eastspring investments

A member of Prudential plc (UK)

REPATRIATING INDONESIAN CAPITAL: SHOW US THE MONEY

Lack of domestic investment capital may constrain President Joko Widodo's ambitious attempt to build much needed Indonesian infrastructure. We wrote earlier about Indonesia's relatively undeveloped capital markets hampering the government's and the private sector's ability to raise funds to finance the infrastructure.

Ari Pitoyo
Chief Investment Officer
Eastspring Investments Indonesia

Another funding shortfall is inadequate tax compliance. The Government's tax amnesty program in 2016-2017 identified USD87 bn of such assets overseas,[1,2] but our estimates of USD306 bn based on extrapolation of Global Financial Integrity Data suggest there is potentially another USD219 bn of undeclared assets abroad and more due from citizens who have not registered with the tax system. The success of Jokowi's effort hinges on the government's ability to bring the money back and widen the tax base.

JOKOWI'S BIG PLAN

President Joko Widodo's administration from the beginning of his term identified infrastructure as the main theme for Indonesia's economic development. Infrastructure spending increased by 65.6% in 2015 (the first year of Jokowi's administration), while the budget allocation for infrastructure continues to mark growth until 2018, meaning that infrastructure remains the big-sized ticket for growth (Fig.1). In addition, the

Fig.1: Infrastructure spending continues to record growth but lags government projections

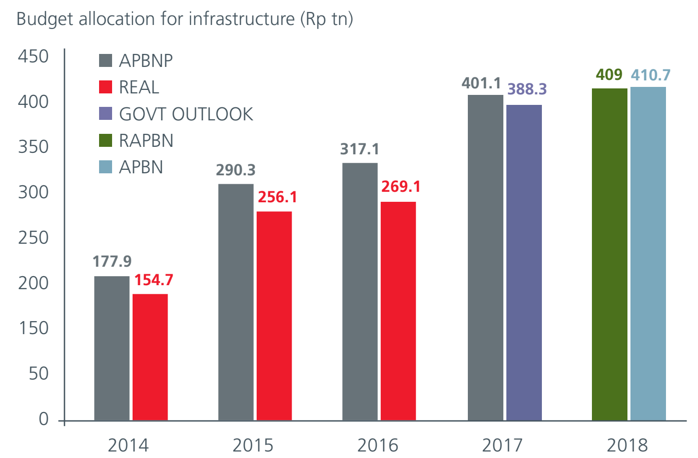


Fig.2: Lowest domestic financial assets to GDP

Latest available	Japan	Korea	Malaysia	Singapore	Thailand	China	Philippines	Indonesia	Period
Banks									July 2017 (China: August 2017)
Deposits (USD bn)	6,694	1,435	403	444	377	24,275	218	384	
Total deposits % to GDP	138.3%	95.8%	129.9%	152.1%	87.0%	205.8%	66.1%	37.6%	
Insurance									2015 (Thailand: 2014)
Total asset (USD bn)	3,296	801	61	134	22	2,035	24.4	35	
Total asset % GDP	75.2%	57.9%	20.7%	45.2%	5.0%	18.1%	8.4%	4.0%	
Pension plans									2015 (Japan: 2014)
Total asset (USD bn)	869	109	0.3	82	25	147	10.4	15	
Total asset % GDP	17.9%	7.9%	0.1%	27.7%	6.2%	1.3%	3.6%	1.7%	
Mutual funds									1Q2017 (Malaysia & Thailand: 2015, Indonesia & Singapore: September 2017
Total asset (USD bn)	1,559	433	89	19.0	103	1,244	5	24	
Total asset % GDP	32.2%	28.9%	30.0%	6.5%	25.7%	10.5%	1.6%	2.4%	
Deposit rate	0.4%	1.6%	2.9%	0.1%	1.4%	1.5%	1.7%	6.7%	2017, latest
Lending rate	1.0%	3.5%	4.6%	5.3%	6.0%	4.4%	5.8%	11.7%	

government has also set an extensive target for infrastructure inside the National Medium-term Development Plan (RPJMN) in 2015-2019, including projects for connectivity (such as roads and toll-roads, airports, and seaports), basic infrastructure, and water supply. During the three years to date of Jokowi's administration (2015-2017), the government has built around seven new airports and 2600 km of new roads[3], including 568km of toll roads, more than double the 212km of toll roads constructed in the previous 10 years.

