PRAKARSA Policy Brief

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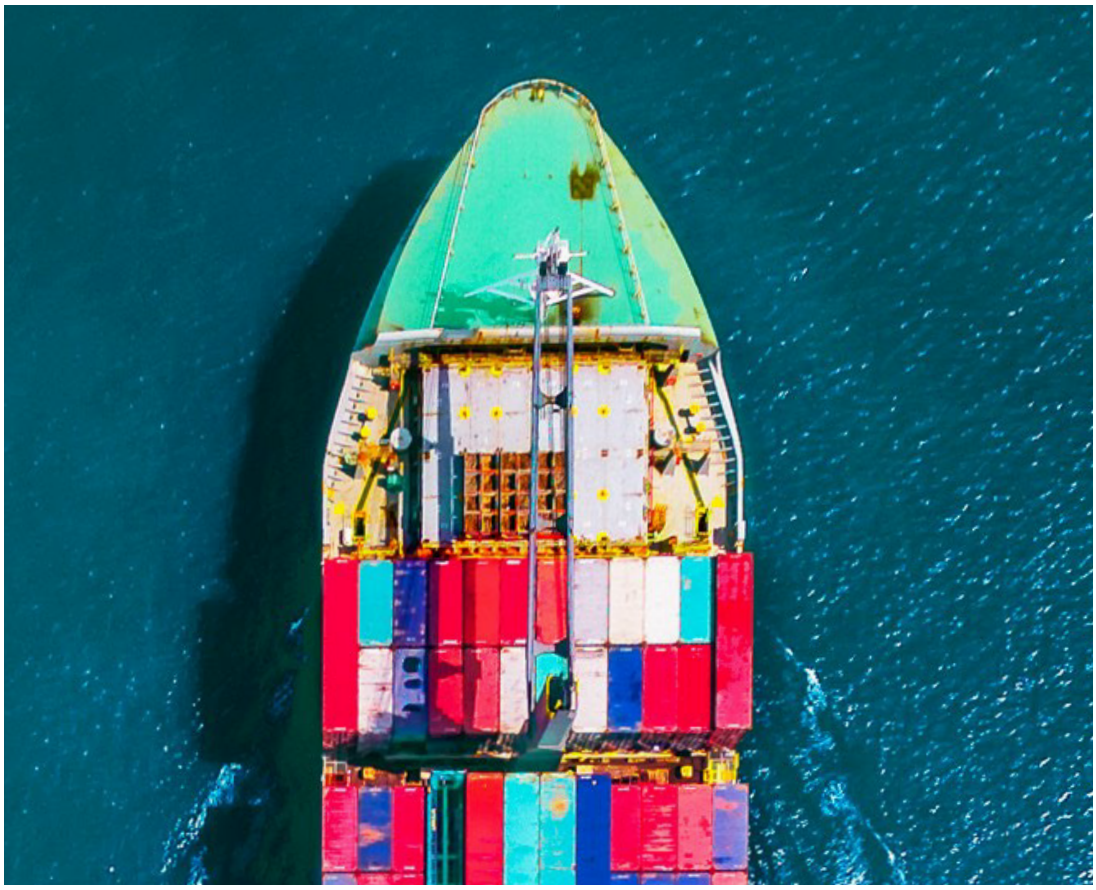
HIGHLIGHTING ILLICIT FINANCIAL FLOW OF INDONESIA'S TOP SIX EXPORT COMMODITIES

Key Points:

- From 1989 to 2017, illicit financial inflows (by over-invoicing) from the top six export commodities, which were coal, copper, palm oil, rubber, coffee, and crustaceans reached to USD 101.49 billion. Meanwhile, illicit financial outflows (by under-invoicing) reached USD 40.58 billion.
- The largest illicit financial outflow in that period came from the coal commodity which caused Indonesia a loss of USD 19.64 billion while the largest illicit financial inflow came from the palm oil commodity which amounted to USD 40.47 billion.
- Based on the illicit financial inflow and outflow, the potential loss of tax revenue in Indonesia during that period reached USD 11.1 billion. The largest was contributed by the coal sector which amounted to USD 5.32 billion.



Source: Anucha Sirivisansuwan/Getty Images

This policy brief is based on a report titled "Exposing illicit financial flow in Indonesia: The scale and the potential of tax revenue loss from the top six export commodities"

Preface

Trade balance is one of the important indicators of economy because it helps economists and investors to determine the economic relative power in a certain country compared to others. Furthermore, trade balance is also useful for policy makers and other relevant parties to delve information on the performance of export and import of a certain country in a certain period. However, many did not know that the trade balance data often does not reflect the real condition of export and import because of recording manipulation by exporters and importers, thus the reason why illicit financial flow occurred.

