

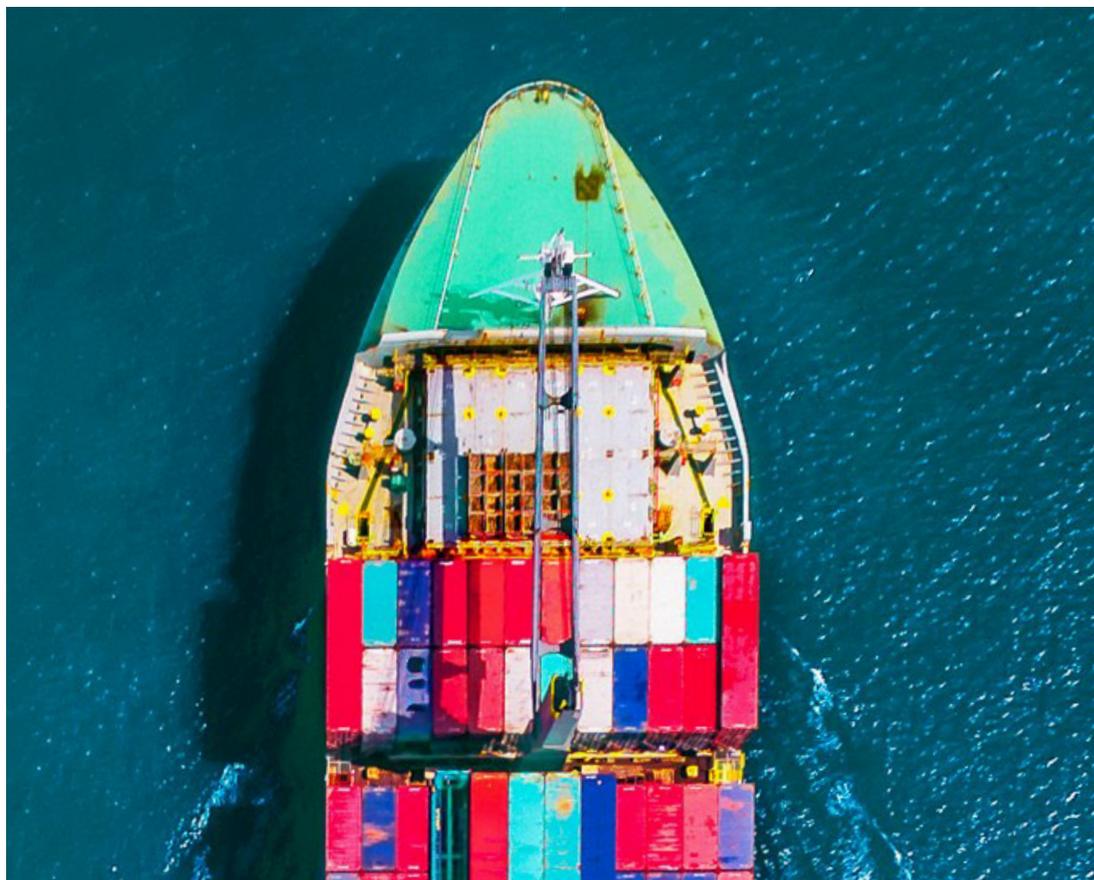
# P R A K A R S A *Policy Brief*

November 2019

## 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 outflows in that period came from the coal commodity which amounted to USD 19.64 billion while the largest illicit financial inflows came from the palm oil commodity which amounted to USD 40.47 billion.
- Based on such amount of illicit financial inflows and outflows from the top six export commodities, the potential loss of tax revenue in Indonesia during that period reached USD 11.1 billion. The largest was contributed by the coal commodity which amounted to USD 5.32 billion.



Source: Anucha Sirivisansuwan/Getty Images

**T**his policy brief is based on a report titled "Exposing Illicit Financial Flows in Indonesia: the Scale and the Potential of Tax Revenue Loss from the Top Six Export Commodities"

### Preface

Balance of trade is one of the important indicators of economy because it helps economists and investors to assess the economic power in a country relative to the others. Furthermore, balance of trade is also useful for policymakers 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 realize that the trade balance data often does not reflect the real condition of export and import because of recording manipulation by exporters and importers. These manipulation in order to avoid and evade the taxes are the main reason why illicit financial flows occurred.

In general, illicit financial flows are 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 flows have been realized to be the factor 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 reducing the illicit financial flows are one of the indicators to be achieved.

