Brief Note

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ILLICIT FINANCIAL FLOWS AND TAX CRIME IN MINING SECTOR

"Illicit financial flows in Indonesia in 2014 is estimated reaching IDR 227.75 trillion ($20 billion). Mining sector contributes IDR 23.89 trillion ($2 billion), mainly derived from trade misinvoicing"

Main Findings

1. PWYP Indonesia estimates illicit financial flows in Indonesia in 2014 reach IDR 227.7 trillion or equal to 11.7% of revised state budget (APBN-P) for 2014.
2. Indonesia ranks seventh in higgest illicit financial flows among developing countries. The value reaches $187,884 million from 2003-2012 (IDR 1,690 trillion with average exchange rate IDR 9,000/USD) or in $18,784 million/year (IDR 169 trillion). – Global Financial Integrity Report, 2014
3. In mining sector for 2014, Illicit financial flow is estimated around IDR 23.89 trillion. Around IDR 21.33 trillion comes from trade misinvoicing, and around IDR 2.56 trillion comes from hot money narrow.
4. Tax ratio of mining sector in Indonesia in 2013 only reaches 9.4%. This low ratio is closely related to the rampant practices of tax evasion and tax avoidance.

Recommendation

1. Improvement of tax system and state revenue transparency
2. Improving tax compliance, and strengthening data integration
3. Synergizing regulation in taxation and mining
4. Law enforcement on tax evasion and tax avoidance cases.

Introduction

The 2014 Global Financial Integrity (GFI) Report entitled "Illicit Financial Flows from Developing Countries: 2003-2012", puts Indonesia in the seventh place of countries in the world with the highest illicit financial flows. The report estimates that total illicit financial flows in Indonesia for 2003-2012 reached $187,844 million (IDR 1,690 trillion, average exchange rate IDR 9,000/US$) or reaches $18,784 million per year. Using the same method, PWYP Indonesia estimates illicit financial flows in Indonesia for 2014 reach IDR 227.7 trillion or equal to 11.7% of revised state budget (APBN-P) for 2014.

Mining sector in Indonesia accounted for 10.5% of total of illicit financial flows in Indonesia, which is predicted reach IDR 23.89 trillion in 2014. Similarly, global trend shows that natural resource rich countries contribute massively to illicit financial flows. China with its rapid economic growth for the last two decades and abundant of natural resources ranks first as the countries with highest illicit financial flows. Likewise, Russia, Mexico, and India that also have abundant natural resources are also among top five countries with the highest illicit financial flows in the world (GFI, 2014).

Loophole of Illicit Financial Flows

In general, illicit financial flows caused by two loopholes: hot money narrow and trade misinvoicing. Hot money narrow may come from money laundering, corruption, tax evasion and other illegal transactions that violate state regulations. Trade misinvoicing involves across borders transaction related to trade in goods and services (Kar & Spancer, 2014).

Analytical Method
Illicit Financial Flows

Estimated by measuring the gap between Balance of Payment data and Balance of Trade. Generally, formulated below:

Illicit Financial Flows (IFF) = Hot Money Narrow (HMN) + Trade Misinvoicing (GER)

- Hot Money Narrow (***HMN***) derives from the gap and recording errors in the balance of payments or known as Net Error and Omissions (*NEOs*).
- Trade Misinvoicing (***GER***) is trade (export-import) between countries that are not recorded as a transaction. Calculated from Direction of Trade Statistics (*DOTS*) of IMF by using Two-Stage Filtration Process Technique as formulated:

$$GER = [Xi] - Mj/\beta + [Mi/\beta] - Xj$$

Mi is the value of imports, ***β*** is the delivery (cargo) cost and insurance adjustment (taken at 10 percent of total imports) and ***X*** is the value of exports. Where I refers to the destination country imports, while **j** refers to the export destination.

Source: GFI (2008), http://www.gfintegrity.org/report/illicit-financial-flows-and-development-indices-2008-2012/

Indonesia is among the five countries with biggest growth rate of illicit financial flows in the world only after China, Russia, India and Malaysia (Fig 1). For the last 12 years (2003-2014), total of illicit financial flows in Indonesia has substantially increased. In 2003, the illicit financial flows reached IDR 141.82 trillion, and estimated to increase IDR 227.75 trillion in 2014. It means that for in the last 12 years, illicit financial flows in Indonesia has increased up to 60.58% or 5.04% in average annually.

