INVESTMENT Insights

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## Contents





# IMPROVING INDONESIA'S INVESTMENT CLIMATE

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**With a large internal market, a growing middle class, abundant natural resources and a strategic location within Southeast Asia, Indonesia has natural appeal to foreign investors. Nonetheless, the Asian crisis of 1997-1998 and the ensuing economic and political turmoil kept economic activity, including investment, far below Indonesia's potential. Years of reforms in a vast range of policy areas are now being rewarded: stable growth, enhanced investor confidence particularly among foreign investors, and a renewed rise in foreign direct investment (FDI) inflows.**

The first *OECD Investment Policy Review of Indonesia*, produced in co-operation with the Government of Indonesia, examines the country's investment climate using the *Policy Framework for Investment* which provides a checklist of important policy issues for creating an environment attractive to all investors and for enhancing the development benefits of investment to society. The review recognises Indonesia's major progress in improving its policy framework for investment, while it also suggests ways in which Indonesia's investment performance could be improved further.


## INDONESIA'S INVESTMENT POLICY DEVELOPMENT

Like many other developing countries, in Asia and elsewhere, Indonesia's early industrial and investment policies were inward-looking and aimed at import-substitution development, financed through a strong balance-of-payments and fiscal position due to high commodity prices. This stance proved unsustainable and inefficient and liberalisation started cautiously in the mid-1980s, centered on export-oriented policies.

The Asian crisis of 1997-1998 dealt a devastating blow to Indonesia's economy, leading to a 13% fall in real GDP and a frustratingly slow recovery process. Indonesia had to reappraise many existing policies, while the remarkably successful and peaceful transition to democracy also introduced new requirements to align the policy-making process and societal demands. A commitment to reform has constituted a major step towards a more open environment for domestic and foreign investment. Since 2004, President Yudhoyono's administration has built further momentum towards investment climate reforms and implemented three major economic reform packages. ►

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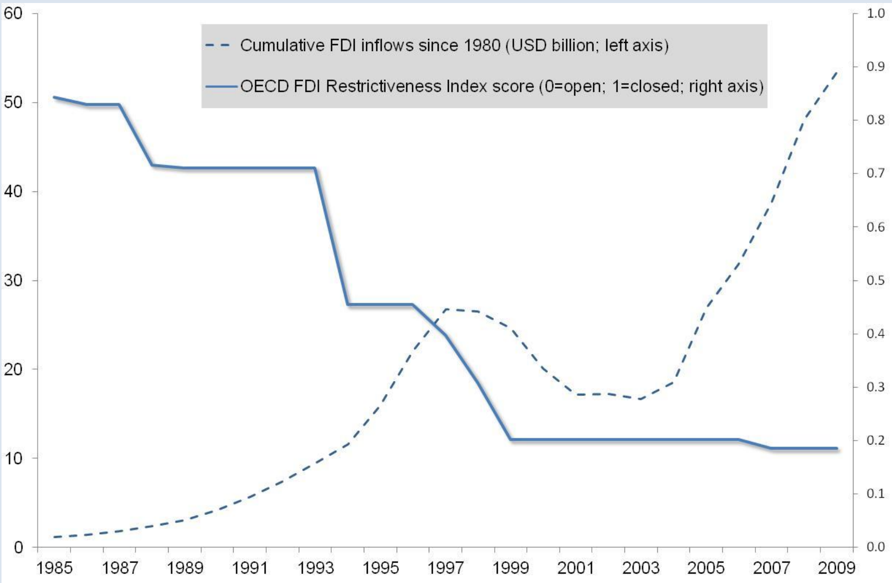
# INVESTMENT Insights

## MEASURING INDONESIA'S INVESTMENT REFORM SINCE 1985

*Over the past 25 years, Indonesia has become significantly more open to FDI*

The *OECD FDI Restrictiveness Index* captures statutory restrictions including equity ownership limits on foreign investment, discriminatory screening procedures for foreign investment and other restrictions on the operations of foreign invested enterprises. Indonesia's reform path can be measured by a simplified version of this Index (Figure 1). Indonesia has liberalised its FDI regime over the past 25 years with little backtracking. Although the Index does not indicate *prima facie* a strong downward trend since 1999, this is partly due to its focus exclusively on statutory restrictions and not on progress in implementation. Some further sectoral liberalisation has occurred, but the emphasis of the government has shifted from liberalisation *per se* to legislative and institutional reform. ►

