would have been higher without the added element of Brexit uncertainties of late).

First of all, it solves an immediate problem of fiscal shortfall for the government this year. Hamstrung by a legal cap which limits its fiscal deficit to 3% of GDP a year at a time of increased infrastructure spending, the government has had to resort to spending cuts elsewhere.

There has also apparently been some over-zealousness by tax officials who are desperate to reach the tax revenue targets, which indirectly dampen the economy by making people and businesses wary in completing big-ticket purchases for fear of bringing unwanted attention on themselves. To the extent that the bonus revenue stream coming from this amnesty can help plug the hole, the tax officials and consumers too can rest more easily.

These are obviously short-term benefits, since the extra revenue is a one-off, extending into Q1 next year and helping to relieve the fiscal pressure until then at best.

Longer term, the chief benefit of the tax amnesty law will be to broaden Indonesia's tax base. It stood at lower than 10% of GDP as of 2015, much lower than the 13-15% that its ASEAN neighbors have. By bringing more taxable assets to light through this exercise, however, the hope is that Indonesia's ratio can go up to 12% in the medium-term.

What can be done to get more juice out of this?
Tax amnesty is obviously not a policy toolkit that the Indonesian government can reach for repeatedly. Otherwise, it could have the opposite effect of shrinking the tax base, since taxpayers would just build in a continuous expectation of get-out-of-jail-free card. "Why pay tax at a higher normal rate, if I can just wait until the amnesty again?" would go most thinking.

Hence, the government has its work cut out in terms of both boosting the total return of this tax amnesty bill and also to prevent the need for such a measure later on.

For the former, clear communication of just what this measure is all about is crucial in increasing the take-up rate. Having the infrastructure set-up to fully accommodate any would-be influx of requests for amnesty would be no less important.

For the latter, the government would have to boost the capacity of the tax authority in preventing tax malfeasance to begin with. While this amnesty law has a good chance of welcoming back the prodigal sons of lost tax receipts of yesteryears, there has be to equal emphasis on minimizing the occurrence of future tax avoidance, as well. The government has already talked about creating an independent tax agency that will report directly to the President. Time to get that into action mode. Interestingly, it has also started to float the idea of creating an onshore tax haven a la Labuan of Malaysia. The idea is to provide for the fact that there is bound to be a hunt for preferential tax structure in any case, so why don't they keep it within its own house rather than let others enjoy the spoils.

What does this say about Jokowi's administration?

It signals the seriousness in which the Jokowi's presidency has put into economic reforms since late last year is continuing in earnest. Like the dozen or so packages that the cabinet has rolled out, market knows it is on the right track but remains somewhat reserved about the impact until they see the measures being fully implemented. In this case, the take-up rate of the tax amnesty would thus take on broader importance.

It pays to note also that this is the first major legislation that is pushed through by President Jokowi, since the second-largest party, Golkar, abandons the opposition camp and joins his. Golkar's change of hearts has inadvertently made things easier for Jokowi, that's true. However, we caution against seeing this as the start of a huge legislative breakthrough, which would allow the president to push through whatever he wants through the parliament now.

As we have said before and will say again, that's wishful thinking. Indonesia's parliament remains a field for an issue-by-issue tussle rather than a simple majority-rules game. For one, even if Jokowi did secure the support of Golkar for today's bill early on, it was reportedly the PDI-P, technically his own party, which was dragging its feet until last minute.

Still, we do view the passage of this law as being positive, not just in and of its own in economic sense, but also as a measure of how much more secure Jokowi's political base appears to be compared to even one year ago. Hence, viewed from both economic and political lenses, Indonesia has more going than most of its peers. That has to be worth something in normal times, but especially now when the game between economy and politics is definitely more about which one is dragging the other one down more at the global stage.

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