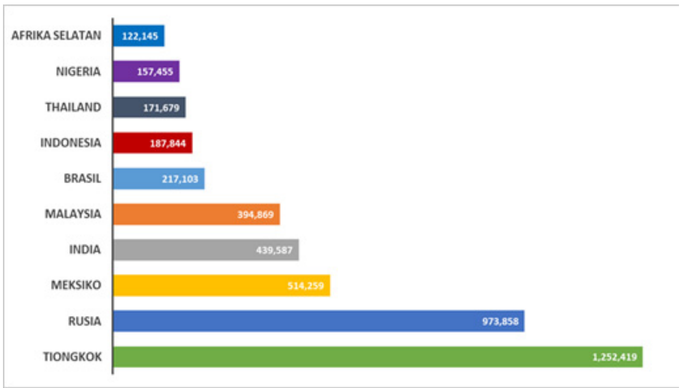

Figure 1. 10 Countries with Biggest Illicit Financial Flows in the World 2003 – 2012 (million USD) Source: Global Financial Integrity, 2015

In mining sector (oil, gas, mineral and coal), the growth of illicit financial flows is considerable, two times bigger than national growth rate. For the period of 2003-2014, it was reached around 102.43% or grew 8.53% annually. In 2003, total of illicit financial flows in mining sector approximately has reached IDR 11.80 trillion. It significantly increases up to IDR 23.89 trillion in 2014. Trade misinvoicing is the main factor behind illicit financial flows in mining sector. It was indicated that trade misinvoicing occurred due to massive illegal mining and the export of mining commodities which are largely unrecorded. For instance, in 2003, total of trade misinvoicing reached IDR 9.30 trillion, and substantially increased to IDR 21.33 trillion by 2014. Whereas for HMN, it reached IDR 2.56 trillion in 2014 (Table 1).

Table 1. Estimates of Illicit Financial Flows in Mining Sector and All Sectors in Indonesia, 2003-2014 (trillion rupiah). Calculated from the contribution of GDP from mining sector (oil, gas, mineral and coal) to illicit financial flows.

	Mining Sector*			All Sectors		
Year	Hot Money Narrow (HMN)	Trade Misinvoicing (GER)	Illicit Financial Flows (IFF)	Hot Money Narrow (HMN)	Trade Misinvoicing (GER)	Illicit Financial Flows (IFF)
2003	2.50	9.30	11.80	30.08	111.74	141.82
2004	2.47	12.25	14.72	27.63	137.00	164.63
2005	0.14	13.25	13.38	1.23	118.93	120.17
2006	-	16.09	16.09	-	146.57	146.57
2007	1.39	17.39	18.79	12.50	155.96	168.46
2008	0.25	28.71	28.96	2.31	262.43	264.74
2009	3.27	19.32	22.59	30.96	182.93	213.89
2010	3.55	13.53	17.08	31.81	121.18	152.99
2011	3.52	16.82	20.34	29.80	142.30	172.10
2012	0.73	22.36	23.09	6.14	189.27	195.40
2013	0.73	24.30	25.03	6.50	215.15	221.65
2014	2.56	21.33	23.89	24.42	203.34	227.75
Total	21.12	214.64	235.76	203.39	1,986.80	2,190.18

Source Table 1: PWYP (2015) analyzed from Balance of Payment (BOP) Indonesia and Direction of Trade Statistic (DOTS) IMF 2003 - 2014

Ministry of Energy and Mineral Resources (2014) also recorded USD 1.2 to 1.5 billion potential loss derived from state revenue. This is equal to IDR 18.3 trillion annual loss from illegal coal export. About 30-40 million tonnages of coal leave Indonesia through illegal trade. This situation supports inidication on illicit financial flows which is mainly caused by trade misinvoicing.

Tax Evasion and Tax Avoidance in Mining Sector

Based on studies conducted by Kar and Spencer (2014), the main cause of global increase of illicit financial flows is rampant practices tax evasion and tax avoidance. Although OECD (2013) has issued Action Plan on Base Erosion and Profit Shifting (BEPS) which regulates preventive mechanism on tax evasion and tax avoidance, these illegal practice remains exist and continually growing.

Indonesia is not spared from tax evasion and tax avoidance issues. Although this issue has been regulated by Law No. 36 Year 2008 on income tax, there are impediments in the implementation. There are numbers of companies that try to avoid their tax obligations, either "legally" by findings loopholes in the taxes regulation system in Indonesia, or illegally.

About IDR 450-480 trillion potential lost from tax revenue are caused tax evasion and tax avoidance (Wiko Saputra/ Prakarsa, 2014). Unsurprisingly, mining sector is one of the main culprit for such practices. Based on revenue data from Directorate General of Taxation (DJP) in 2013, taxes revenue from mining is IDR 96,9 trillion. Ratio of taxes revenue from mining sector (income tax, company tax, and VAT) to GDP shows that tax ratio of mining sector is categorically low, only up to 9,4% (Fig 2). The ratio is also below national average. Indeed, tax ratio in Indonesia is also low compare other lower middle income countries. Thus, there are massive source of tax revenue that can be optimalised in the mining sector, that has not been targeted or collected.