**Figure 1. FDI liberalisation in Indonesia and the foreign investor response**




Source: OECD Investment Division

Note The FDI Index score in this figure does not correspond to the score based on the full Index in Figure 3 because the historical trend captures restrictions only in key sectors, as well as horizontal restrictions

## INDONESIA'S PERFORMANCE IN ATTRACTING FDI

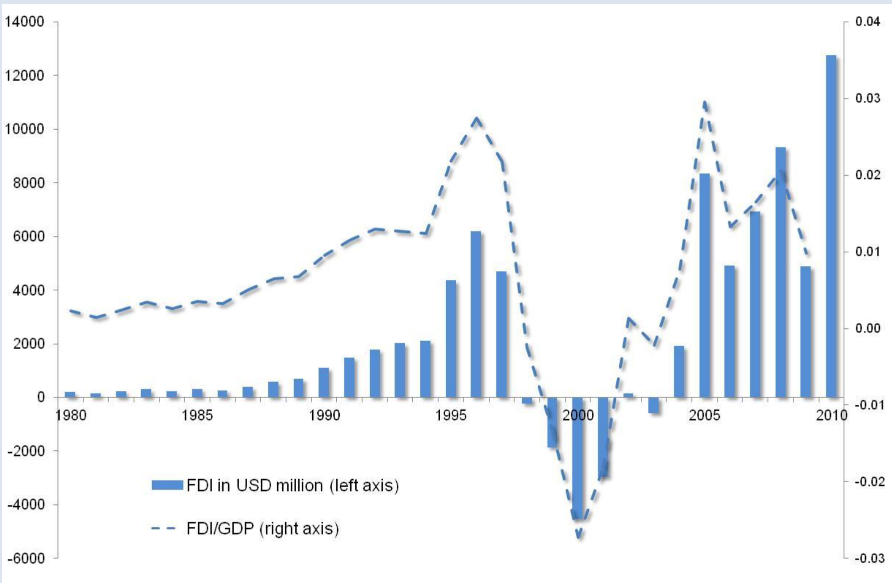
*In 2010, Indonesia attracted record FDI inflows*

Foreign investors have taken notice of these reforms. FDI flows to Indonesia have been responsive to policy changes, albeit sometimes with a time lag (see Figure 2). Periods of increasing openness were followed by surges of foreign investment flows. The exception was the late 1990s and early 2000s, when FDI liberalisation was not sufficient to offset the damage caused by the 1997-98 crisis. The tarnished perception of the investment climate caused massive net FDI outflows and haunted the country for several years.

With macroeconomic and political stability earned through reform efforts, investor confidence has finally picked up in recent years. The average annual FDI inflow of almost USD 8 billion since 2005 compares with an average net outflow of USD 1.3 billion in the previous six years. Indonesia was not spared the consequences of the recent global financial and economic crisis, but following an immediate fall in FDI flows, Indonesia is estimated to have attracted record amounts of FDI in 2010 of USD 12.7 billion – the first time inflows have exceeded USD 10 billion. Throughout much of the recent recovery period, FDI inflows were biased towards relatively small projects aiming at quick profits, rather than at larger and riskier projects with long gestation periods such as in infrastructure and in the mining sector where large investment needs persist.

The contribution of FDI to gross fixed capital formation in Indonesia has been relatively small, compared to other ASEAN peers, but FDI has created jobs, boosted productivity growth and improved access to the global market. Competition for FDI in Asia is becoming intense, among ASEAN member countries as well as with China and India. For Japan and Korea, for example, the share of FDI flowing to Indonesia has decreased vis-à-vis other Asian destinations. ►

**Figure 2. FDI inflows in Indonesia**




Source: Bank Indonesia

FDI in the labour-intensive manufacturing sector has created jobs and contributed to the increasing share of manufacturing in exports. The recent shift of FDI projects to capital-intensive sectors, such as mining, and services may not be equally advantageous in terms of employment. The challenge for Indonesia now is to improve further its policy framework to attract new foreign investment which can generate more and better jobs, upgrade the industrial and export structure, and improve competitiveness.

## WHAT MORE CAN BE DONE TO ATTRACT HIGH-QUALITY FDI?

### 1. Enhance policy predictability to ensure that investors easily understand the rules of the game

*The 2007 Investment Law enshrines both national treatment and investor protection for FDI in Indonesia"*

Economic and political uncertainty was once considered one of investors' greatest concerns. After a long period of difficult political and economic transformation, Indonesia's investment environment has greatly improved and the rules of the game have become more predictable. A number of new laws and regulations have been introduced to clarify rules for investors, of which the Investment Law of 2007 is the most important. The Law enshrines national treatment for foreign investors and investments and provides standard protection for investors. The Law has also set an overall framework of providing investment incentives, an institutional arrangement to administer investment projects, and a list of obligations/responsibilities for investors. More institutionalised public consultation on the government's new policies as well as a strengthened appeal process for investors are welcome signs of progress in creating a more transparent and predictable policy environment. But subsequent delays in creating implementing regulations partly undermine this general progress in legislation.