In general, illicit financial flow is a form of movement of money or capital that occurs when it is illegally earned, transferred, or utilized (Baker, 2005). Within the last few years, illicit financial flow was understood to be the cause of economic slowdown in developing countries since it causes the loss of potential fund for investment sourced from tax or non-tax revenue. This issue then receives a global attention and became one of the key issues in Sustainable Development Goals number 16 and indicator 16.4 where minimizing the illicit financial flow is one of the indicators to be achieved.

In Indonesia, the issue of illicit financial flow is a necessary and crucial matter to overcome since Indonesia is on its way to become a developed country but challenged by a low ratio of tax to Gross Domestic Product (GDP). In 2017, income per capita in Indonesia still hovering around USD 3,540 which is considered to be a lower-middle country. On the other hand, the ratio of tax to GDP has stagnated within the range of 10-13 percent within the last 20 years.

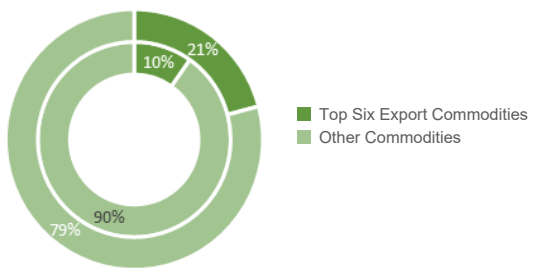
In the last few decades, the driving force of

Indonesian exports came from non-oil and gas commodities (extractive, manufacture, and agriculture), specifically the top six commodities which were coal, copper, palm oil, rubber, coffee, and crustaceans. Unfortunately, we never discover whether the Indonesian economy so far received the maximum benefit from the contribution of those top six export commodities. This document is a policy brief to highlight leakage in trading in a form of illicit financial flow of the top six export commodities and provide policy recommendations which will address the matter of illicit financial flow in Indonesia.

Development of Six Export Commodities' Rate

in 2017, six commodities, which were coal, copper, palm oil, rubber, coffee, and crustaceans became Indonesia's top export commodities. Coal and copper were the largest export commodities from the extractive sector, and rubber and palm oil were the largest export commodities from the manufacturing sector. Meanwhile, coffee and crustaceans were the largest commodities from the agriculture sector.

The rate of Export of the Top Six Commodities against Total Export, 1989 (inner circle) and 2017 (outer circle)



These six export commodities are vital to Indonesian export performance. Out of more than 1,200 types of commodity exported by Indonesia in 2017, the six commodities contribute to 21 percent of the total export. Whereas in 1989 the contribution of the six commodities worth only 10 percent of the total export from Indonesia.

From 1989 to 2017 the value of export of these six commodities grew significantly. The export value of these commodities improved from USD 2.1 billion in 1989 to USD 35.2 billion in 2017. This signifies that, the six commodities grew 1,533 percent from 1989 to 2017. The largest contributor to this growth of export value came from coal and palm oil. From 1989 to 2017, the annual growth of coal and palm oil were respectively 1,081 and 2,782 percent on average.

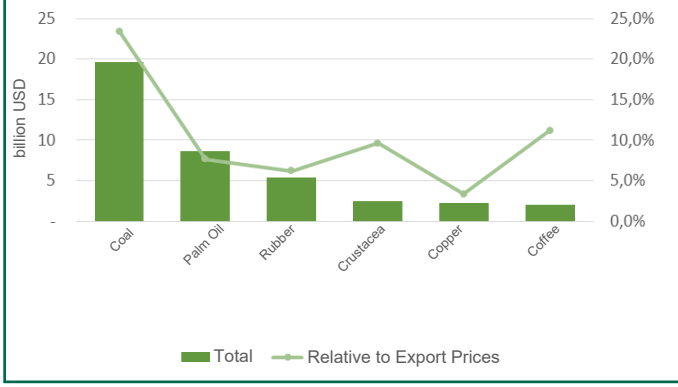
Scale of illicit financial flow

from mid-2018 to early-2019, Prakarsa conducted a research to calculate the illicit financial flow of Indonesia's top six export commodities for the period of 1989-2017. the export data was received from the United nations Comtrade Database using a Harmonized System classification. The Global Financial Integrity approach was used to estimate the illicit financial flow where it calculates trade mis-invoicing that includes over-invoicing an under-invoicing. The trade mis-invoicing can be calculated using the Gross Excluding Reversal (GER). This method calculates disrepancy between the export value report from a certain country with the import value report from another country.

