Inside Indonesia

# Home Sweet Home?

# Indonesia's tax amnesty and fund repatriation prospects

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- **"Bring your money home. We'll tax you just a bit but you'll be legally cleared thereafter" is the gist of a tax amnesty law that Indonesia's parliament is deliberating in the coming weeks.**
- **If the government's optimistic view pans out, this could bring in two quadrillion Rupiah (~USD150bn) home this year. In theory, that could more than double its foreign reserves, single-handedly increase its tax take by 5%, and provide a stabilizing ballast for its currency, bond and equity markets.**
- **In practice, how successful the measure is ultimately a confidence game. The moneyed folks have to believe in the pull factor of Indonesia's legal amnesty, and also worried enough about the push factor of the eventuality of a worldwide tax evasion crackdown.**

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## Somewhere out there

John Maynard Keynes once quipped that the only intellectual pursuit that carries any reward is thinking about how to avoid taxes. Judging from some of the estimates on how much Indonesian money has been kept undeclared as part of tax avoidance efforts, there appears to be a significant number of Indonesians who have been cracking their brains in that particular pursuit.

For instance, Minister of Finance, Bambang Brodjonegoro, was quoted in local media recently as saying that, at home, as much as IDR1400tn (~USD101bn) of assets have not been declared to the authorities. When it comes to Indonesia's wealth that is parked offshore, he mentioned that up to IDR2700tn (~USD195bn) is sitting in just one single foreign country alone. (*Republika, 11 Dec 2015*).

The exact number for offshore wealth is obviously hard to pinpoint, given its very nature. However, estimates provided by Global Financial Integrity, a non-profit research and advisory outfit, suggest that the number floated by the government are within the realms of reason. By tallying up under-invoicing of exports in trade data and unexplained outflows in the balance of payments, it established that USD180.7bn may have flowed out illicitly from Indonesia, in aggregate, between 2004-2013.

## If only we can

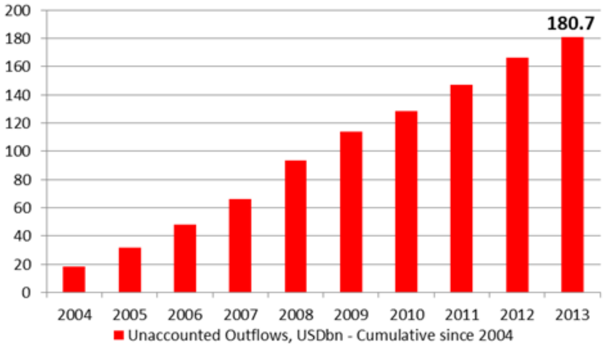
With such a mother lode of wealth supposedly lying untouched offshore and undetected onshore, the idea that if only Indonesia's government could bring it into the folds of formal economy – and thus making it taxable – a lot of problems could then be solved is obviously not a new one.

Indeed, Indonesia last offered some form of tax pardon in 2008. Targeting the onshore segment, the tax department under the leadership of current Economics Minister, Darmin Nasution, rolled out an initiative known as "Sunset Policy". By coming clean on any previously undeclared assets, taxpayers would be relieved of fines and interests due on unpaid taxes, and received legal clemency as well.

The policy was deemed to be a success, with 2008 marking one of the few occasions when the tax authority managed to exceed their targeted tax take. Since then, the ratio has been largely slumping with just 85% of taxes collected compared to what was originally targeted in 2015, thanks in part to the commodities slump.

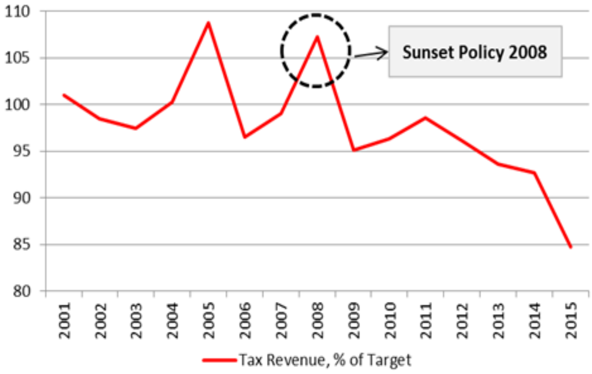
Indeed, the shortfall in tax revenue is one reason why talks of tax amnesty have made the rounds since last year and a bill looks set to be tabled in the parliament in the coming week or two, with some hope that it will be finalized by end of March or early April.

***Fig 1. USD180.7bn unaccounted outflows (2004-13)***




*Source: Global Financial Integrity.*

***Fig 2. Tax Rise and Sunset***




*Source: CEIC, OCBC.*

**Come back**

Compared to the Sunset Policy of 2008, which focused on onshore undeclared assets and left errant taxpayers liable still for the principal sum of taxes, the government appears to be going for broke this time round. It wants to rope in hitherto tax-shy assets that are sitting both onshore and offshore. And, it intends to do so by offering not only legal amnesty but also deep haircuts on applicable tax rates. While the normal rate of personal income tax runs from 5% to as high as 30%, and that for corporations is at 25%, the upcoming tax amnesty law may enforce a rate that ranges from 1-6%, depending on how quickly one comes clean and if the assets are repatriated.