There have been recent cases where new regulations introduced by sector Ministries or by local governments were not consistent with higher-level regulations/policies. For example, the Ministry of Communication and Information introduced new regulations preventing any foreign equity participation in owning and managing telecommunication towers in 2008, a move which was not consistent with the prevailing list of sectors closed for foreign equity ownership.

*Implementing laws both efficiently and consistently across the country has been a challenge under the decentralised governance system*

Indonesia's "big-bang" decentralisation has also complicated policy and regulatory certainty for investors. Many responsibilities have been transferred to local governments which have variable capacity to formulate, implement and enforce regulations. New or revised regulations on taxes and levies on business activities have proliferated at the local level, adding to the burden for investors. Many local regulations conflicting with higher-level laws/policies have been already cancelled by the central government, but the ease of obtaining various business licences and land titles from local level authorities still varies greatly across the country.

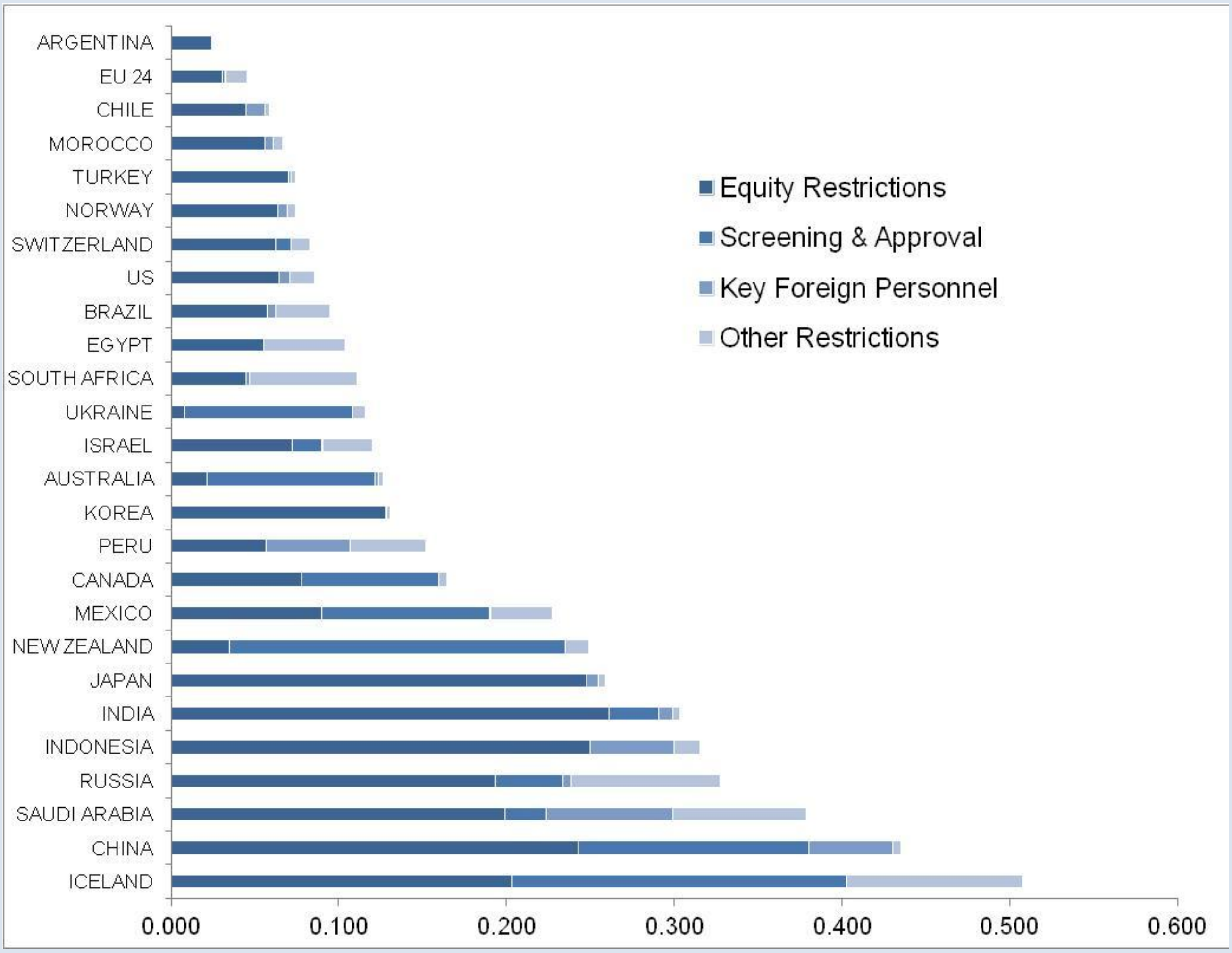
More generally, Indonesia's huge inventory of laws/regulations which are often overlapping, inconsistent, or conflicting is in part due to the lack of a systematic mechanism to develop, monitor and evaluate laws/regulations or a centralised regulatory oversight body with "whole of government" responsibility for regulatory policy. The past regulatory reform efforts have been mostly taken up at an institutional level and limited in-scope. Under the current Medium-Term Development Plan (2010-2014), the government, led by the National Development Planning Agency (Bappenas), plans to ►