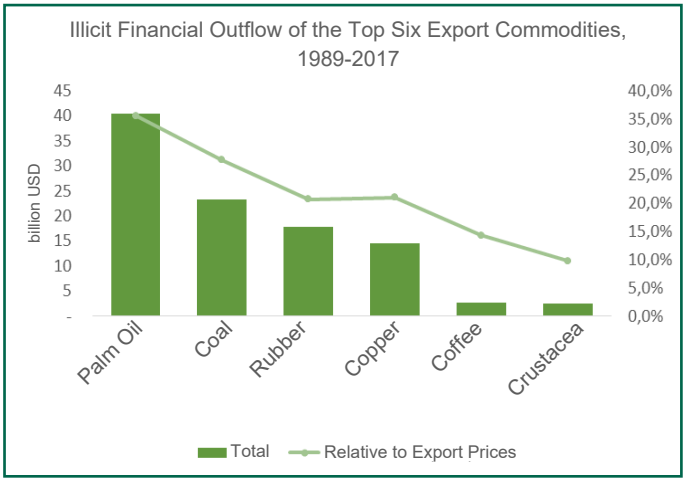
Prakarsa discovered that Between 1989 to 2017, Indonesia experienced an illicit financial inflow (by over-invoicing) amounted to USD 101.49 billion and experienced an illicit financial inflow USD amounted to USD 40.58 billion due to discrepancies in trade records of the top six export commodities between countries. This finding signifies that Indonesia experience more illicit financial inflow than outflow on the top six Indonesia's export commodities amounted to more than USD 60 billion. In average, Indonesia experience illicit financial outflow for the six commodities worth USD 233 million every year. Meanwhile, the illicit financial inflow amounted to USD 583 million in average.

The largest illicit financial outflow can be found for coal, followed by palm oil and rubber. from 1989 to 2017, Indonesia lost USD 19.64 billion in coal commodity. The highest proportion of illicit financial outflow against the export value of this commodity can be found in 2001 where it reaches 86 percent. When comparing with the proportion against export value, the illicit financial outflow of this commodity is also the largest, it reaches 23.42 percent.

Illict Financial Outflow of the Top Six Export Commodities, 1989-2017



The largest illicit financial inflow came from the palm oil commodity, amounted to USD 40.47 billion. This is followed by rubber and coal. The proportion of the highest illicit financial inflow of palm oil commodity can be found in 2001, which reached 167.5 percent. Compared to the other five commodities, when measuring the proportion against export value, the illicit financial inflow from palm oil is also the highest, which reached 35.62 percent.



Although illicit financial outflow was happening more for coal commodity, in 2013 there was a relatively significant spike of illicit financial inflow, which amounted to USD 1.95 billion. On the other hand, within the last few years the trend of net illicit financial inflow for palm oil was increased. Of the other four commodities, the trend for illicit financial flow were fluctuating, even when there was more illicit financial inflow to Indonesia.

From 1989 to 2017, illicit financial outflow of coal commodity was headed mostly towards India which amounted to USD 6.29 billion. If seen from the proportion of the total export, Indonesia experience loss of more than eightfold (426 percent) due to illicit financial outflow towards Italy, largest among other countries. On another hand, the largest illicit financial inflow came from Brunei Darussalam amounted to USD 6.38 billion. The largest proportion of illicit financial inflow against export value came from Belarus, which reached 100 percent. Prakarsa discover an interesting fact that Brazil (where illicit financial outflow reached USD 122 million), Macedonia and Laos were not the destination for Indonesian coal export, according to Indonesian export record, even though they claim to be one of the largest coal importers from Indonesia.

On copper commodity, the largest illicit financial outflow goes to Japan which amounted to USD 646 million. Proportionally, the largest illicit financial outflow goes to Sweden reaching 36% against the total export. Meanwhile, the largest illicit financial inflow of this commodity came from Spain amounted USD 3.78 billion. Whereas against the proportion of export value, the largest came from Canada which reached 67%. Moreover, Prakarsa estimate there is an illicit financial outflow from copper to Oman worth USD 70 million where Indonesia never even claim there was an export of such commodity to Oman.

Palm oil experience the largest outward trade leakage compared with other commodities. From 1989 to 2017, the largest illicit financial outflow goes to Russia amounted to USD 1.28 billion. The largest illicit financial outflow proportion goes to France which reached 618% against the total export. On the other hand, the largest illicit financial inflow came from Bangladesh which amounted to USD 806 million. When looking at the relative value of export, the illicit financial inflow came from Iran and Saudi Arabia which reached 96%. The same with coal, there were countries that were not even recorded as the export destination of this commodity. For example, there was a suspected illicit financial outflow towards Finland worth USD 19.98 million from palm oil, even though Indonesia never record any export of palm oil to Finland.

The largest illicit financial outflow for rubber goes to Luxembourg. The amount of money flowing to this country worth USD 806 million. it is also the largest in proportion against total export, which reached 534%. on the other hand, the largest illicit financial inflow of rubber came from Singapore which amounted to USD 2.9 billion even though the export of this commodity to Singapore only worth USD 4.1 billion. This means that the relative proportion of illicit financial inflow against export of rubber to Singapore reached 72%.

