PRAKARSA Policy Brief

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Potential Revenue Loss from Illicit Financial Flows in Fishery and Coal Sectors in Indonesia

Key Points:

- Indonesia lose around IDR74 trillion in the last ten years from international trading activities (export-import) in fishery and coal sectors.
- In fishery sector, the largest embezzlement was with trading partners from the United States and China, i.e. in the crustaceans and mackerel commodities. Meanwhile, in coal sector, it involved trading partners from India, South Korea, the Netherlands, and Australia. Bituminous coal and coals other than anthracite are commodities with the highest embezzlement potential in the coal sector.
- Many loopholes must be closed to address illicit financial flows, for instance, by optimizing the Automatic Exchange of Information (AEOI), improving beneficial ownership data transparency, digitizing and integrating trading data, and improving tax oversight.

Challenges in optimizing state revenue

Tax revenues significantly contribute to state revenues, but with increased expenditures, deficits also looming. For the first time in the last 12 years, realized revenues exceeded the target revenues in the annual state budget (APBN). In 2021, the surplus revenue was 15.35% and in 2022 the surplus was 15.9% (Ministry of Finance, 2022 & 2023). However, due to COVID-19 pandemic, such surplus should be taken with a grain of salt, because expenditure also increased. State expenditure reached IDR 2,784.4 trillion, or 1.32% above the 2021 expenditure target. Based on the realized revenue and expenditure, the 2021 State Budget suffered from deficits amounting to IDR 775.1 trillion.

In addition to the deficits, Indonesia also has low tax-to-GDP ratio, which means Indonesia's tax revenue is relatively insignificant compared to the country's economy size. The ratio of tax to GDP in 2021 was only 9.11% (Ministry of Finance, 2022). Although the ratio was slightly increased from 8.33% in 2020, Indonesia's tax ratio remained significantly lower than other countries in the Asia-Pacific region which was 19.1% and even lower than the average ratio in the low-income countries which was around 14.3% (PRAKARSA, 2019). Indonesia's tax ratio was only higher than countries like Laos (8.9%) or Bhutan (8.9%). The World Bank suggested that 15% tax-to-GDP ratio or higher ensures economic growth and, thus, poverty reduction in the long-term (World Bank, 2021).

Global Illicit Financial Flows and Sustainable Development Goals (SDGs)

With deficits and low tax-to-GDP ratio, it is challenging for country like Indonesia to boost state revenues much needed for development and poverty reduction. Another challenge in optimizing state revenues is illicit financial flow (IFF). Literature on IFF suggested that this practice has a detrimental effect on country's economy in general. The World Bank (2017) asserted that IFF could reduce domestic resources and state revenues required to finance poverty alleviation programs and infrastructure in developing countries. IFF also signifies other problems such as lack of state transparency and accountability, and reflects a situation where the interests of few people take precedence over public interests.

In general, potential loss of revenues caused by leakages in the trade sector harms the overall economic structure, especially in developing and low-income countries. This loss is observable from the transfer of domestic income and wealth abroad, usually to high-income countries. This problem may even occur in developed countries when their productive capacity is limited. The social costs of this problem can undermine sustainable growth in developed countries and exacerbate inequalities in the distribution of income and wealth, including poverty alleviation.

One of the goals in the SDGs is Goal 16, which includes peace, justice, and strong institutions. Target 16.4 explicitly states that, by 2030, the illicit financial and arms flows will be significantly reduced, the recovery and return of stolen assets will be strengthened, and all forms of organized crime will be combatted. The measurement of indicator 16.4.1 involves the total value of inward and outward illicit financial flows (in current USD) (The Ministry of National Development Planning/Bappenas, n.d). However, in the document from Statistics Indonesia or BPS (2021) regarding indicators for sustainable development goals, no reports or measurements could demonstrate Indonesia's progress in achieving indicator 16.4.1.

Meanwhile, Indonesia lose some potential state revenues, especially from natural resource commodities. PRAKARSA's study (2019) revealed that from 1989 to 2017, the illicit financial flows from six export commodities i.e. coal, copper, palm oil, rubber, coffee, and crustacean fisheries reached US$11.1 billion. Coal was the commodity with the highest loss, amounting to US$5.32 billion. Furthermore, the Ministry of Maritime Affairs and Fisheries (KKP) stated that leakages have also occurred in the fisheries sector since 2013 and claimed that the fisheries sector had suffered losses of up to IDR2,000 trillion due to illegal fishing (KKP, 2018).