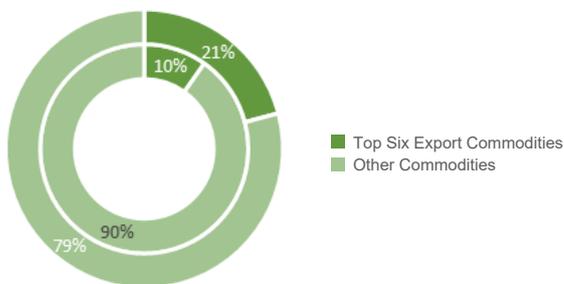
In Indonesia, the issue of illicit financial flows are a necessary and crucial matter to overcome since Indonesia is on its way to become a developed country but challenged by a low ratio of tax to Gross Domestic Product (GDP). In 2018, based on Statistics Indonesia data, Indonesia's income per capita still around USD 3,900 or IDR 56 million which is considered to be a low-middle income country. On the other hand, the ratio of tax to GDP has also been stagnating within the range of 10–13 percent within the last 20 years.

In the last recent decades, the main engine 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 found whether the Indonesian economy so far received the maximum benefit from the contribution of those top six export commodities. This policy brief intends to highlight the leakage in cross-border trade activities in a form of illicit financial flows of the top six export commodities and provide policy recommendations which will help Indonesia to address the problems of illicit financial flows.

### Development of the Export Value of Six Export Commodities

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.

Share of Export of the Top Six Commodities, 1989 (inner circle) and 2017 (outer circle)



These six export commodities are vital to Indonesian export performance. Out of more than 4,000 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 indicates that the six commodities grew 1,533 percent during that period. 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.

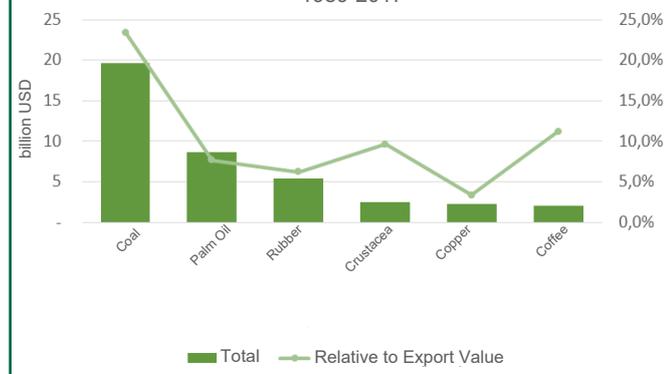
### Scale of Illicit Financial Flows

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

PRAKARSA discovered that between 1989 to 2017, Indonesia experienced an illicit financial inflows (by over-invoicing) amounted to USD 101.49 billion and experienced an illicit financial inflows 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 inflows than outflows on the top six Indonesia's export commodities amounted to more than USD 60 billion. On average, Indonesia experience illicit financial outflows for the six commodities worth USD 233 million every year. Meanwhile, the illicit financial inflows amounted to USD 583 million on average.

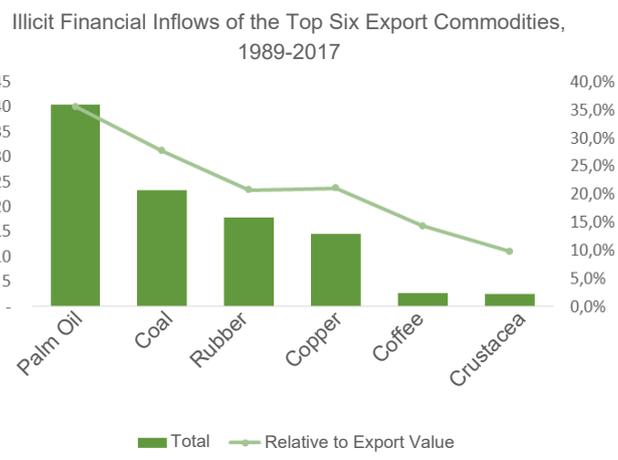
The largest illicit financial outflows were from coal, followed by palm oil and rubber. During 1989 to 2017, Indonesia lost USD 19.64 billion in coal commodity. The highest proportion of illicit financial outflows relative to the export value of this commodity occurred in 2001 where it reached 86 percent. When comparing with the proportion against export value, the illicit financial outflows of this commodity was also the largest, it reached 23.42 percent.

Illicit Financial Outflows of the Top Six Export Commodities, 1989-2017



The largest illicit financial inflows came from the palm oil commodity, amounted to USD 40.47 billion. This is followed by the rubber and the coal. The proportion of the highest illicit financial inflows 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 inflows from palm oil is also the highest, which reached 35.62 percent.