On crustacean, the largest illicit financial outflow goes to The United States amounted to USD 1.16 billion. In proportion against total export, illicit financial outflow of this commodity goes to Spain which reached 80%. Meanwhile, Japan is the largest country where crustacean commodity experienced the largest illicit financial inflow amounted to USD 486 million.

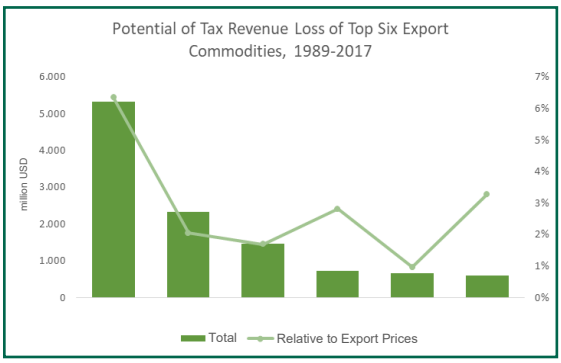
Coffee as one of the main commodities from Indonesia experience the largest illicit financial outflow to the United States amounted to USD 414 million. However, even though the United States was the largest destination for illicit financial outflow of coffee, proportionally, Indonesia actually experience the largest illicit financial outflow to Armenia which reached 77% against the total export. Meanwhile the largest illicit financial inflow to Indonesia came from Belgium worth USD 257.5 million. Interestingly, Indonesia only record USD 4.2 million of coffee export to Belgium. This means the illicit financial outflow to Belgium reached more than 6000% of the total export value.

Potential of Loss Tax Revenue

All activities, whether it's under or over-invoicing, an inward or outward trade will create loss for all countries involved. Global Financial Integrity (2018) explained that under-invoicing exports were used to reduce domestic tax and royalty payments. By calculating the low exports volume with the recorded exports volume at the destination country, companies will pay lower tax and royalties (for specific commodity) than they should.

The same applies to export over-invoicing, this is a practice to reduce the existing Value-Added-Tax (VAT) and export tax because the government provide export stimulation in the form of VAT-free for exported goods. In some countries, the stimuli provided by the government to increase export is by reducing the import tariff and VAT on export-oriented raw materials. By practicing export

over-invoicing, companies received profit from the reduction of import tariff over raw materials import and reduction of VAT for exported goods.



In this research, Prakarsa attempted to estimate the potential loss in tax revenue loss caused by export under-invoicing practices. Out of the 6 commodities, the largest potential of loss caused by export under-invoicing practice is in coal commodity with the estimated total loss worth USD 5.32 billion from 1989 to 2017. Another significant loss because export under-invoicing practice occurs in palm oil and rubber totaling USD 4 billion. Meanwhile, export under-invoicing practice for the other three commodities caused potential loss of under USD 1 billion. These numbers were calculated based on the total number of export under-voicing with the corporate tax rate at a certain year.

In further detail, the tax revenue loss potential because of export under-invoicing practices of the top six export commodities, is increasing annually. The largest potential loss occurred between 2001 and 2017 totaling USD 900 billion. Although the state's loss potential increased, when compared with the export value on the six commodities, the potential of tax revenue loss has been decreasing since 2005. The largest tax revenue loss potential relative to the value of export, happened in 2004 where the potential of tax revenue loss reached 5.80 percent of the total export value due to export under-invoicing. In average, the potential of state loss because of under-invoicing practices of Indonesia's top six export commodity was 3.27% per year.

By looking at the data and the calculation above, we can see that the government effort's in handling leakages of export and import activities was getting better over time. The government can be seen closing loopholes which enable loss of revenue by fixing export and import's fiscal administration activities.

Policy recommendations

1. the government needs to carefully review whether the incentives of export and import has the potential to create loopholes which can be used to avoid tax, especially for strategic commodities which contribute to a large export value for Indonesia.
2. The government need to perform supervision on exporting companies and the mechanism of exporting in coal commodity, considering that this commodity contributes the largest amount of illicit financial outflow.
3. the government need to build more coherent efforts in handling illicit financial flow by involving cross-ministries actors with various priorities such as the Ministry of Finance, Ministry of Foreign Affairs, Ministry of Trade and the Ministry of Law and Human Rights, and the effective participation and advice from a number of operational and regulatory bodies.
4. Built coordination with international organizations and donors that could provide objective recommendations and aids which world bridge communications in the transparency of illicit financial flow between countries.

This policy brief is based on a comprehensive study, "Exposing illicit financial flow in Indonesia: The scale and potential of tax revenue loss from the top six export commodities", which was funded by the Ford foundation.

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PRAKARSA *Policy Brief* is an independent policy analysis and recommendation about various critial issues related to development and welfare.

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