***Fig 3. Potential penalty tax rates under tax amnesty law***

| Type of Previously Undeclared Assets | Period of Compliance | | |
|---|---|---|---|
| | *Less than 3 months* | *3-6 months* | *More than 6 months* |
| Onshore assets | 2% | 4% | 6% |
| Offshore assets that stay offshore | 2% | 4% | 6% |
| Offshore assets that are repatriated | 1% | 2% | 3% |

*Source: Various domestic media, OCBC. Note: The figures are preliminary based on press reports. Ultimate tax rates to be determined by the parliament in the coming weeks.*

Obviously, given the huge gaps between ongoing tax rates and those that are applicable to the money that is newly returning to the righteous path, there is an obvious risk of moral hazard. After all, if you are an Indonesian who has been dutifully paying the full sum of taxes on all the assets you have declared without fail, you are probably left with a bitter taste in your mouth and must be thinking you should have waited for such sweet deals.

Thankfully then, it appears that very few Indonesians belong in that category. Going by figures from the tax authority, only 10mn Indonesians bother to file tax returns every year. In turn, among them, only 10% is said to have filed them truthfully. That's a dismal 0.4% of Indonesia's total population of 250mn.

Indeed, one of the reasons why the government has decided to offer such generous terms to its wayward citizens is perhaps the realization that the problem of tax evasion has run so deep for so long that it is more worthwhile to bite the bullet by offering an attractive way-out for them to come clean, in order to broaden the tax base in the long run. After all, Indonesia's tax base is narrow, with tax ratio over GDP of below 10% after last year's subpar tax collection. In comparison, the tax ratios for most of its ASEAN neighbors range between 13 to 15% of GDP.

***Figure 4. Tax ratio is still low***


*Source: CEIC, OCBC.*

**Carrot and stick**

Apart from the pull factor of legal amnesty, the program also comes at a time when there may be an increasingly powerful push factor on the global front. Here, we are referring to the Automatic Exchange of Information ("AOEI") initiative that the OECD and G20 have been promoting, whereby various countries have promised to share information about cross-border financial accounts. While the effectiveness of such a global scheme is yet to be fully tested until it is implemented in stages in 2017-18, the idea is that – eventually – it will become increasingly harder for tax evaders to do their deed through offshore accounts.

Hence, rather than just the carrot of tax-amnesty-on-the-cheap being dangled by the Indonesian government, there is also the stick of eventual loss of cross-border shelter that any holdouts would have to contend with fairly soon – which should serve as another incentive to comply now. After all, the subtext of it all is that "Either you come clean while the terms are still favourable, or we will find out eventually anyway and things will no longer be as friendly."

**Argentina's at it too**

Indonesia is not alone in trying to capitalize on the renewed global effort to crack down on tax evasion. South Korea announced a tax amnesty plan in September 2015 that is valid until end of March this year, for citizens to declare their offshore assets without getting prosecuted or slapped with late fees. Across the Pacific, a partial tax amnesty by the Chilean government has reportedly uncovered around USD20bn of previously hidden assets and added 1.5bn to the tax coffers. Meanwhile, at its Andean neighbour of Argentina, the recently elected President Mauricio Macri too is offering legal pardon to those who own up to having assets abroad, with lower tax rates for those who repatriate their money home and lock it in by purchasing bonds.

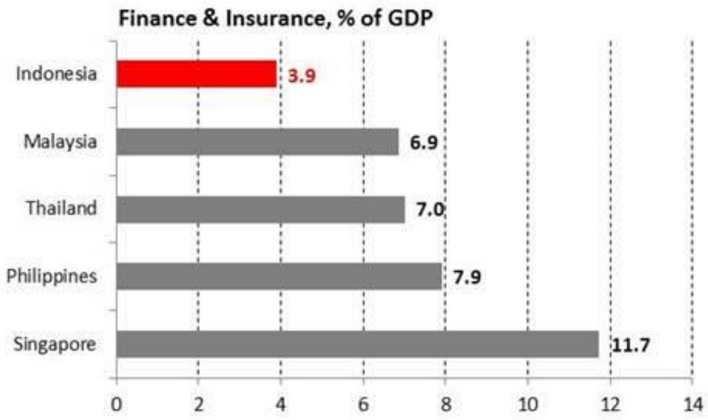
Indeed, as far as we can tell, it appears that the draft bill for Indonesia will also be featuring elements similar to that of the Argentinian plan. This includes forgiveness for all offshore assets that come clean, but an even more attractive tax rate for those that are repatriated home. It is likely to involve a lock-up period, with one year being talked about in the local media. Furthermore, the program should ideally offer incentives to those who park their prodigal money in government papers or even infrastructure bonds.