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

From 1989 to 2017, illicit financial outflows 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 experienced loss of more than eightfold (426 percent) due to illicit financial outflows towards Italy, largest among other countries. On another hand, the largest illicit financial inflows came from Brunei Darussalam amounted to USD 6.38 billion. The largest proportion of illicit financial inflows against export value came from Belarus, which reached 100 percent. PRAKARSA found 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 report, even though they claimed importing coal from Indonesia.

The largest illicit financial outflows of copper commodity went to Japan which amounted to USD 646 million. Proportionally, the largest illicit financial outflows went to Sweden reaching 36 percent relative to total export. Meanwhile, the largest illicit financial inflows 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 percent. Moreover, PRAKARSA estimated there was an illicit financial outflows of copper to Oman worth USD 70 million where Indonesia never even claim there was an export of such commodity to Oman.

Palm oil experienced the largest trade leakage compared with other commodities. From 1989 to 2017, the largest illicit financial outflows goes to Russia amounted to USD 1.28 billion. The largest illicit financial outflows goes to

France which reached 618 percent against the total export. On the other hand, the largest illicit financial inflows 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 outflows of rubber went to Luxembourg. The amount of money flowing to this country worth USD 806 million. It was also the largest in proportion against total export, which reached 534 percent. On the other hand, the largest illicit financial inflows 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 inflows against export of rubber to Singapore reached 72 percent.

For crustacean commodity, the largest illicit financial outflow went to The United States amounted to USD 1.16 billion. In proportion against total export, illicit financial outflows of this commodity went to Spain which reached 80 percent. Meanwhile, Japan was the largest country where crustacean commodity experienced the largest illicit financial inflows amounted to USD 486 million.

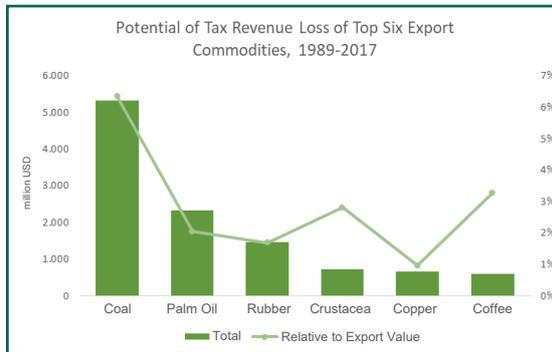
Coffee as one of the main commodities from Indonesia experienced the largest illicit financial outflows to the United States amounted to USD 414 million. However, even though the United States was the largest destination for illicit financial outflows of coffee, proportionally, Indonesia actually experienced the largest illicit financial outflows to Armenia which reached 77 percent against the total export. Meanwhile the largest illicit financial inflows to Indonesia came from Belgium worth USD 257.5 million. Interestingly, Indonesia only recorded USD 4.2 million of coffee export to Belgium. This means the illicit financial outflows to Belgium reached more than 6,000 percent of the total export value.

### Potential of Loss Tax Revenue

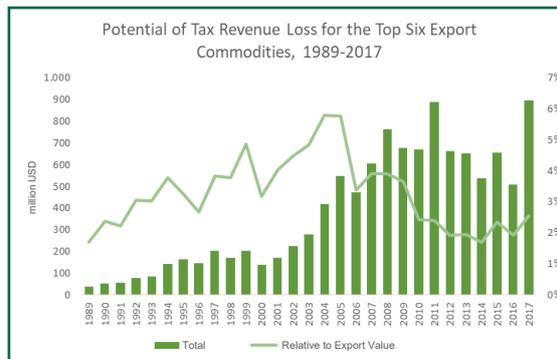
All activities, whether they are under or over-invoicing, in import or export activities will create loss for all countries involved. Global Financial Integrity (2018) explained that export under-invoicing is used to reduce domestic tax and royalty payments. By lowering the export records value than the actual export value in a country destination, companies will pay lower tax and royalty (for particular commodities) 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 incentive in the form of VAT-free for exported goods. In some countries, the stimulus 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 receive 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 six 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-invoicing 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 has been increasing annually. The largest potential loss occurred between 2001 and 2017 totaling USD 900 billion. Although the potential of tax revenue loss increased, when compared with the export value on

This policy brief is based on a comprehensive study, "Exposing Illicit Financial Flows in Indonesia: the Scale and the Potential of Tax Revenue Loss from the Top Six Export Commodities", which was funded by the Ford foundation.

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 percent 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. It can be seen that the Indonesian government has been trying to curb the loopholes which create government revenue loss by fixing export and import's fiscal administration activities. However, what the Indonesian government has been done is not enough since the Indonesian government has not been able to reform the system and the existing law.

### 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 flows 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 flows between countries.

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