conduct a comprehensive regulatory review to inventory, review and simplify laws and regulations at both central and local government levels. The OECD is supporting this initiative through a regulatory policy review of Indonesia in close co-operation with the government.

Corruption undermines fair and efficient implementation of laws and regulations and has been a major concern for businesses in Indonesia. The fall of the Suharto regime has generally improved conditions affecting the quality of governance including the freedom of the press and civil society activism, and a major push to eliminate corruption started with the Corruption Eradication Commission (KPK) and the Corruption Court from 2003. Although these two institutions have gained credibility and popular support, they still need to establish a modus operandi with other, older law enforcement institutions. ▶

**Figure 3. FDI restrictiveness index**

*(0 = open; 1 = closed)*




Source: OECD Investment Division

## 2. Encourage private sector development by further reviewing existing restrictions

*A Negative List of closed or partially restricted sectors has added greatly to transparency*

Indonesia publishes a so-called Negative List of Sectors for Investment listing sectors where private investment is either prohibited, reserved to micro, small and medium-sized enterprises, or subject to special requirements or where foreign investors face certain restrictions, notably joint venture requirements and limits on foreign holdings of company shares. This negative list approach has added greatly to the transparency of Indonesia's investment regulations over the earlier positive list approach where foreigners could invest only in sectors included on the list. In particular, the negative list approach has eliminated overlaps in various regulations and clarified areas which had been ambiguous or open to interpretation.

*While the Negative List is relatively long, the government has been striving to open up more sectors to FDI and to ensure greater policy stability*

The current list of sectors with restrictions for FDI is nevertheless long, making Indonesia's FDI regime more restrictive than the average in OECD countries, according to the *OECD FDI Restrictiveness Index* (see Figure 3). While Indonesia has no separate screening mechanism for foreign investment across the board, the restrictions typically take the form of foreign equity ownership limits, particularly in services. As Ministries have been largely free to set their own equity limits, there is a bewildering range of limits between 0-99%, the harmonisation of which can simplify the regulatory environment for foreign investors. The list was most recently revised in June 2010 and offered both increased sectoral liberalisation and an improved presentation. To ensure the stability in the List and avoid sudden changes to the status quo, the government proposes new procedures to require Ministries to perform cost-benefit analysis to justify any future changes in restrictiveness under the Negative List. Such analysis can also be applied to existing restrictions when they are reassessed in light of the policy objectives they are intended to achieve.

A regulatory environment conducive to competition is a good basis for private sector development including both domestically- and foreign-owned enterprises. On this aspect, Indonesia has improved since 1999, starting from highly distorted market conditions where monopolistic practices by a few conglomerates were prevalent and the government maintained many anti-competitive regulations. The first Competition Law was enacted in 1999 and the Commission for the Supervision of Business Competition (KPPU) started to enforce the Law in 2000. As the implementing regulations concerning M&A transactions were finally issued in 2010 after a long delay, KPPU is expected to start actively reviewing M&A cases including cross-border transactions, with a view to preventing any anti-competitive impact. Enforcement of vigorous anti-monopoly and competition legislation will facilitate further liberalisation of entry restrictions on foreign investment ▶

**Box 1. Sectoral laws relating to infrastructure, 1999-2009**

Aviation (2009)

Electricity (2002, 2009)

Energy (2007)

Geothermal energy (2003)

Information and electronic transactions (2008)

Railways (2007)

Roads and toll roads (2004)

Road traffic (2009)

Sea transport (2008)

Telecom (1999)

Water resources (2004)

by eliminating local fears that liberalisation would allow foreign-invested enterprises to exploit their market power.