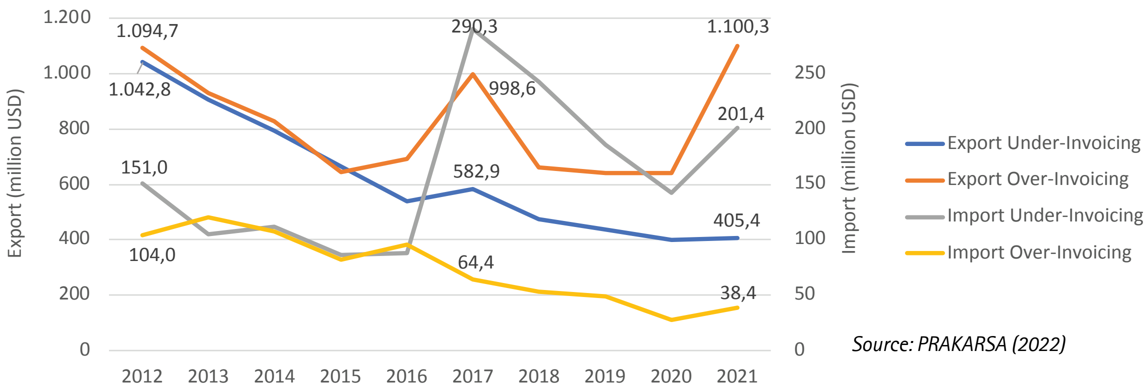
Estimated potential loss of state revenues from illicit financial flows in the fishery and coal sectors

Employing the Gross Export Reversal (GER) method developed by Global Financial Integrity (GFI), PRAKARSA calculated the estimated gaps or misinvoicing in Indonesia's trade records with partner countries. PRAKARSA compared the export and import records of the six HS (Harmonized System) code data released by UN-Comtrade. From this estimation, PRAKARSA also calculated the potential tax that could have been imposed.

Fishery Sector

In the fishery sector, over the past 10 years (2012–2021), an estimated embezzlement value of US$ 9.7 billion or IDR128.6 trillion has been found. This value comprised export misinvoicing worth US$7.34 billion (IDR 97.3 trillion) and import misinvoicing worth US$2.3 billion (IDR30.5 trillion).

Chart 1. Illicit financial flows in the fishery sector from 2012–2021



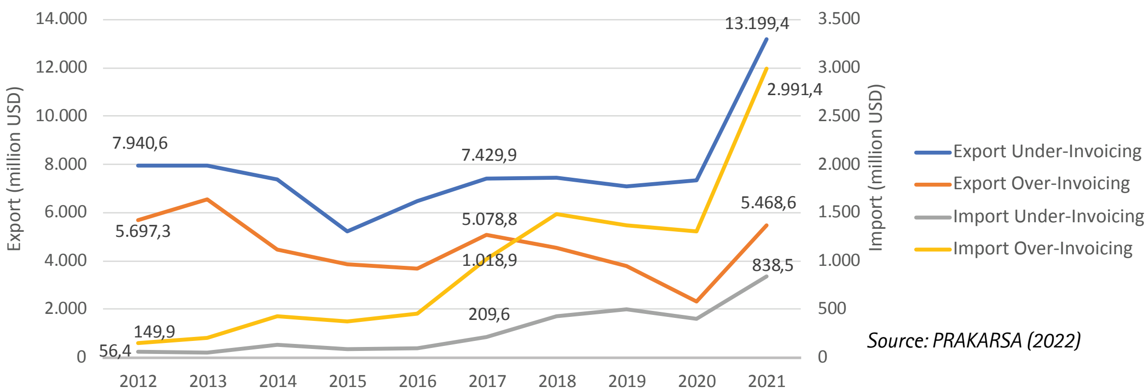
Source: PRAKARSA (2022)

The highest export under- and over-misinvoicing was identified in the crustacean commodity (code 30617) for the United States, partner country with the highest export misinvoicing. Meanwhile, import misinvoicing, both under-misinvoicing and over-misinvoicing, could be identified in a single commodity, i.e., mackerel (code 30354). The highest under-invoicing was caused by China, while the highest over-invoicing came from the United States. Based on these estimation results, the commodities in the fishery sector and its derivatives that require more comprehensive monitoring is the export of crustaceans, particularly to the United States. For the imported commodities, frozen mackerel imported from China and the USA require better monitoring.

Coal Sector

In the coal sector, over the past 10 years (2012–2021), an estimated embezzlement value of US$133.5 billion or IDR1,770 trillion has been found. This value comprised export misinvoicing worth US$12.9 billion (IDR1,630 trillion) and import misinvoicing worth US$12.5 billion (IDR165.8 trillion), which was greater than that in the fishery sector.

Chart 2. Illicit financial flows in the coal sector from 2012–2021



Source: PRAKARSA (2022)

Export misinvoicing was found in two different commodities, where under-invoicing occurred in bituminous coal (270112), while over-invoicing occurred in all types of coal other than anthracite (270119). The highest export under-invoicing was identified in India, while the highest export over-invoicing was found in South Korea. Export under-invoicing resulted in losses since the relevant country lost revenue from royalties and income tax. The potential loss of revenue from royalties reached USD3.8 billion (IDR50.4 trillion) and USD1.16 billion (IDR15.4 trillion) from income tax (1.5%). Under-invoicing, leading to state losses in tax revenue, came from India. Contrastively, South Korea turned out to be the country rendered over-invoicing in Indonesia.