**Impact on economy**

As and when it takes place, the government appears to think that the tax amnesty law will bring back IDR2000tn(~150bn) this year and has estimated that as much as IDR60tn (~USD4.4bn) will be added to the tax coffers from the action. The tax proceeds are equivalent to around 5% of the total tax revenue received last year, and could be the make-or-break factor with regard to whether the government has a shooting chance at achieving its tax target this year or not.

Apart from boosting things on the fiscal side, the measure could potentially have far-reaching implications on Indonesia's financial market development, as well. To be sure, not all of the USD150bn sum that the government thinks would be repatriated will indeed come home. However, even if at least some of the money does return, it could make quite a lot of difference just because of the relatively undeveloped financial sector in the economy. Indonesia's finance and insurance sector commands just 4% of its GDP. That is much lower than the sector's share of the economy in neighboring countries, especially that of Singapore, the regional asset management hub.

***Figure 5. Finance remains a small portion of Indonesia's economy***




*Source: CEIC, OCBC.*

There is naturally a bit of a chicken-or-egg dilemma in this. After all, one reason why there might have been so much money abroad is that the domestic financial sector has not developed fast enough to cater to the wealth management needs of Indonesians to begin with. In any case, the tax amnesty program gives the country a good chance in at least trying to break that cycle. By potentially bringing home a considerable sum of money, it could act as a catalyst for the development of the onshore industry.

The longer term effect aside, the introduction of the tax amnesty law could also affect the current asset markets of Indonesia profoundly, even if it does not reach the potential target in full. A quick mental exercise puts the sums into perspective. For instance, even if just 73% of the targeted USD150bn sums come back, Indonesia's foreign reserves would have doubled, assuming the central bank socks up each and every cent of the dollar inflow and keeps the Rupiah from appreciating on the new demand. If the government achieves just 28% of the target, it would have brought in enough money to buy out, hypothetically speaking, the total USD42bn or so that foreigners hold in its government bonds. A 20% success rate, meanwhile, would bring in as many dollars as what Foreign Direct Investment inflows have brought in 2015.

In short, if the estimated wealth out there is anywhere near the size imagined, and that at least some of it would be enticed home, this amnesty law could shape up to be a huge boon for Indonesia. In fact, Indonesia should also spare some thought regarding the potential negative effects that might arise should the program turn out to be a real success.

Just like how winning a jumbo lottery can change life for better or worse, there can be too much of a good thing. Here, we are referring to a possible sudden appreciation pressure for the currency if the inflows are not spaced out and well managed. The central bank could channel most of the inflows into its foreign reserves – obviously not a bad thing in itself given the unsettled global environment – but should watch out for the need to sterilize the likely uptick in money supply. While a lock-up period requiring the returnee money to park itself in government bonds would limit the potential for sudden rush to other assets such as equities, corporate bonds and property market in the near term, just how it would be deployed without causing inflation pick-up also warrants a close watch down the road.

**Path to success**

Overall, the confluence of domestic policy momentum and potential global tax evasion crackdown offer Indonesia an opportune time to entice at least some of the country's wealth back home. How much and how quickly will of course remain a mystery until the details of the program are finalized and things are implemented on the ground. But, a number of things will increase the chances of success.

For one, a smooth deliberation process at the parliament will increase the "trust factor" that the legal umbrella behind any tax amnesty will be a dependable one, and thus boost its buy-in rate. In contrast, politically driven and protracted debates would work against the program. To the extent that Jokowi's government has received the support of Golkar, the second-largest party in the parliament, it should technically make it easier to push things through. However, as we cautioned our clients before, parliamentary politics is highly fluid in Indonesia and pushing for a law to forgive and forget all the tax evasions that the moneyed folks have allegedly committed over the years can provide fodder for a lot of political drama, potentially.

On top of that, there has to be a belief that this program presents a last chance to come clean, that it is now or never. After all, if Indonesians assume that the government might roll out another plan down the road, they might think it is better to wait out to see if the whole AOEI initiative that may leave them vulnerably exposed is for real, or just a paper tiger with no real bite.

Moreover, as with most policies in Indonesia, implementation will remain crucial. The tax authority and broader bureaucracy have to prepare for what may come. If indeed the program turns out to be a success and that billions of dollars return home to roost, the government has to be ready to process the stacks of applications quickly. After all, inherent in any move to shift money back to Indonesia is a vote of confidence in the country, and nothing kills confidence more quickly than a botched job at a much-touted program.

Last but not least, ongoing tax rates may have to go down to alleviate the sense that any law abiding taxpayer has been short-changed in the whole process. The government has talked about reducing its corporate tax rate down to 18% from the current 25%. Similar trajectory should be adopted for personal income taxes. No less importantly, tax compliance should be ramped up more judiciously to make sure that post-amnesty, the relevant laws would be upheld.

All in all, the tax amnesty law represents a rare opportunity for Indonesia to attract a significant chunk of its citizens' money back onshore. As discussed, this could boost its fiscal health, create demand for its asset markets, and deepen its financial market development. If done right, there could also be a multiplier effect, as foreign investors see it as a potent positive catalyst and want in as well.

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