BUT DOMESTIC FINANCIAL ASSETS CANNOT SUPPORT THE FUNDING NEEDS

Despite being Southeast Asia's biggest economy, Indonesia lags other countries in Foreign Exchange Reserves, Money Supply, Bank Deposits, Insurance, Pension Plans, Mutual Funds and Tax Collection as a percentage of GDP. Several indicators show that Indonesia ranked the lowest compared to peers in terms of financial asset accumulation as a percentage of its economic size (Fig.2). On the positive side, this means there is a large potential ahead for growing financial participation, although Indonesia's aging population and reduced birthrate is expected to lead to a nadir in the dependency ratio in 2030 at about 45%, which will then begin a gradual climb over the following decades and is expected to return to the current level at about 2040.

HOW MUCH MONEY IS STASHED OFFSHORE?

According to the World Bank, IFFs (illicit fund flows) reduce domestic resources and tax revenue needed to fund poverty-reducing programs and infrastructure in developing countries; accordingly, they are receiving growing attention as a key development challenge.

From discussions with several of our economists, we conclude that the low percentage of foreign exchange reserves compared to Indonesia's GDP, especially in comparison to the peer countries, suggests 'leakage' of financial assets overseas. The regime of free foreign exchange transactions in Indonesia enables domestic financial assets to be kept offshore, while social tensions and past instances of political instability may have triggered the initial transfers of financial assets to safer havens.

To estimate the undeclared assets offshore, we use the illicit financial flows data published by the Global Financial Integrity, which shows Indonesia in the top ten. Based on the report, Indonesia's cumulative illicit financial outflows reached USD181 bn in 2013-2014 and averaged USD18 bn per year (Fig.3)[4]. If we extend the cumulative illicit financial outflows to include the seventeen-year period from 2000-2016, then the amount of undeclared assets offshore is around USD306 bn or IDR4,070 tn. We note that the 2015 transfer of Standard Chartered's Guernsey trust accounts to Singapore ahead of Guernsey's adoption of the OECD common reporting standards involved 81 Indonesian entities with total assets of USD1.4 bn. This is just one offshore tax haven, and as Singapore won't begin reporting until 2018, and is closer, it is likely to be a more popular destination for Indonesian money. Indeed, Singapore accounted for nearly half the overseas assets declared during the tax amnesty according to the Straits Times[5].

Our own rough estimation using the average of the ratios of Philippines and Thailand for deposit, insurance, pension fund, and mutual fund investments as a percentage of GDP and compared to that for Indonesia would result in an amount of USD562 bn. Bear in mind that the Illicit Financial Flows cumulative figure below of USD181 bn did not cover the period of Suharto-era money. What remains as a challenge is to find and repatriate the missing USD306 bn to USD562 bn for Indonesia to invest in its economy.

Fig.3: Illicit financial flows from the top ten source economies, 2013-2014 (USD mn)

	Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Cumula-tive	Aver-age
1	China, Mainland	81,517	82,537	88,381	107,435	104,980	138,864	172,367	133,788	233,767	258,640	1,392,276	139,228
2	Russian Federation	46,064	53,322	66,333	81,237	107,756	125,062	136,622	183,501	129,545	120,331	1,049,772	104,977
3	Mexico	34,239	35,352	40,421	46,443	51,505	38,438	67,450	63,299	73,709	77,583	528,439	52,844
4	India	19,447	20,253	27,791	34,513	47,221	29,247	70,337	85,584	92,879	83,014	510,286	51,029
5	Malaysia	26,591	35,255	36,554	36,525	40,779	34,416	62,154	50,211	47,804	48,251	418,542	41,854
6	Brazil	15,741	17,171	10,599	16,430	21,926	22,061	30,770	31,057	32,727	28,185	226,667	22,667
7	South Africa	12,137	13,599	12,864	27,292	22,539	29,589	24,613	23,028	26,138	17,421	209,219	20,922
8	Thailand	7,113	11,920	11,429	10,348	20,486	14,687	24,100	27,442	31,271	32,971	191,768	19,177
9	Indonesia	18,466	13,290	15,995	18,354	27,237	20,547	14,646	18,292	19,248	14,633	180,710	18,071
10	Nigeria	1,680	17,867	19,160	19,335	24,192	26,377	19,376	18,321	4,998	26,735	178,040	17,804
Total of top 10		262,994	300,565	329,526	397,912	468,623	479,289	622,435	634,524	682,086	707,765	4,885,718	488,572
Top 10 as per-cent of total		56.5%	57.3%	60.6%	56.9%	56.6%	64.2%	68.7%	63.0%	65.8%	64.9%	62.3%	-
Developing world total		465,269	524,588	543,524	699,145	827,959	747,026	906,631	1,007,744	1,035,904	1,090,130	7,847,921	784,792