On the other hand, import misinvoicing, both under-invoicing and over-invoicing, could be identified in a single commodity, namely bituminous coal (code 270112). Under-invoicing in imports reached USD 2.8 billion (IDR37.1 trillion), while over-invoicing amounted to USD 9.7 billion (IDR 128.6 trillion). Further, the highest under-invoicing was caused by the Netherlands, while over-invoicing came from Australia. Therefore, in terms of export, two commodities requiring strict supervision include bituminous coal (270012) and coals other than anthracite (270119), particularly to India and South Korea. In contrast, the import of bituminous coal (270112) also demands close control, especially from the Netherlands and Australia.

Policy Gaps in the Practice of Illicit Financial Flows

Trading of Indonesia's natural resources continues to be one of the most potential activities to boost state revenues. The Government has implemented various tax and non-tax instruments, such as Income Tax (PPh), Value Added Tax (VAT), and royalties. Nevertheless, practically, the trading of Indonesia's natural resources (export and import), including fisheries and coals, still indicate gaps on the invoice. Such a case can be classified into illicit financial flows.

Given the complexity of the issue, the measures taken by the Government have yet to result in significant outcomes and require cross-sectoral acceleration. The practice of illicit financial flows in some developed and developing countries suggested that such a practice arose due to several reasons, including gaps on the invoice as the result of the self-assessment reporting system, transits during the delivery, and non-centralized international transaction recording.

Tax policies are considered less powerful in addressing transfer pricing and profit-shifting issues committed by export companies, which often establish cooperation with the partners of holding companies or subsidiaries. These practices are common in extractive and coal industries. The modus operandi is made by billing a higher price than the actual price in the company's financial statement. Thereby, the corporate income tax (PPh) drops much lower than the relatively insignificant increase in the Value Added Tax (VAT). It can be concluded that the action of such export companies becomes a factor driving the fishery and coal sectors to be extremely undertaxed, where tax contribution hits a lower level than the GDP.

The potential illicit financial flows in the fishery and coal sectors in Indonesia are also aggravated by inconsistent regulations. For instance, in the coal sector, there were several changes in the grant of permits, tariff imposing, and contract system of companies throughout 2022, though there had been a restriction in the export policy. These changes constituted a hole for rent-seekers to take benefits as they would find it more uncomplicated to seize the chance to enable illicit financial flows.

Conclusion and Recommendations

From 2012 to 2021, gaps in the invoice of exports and imports in fishery and coal sectors in Indonesia reached USD 3.51 billion (PRAKARSA, 2022). PRAKARSA's study (2022) also revealed that Indonesia encountered a potential loss of revenues for ten years, amounting to USD 5.58 billion or equivalent to IDR 74 trillion (IDR 7.4 trillion per year). These potential losses were derived from four tax sources: VAT, royalties, income tax Article 22 (2.5%), and income tax (1.5%).

Based on these overall findings, we propose the following recommendations:

- The Ministry of Finance and the Directorate General of Taxes should maximize the information integration about export and import activities among countries through the Automatic Exchange of Information (AEOI) mechanism to minimize misinvoicing practices. In addition, strict supervision of taxpayers' compliance in the fulfillment of tax obligations, either formally or materially, should be advanced, specifically in sectors with high risks of IFF practices.
- The Directorate General of Customs and Excise should review the reporting system employing self-assessment method due to the high gap in trade misinvoicing as the information was incorrectly provided. Apart from that, mapping the recording of the HS code is deemed necessary to match the recording of exported or imported goods with the code in the Indonesian Customs Tariff Book (BTKI).
- The Ministry of Energy and Mineral Resources should align the laws and regulations related to the authority in granting permits for mineral and coal mining activities to prevent gray areas or loopholes that conflict with the laws and regulations.
- The Ministry of Industry and Trade should form a team authorized to supervise each commodity's exports. It is also essential to integrate information and data among government institutions involved in export and import activities as well as state revenues, including taxes, customs, and non-tax state revenue, to form a database that may be used to monitor exporters and importers. Besides, the business process database from upstream to downstream for sectors vulnerable to IFF practices should be made digitally, regularly updated, and integrated.
- The Ministry of Maritime Affairs and Fisheries should periodically update the benchmark price of fish (considering the applicable HS code) to calculate levies on fishery products. Such a way is intended for the

benchmark price of fishery commodities to accurately represent the prevailing market price, which will ultimately be reflected in state revenues that are more in line with fish market prices. Apart from that, utilizing a standardized classification system (HS code) as a reference can generate a valid database.

- The Government is expected to involve INFA (Indonesian Forwarders Association) to monitor the export and import activities as well as prevent and reduce the practice of illicit financial flow or IFF.

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