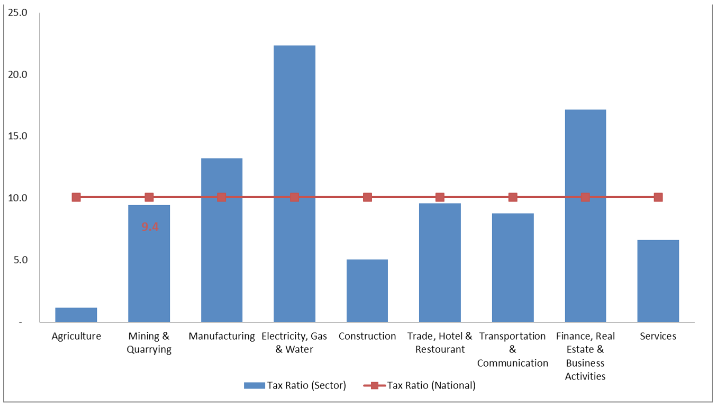

Figure 2. Tax ratio by Sectoral in Indonesia, 2013. Source: PWYP (analyzed from DG of Taxation, 2014)

The inefficiency in the tax revenue from mining sector aligns with findings from anti corruption commission through coordination and supervision in the mining sector. Mining companies are still not complying with tax payment regulation. For instance, out of 7.834 companies listed in DG of taxation, 245% of them have not obtained tax file number (NPWP), while 35% of companies have not submitted annual tax payment report.

Paradox of rich resource country and challenges in governing extractive sector

High flow of illicit finance in the mining sector in Indonesia is a consequence of poor governance practices in the mining sector in the last decade. This is especially in coal industry. There was big expectation in the booming of mining licenses to boost productivity in mining sector and economic growth. However, poor qualification process combined with lack of good governance, have failed the expectation and created insignificant contribution to the revenue and social welfare. In fact, it creates paradoxical impacts such as environmental degradation, loss of livelihood, social conflicts, and violation of human rights.

In 2014 revenue evaluation report, Non Taxes Revenue from Coal and Mineral Sector only records IDR 34.2 trillion which is far below revenue target of the sector at IDR 39 trillion. Importantly, Anti Corruption Commission found that there are IDR 28.5 trillion of non tax revenues that potentially lost due to administrative, licensing, and enforcement failures.

Economic growth without effective system and enforced regulation will only push for more underground economy which indicated by numbers of unrecorded economic activities. This situation is similar to findings of Dev Kar (2013) that economic acceleration in Russia in the last five year was been 'free-riding" and weakened by enormous underground economy which caused massive illegal economic transactions.

Unfortunately, entangled and lack of good governance in the mining sector in Indonesia has turned into a classic problem that is perceived as new normal in business sector. In addition, failure of policy maker to comprehensively regulate the sector has created overlapping in decision making and implementation. Governance challenges such as land management, licensing system, tax compliance, social and environmental protection become headlines in the heavy journey to reform the mining sector.

There are also overlapping of regulation, especially on licensing system, between ministry of energy and mineral resources, ministry of forest and environment, and local government. As consequence, there are numbers of awarded mining licenses that are located in conservation forest that is a no go area for any extractive activities, or open pit mining that is practiced in protection forest. About 6 million hectares of mining concession located in the these forest. This is worsen by absence of definitive map that interactively accommodates various sectors, incoherence between mining and local government spatial plan. In fact, 4,276 mining licenses out of 10,432 mining licenses are still in Non Clean and Clear Status due to failure to comply with administrative procedures, land arrangement, and royalty and land rent payment.

Policy Recommendation

1. **Reforming taxation system and revenue transparency**

   There is urgent need to improve quality of human resources and institution of taxation office, to ensure optimalisation of tax revenue, as well as to control and monitor taxation sector. Revenue transparency should be promoted especially in aspect of mining production, trading and export, as well as ensuring readiness of monitoring process and validation for tax and revenue calculation.

2. **Improving tax compliance and strengthening data integration**

   Compliance should be ensured since the beginning, which is in the licensing process. Authority should ensure that mining license is given to company who has obtained tax file number. In addition, awarding punishment to license holders who do not have. Compliance also can be increased through improving internal control and enforcement, and strengthening tax court. Strengthening data integration is an important requirement to ensure compliance, as well as determining roles of open data and big data to prevent loopholes in tax revenue.

3. **Synergizing regulation in taxation and mining**

   Revision of Oil and Gas Law and Mineral and Coal Law in the agenda of House of Representatives should become momentum to revisit and synergies regulation. Thus, avoiding overlapping of authority, creating adequate incentive and disincentive in the taxation and mining sector.

4. **Law enforcement on tax evasion and tax avoidance cases**

   Stagnancy of follow up of tax evasion and avoidance that should be address by DG of Taxation will create distrust in the public and uncertainty in business sector. Such situation in the short and long run will impact economic growth and government target on optimizing tax revenue likely will be missed. Strengthening function of tax court and ensure prosecution and follow up of each cases will not just retrieve back national revenue, but also prevent potential violation in the future.

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