EFFORTS HAVE BEEN MADE TO BRING THE MONEY HOME, THE LATEST…. TAX AMNESTY

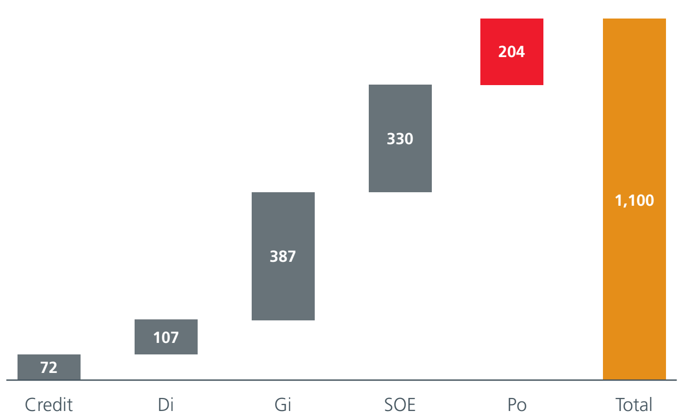
In fact, the government has made headway in identifying undeclared assets offshore through the amnesty program introduced in July 2016 to March 2017. Ultimately, the government hopes to establish a wider tax base that will generate a more sustained stream of revenue. Finance Minister Indrawati's tax reform team aims to increase the tax ratio to 15 percent of GDP in 2020 from about 11 percent now. That compares with a global average of 14.8 percent in 2014, according to the World Bank[6]. Fifteen percent of Indonesia's 2016 GDP is about USD140 bn. Only about 28 mn citizens are registered to pay taxes out of an adult population of 185 mn, which suggests rampant tax evasion.

The amnesty program offers dispensation for any taxes due, administrative sanctions, and tax criminal sanctions by declaring the assets both onshore and offshore by paying a low tax penalty. The program (Tax Office, Investor Daily 4 April 2017) ended with total asset declaration reaching IDR4,866 tn or 39% of GDP, which is the highest among countries which have recently implemented tax amnesty. However, the offshore declaration (both non-repatriated and repatriated) only reached a total of IDR1,178.8 tn or about USD87 bn, well under our low range estimate of what is stashed offshore. We conclude that Indonesian entities offshore are still hesitant to declare their assets, which we suspect may be due to continuing concerns about political instability as well as regulatory issues.

THE BIG TASK: BRINGING THE MONEY BACK

We estimate the government needs IDR5,500 tn (USD407 bn) to fund the infrastructure targets stipulated in the National Medium-term Development Plan (RPJMN) for 2015-2019, meaning that an average of at least IDR1,100 tn

Fig.4: Indonesia's estimated infrastructure funding needs per year – IDR1, 1tn



(USD81.4 bn) is required per year. Our estimate shows that there is a large gap between infrastructure funding requirements and the current funding which can be fulfilled with alternative financing such as capital markets and investor-based fundraising of around IDR204 tn per year (Fig.4). In other words, the government needs more private participation for infrastructure financing going forward which requires greater financial assets inside the country. Repatriation of domestic assets abroad is essential to fund government infra-spending. Not only can it help to sustain the infrastructure development targets, but also to strengthen the domestic financial structure and currency, since currency fluctuations may result from the movement of large rupiah-denominated assets outside of the country.

Sources: [1]https://www.reuters.com/article/us-indonesia-economy-tax/indonesia-tax-amnesty-nets-330-billion-now-for-reform-idUSKBN16S0AS. APBNP = Anggaran Pendapatan dan Belanja Negara Perubahan. REAL = Realisation. RAPBN = Rancangan Undang-Undang tentang Anggaran Pendapatan dan Belanja Negara. APBN = Anggaran Pendapatan Dan Belanja Negara. [2]IDR/USD=13,500. [3]https://www.reuters.com/article/us-indonesia-economy-infrastructure/private-sector-left-in-dust-in-indonesias-infrastructure-push-idUSKBN1CP12B. [4]http://www.gfintegrity.org/report/illicit-financial-flows-to-and-from-developing-countries-2005-2014/. [5]http://www.straitstimes.com/asia/se-asia/tax-amnesty-indonesians-repatriate-88b-from-singapore. [6]https://www.reuters.com/article/us-indonesia-economy-tax/indonesia-tax-amnesty-nets-330-billion-now-for-reform-idUSKBN16S0AS. Fig.1. Ministry Of Finance Indonesia. Fig.2. CEIC, IMF, World Bank, OECD, IIFA, Bloomberg Finance LP. Fig.3. Global Financial Integrity, Dev Kar and Joseph Spanjers, as at December 2015. Fig.4. Bappenas, BKPM, CEIC, Ministry of Finance, Mandiri Sekuritas estimate. Credit = Credit to infrastructure. Di = Direct investment to infrastructure. Gi = Government infrastructure spending. SOE = State-owned enterprise allocation for infrastructure. Po = Potential capital market financing/year.

eastspring investments

A member of Prudential plc (UK)