*Sectoral reforms are opening up SOE dominated markets to private sector participation*

Promotion of competition and hence productivity growth also require sectoral reforms, particularly in infrastructure and utility services sectors which have been dominated by a few state-owned enterprises (SOEs). To open up these markets to private sector participation and clarify the regulatory environment, Indonesia has enacted new laws or revised existing laws in all major infrastructure sectors (see Box 1). In some cases, new sectoral regulators have been set up; in other cases corporate governance of the SOEs has been improved to inject commercial principles in their operation. The recent reforms have been motivated by the government's need for the private sector to finance the country's large infrastructure deficit and the expectation that the private sector can bring not only additional finance but also technical expertise and management competence. Despite a legislative and institutional framework put in place by the government to accommodate private investment, regulatory uncertainty seems to remain a major obstacle to private investors.

## 3. Continue cutting red tape for investors at both local and central levels

*The government is committed to implement one-stop integrated services for investors both centrally and locally*

Investment promotion and facilitation is the responsibility of the Indonesian Investment Co-ordination Board (BKPM) which registers both domestic and foreign investment projects as well as acting as the country's investment promotion agency (IPA). Motivated partly by its relatively poor performance in the World Bank's *Doing Business* indicators, Indonesia has focused efforts to reduce red tape for business on implementing one-stop integrated services (PTSP) for investors at both central and local levels. This PTSP system aims to consolidate multiple licences into one administrative step, introduce an electronic, automated platform, and hence cut the processing time and improve the predictability and transparency in investment registration significantly. BKPM is designated as the central level agency to provide PTSP while a respective regional body responsible for investment is to implement it at the local level.

Although a number of government regulations and notifications have been issued to support the PTSP system, the actual impact on the investment climate has so far been slight. While several Ministries have transferred their licensing authority or technical staff to BKPM, there remains an excessively large number of licences which should be further streamlined. Local level implementation of PTSP has been uneven, reflecting the great diversity in capacity, political support, co-operation from other technical departments and pressure from local business. Strong government leadership and careful planning of implementing steps in consultation with stakeholders are necessary to achieve more efficient and predictable investment registration.

At the same time, decentralisation has encouraged enterprising local governments to experiment with innovative economic reforms and investment promotion activities. Healthy competition among local governments can spread good practices across the country. The central government can support this process by clarifying authority and responsibilities between the central and local governments, providing guidance and capacity building for local governments to enforce the central level regulations, and facilitating learning and exchange of good practices among local governments. ►

## 4. Maintain investment incentives to be non-distorting, transparent and broad-based

*Indonesia currently provides fiscal incentives for investment for several business fields and locations regardless of the ownership of enterprises*

Indonesia has tried many different approaches to investment incentives, including periods when no incentives were offered. As the corporate tax rate has decreased for all enterprises over time, the role and impact of specific incentives have been significantly reduced. The Investment Law of 2007 defines the type and criteria for granting fiscal incentives for investment, and the current regulations to provide investment incentives target several business fields and locations, regardless of the ownership of enterprises. The procedure for enterprises to avail themselves of these incentives is transparent and clear.

In spite of improvements in the design and administration of investment incentives, the benefits from incentives – if they materialise – may be marginal vis-à-vis the costs, estimated to be between one half to two per cent of GDP in ASEAN countries.* Hence, continuous review of existing and proposed incentives is necessary to ensure that incentives achieve their objectives without any unintended distortions. Indonesia should designate this review responsibility to a taskforce or a government agency, such as the National Team on Export and Investment Promotion (PEPI).

*The government has adopted the Law on SEZs as part of zone-based investment promotion strategies*

The government has also pursued zone-based investment promotion strategies, upgrading existing export promotion, bonded and industrial zones. Zone-based investment promotion might be promising for Indonesia which is geographically too large to ensure adequate infrastructure, human resources and administrative capacity for investment promotion across the whole country in a short period of time. The Law on Special Economic Zones (SEZs) was adopted in 2009 to provide a legal and institutional framework to develop more comprehensive economic zones which are expected to become a locomotive for economic development in targeted regions. It is still too early to analyse the impact of SEZ policies, as implementing regulations have not been issued. ■

* OECD (2004), "Investment incentives and FDI in selected ASEAN countries", International Investment Perspectives, Paris

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### For further reading:

OECD work on international investment
www.oecd.org/daf/investment