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Foreword

Building on the achievements since the first *OECD Investment Policy Review of Indonesia* completed in 2010, this *2nd Review* presents an assessment of the investment climate in Indonesia to support the government in its ongoing reform efforts. Based on the *OECD Policy Framework for Investment*, the *Review* identifies challenges and opportunities and provides recommendations to increase competitiveness, support growth and ensure investment contributions are widely shared and environmentally sustainable. Chapters cover trends and impact of foreign direct investments (FDI), re-thinking the FDI regime, investor protection and dispute resolution, promoting and enabling responsible business conduct, investment promotion and facilitation, and investment policy and regional development in decentralised Indonesia. The *Review* places great emphasis on measures to build a sound, transparent and responsible investment environment to support a resilient economic recovery from the COVID-19 pandemic.

This *Review* has been prepared by the OECD Secretariat at the request of the Government of Indonesia. It was carried out in close co-ordination with the Indonesian Investment Coordinating Board (BKPM) and supported by an inter-ministerial task-force established to discuss the *Review* in a whole-of-government approach. It has benefited from the peer review of the OECD Investment Committee and stakeholder consultations with Indonesia-based foreign government representatives, international organisations, the private sector, civil society and academia.

The *Review* was prepared by a team led by Alexandre de Crombrugghe and comprising Fares Al Hussami, Alessandra Celani, Fernando Mistura, Letizia Montinari and Baxter Roberts from the OECD Investment Division, and Tihana Bule from the OECD Centre for Responsible Business Conduct, under the overall guidance of Stephen Thomsen, Head of OECD Investment Policy Reviews. Massimo Geloso Grosso, Head of Jakarta Office, and Yulianti Susilo, consultant, provided help in the co-ordination and organisational process in Indonesia. Edward Smiley prepared the report for publication. Angèle N'Zinga provided administrative assistance. Secretariat inputs and comments were received from Ana Novik, Head of the Investment Division, Syrine El Abed, Clémentine Faivre, David Gaugkrodger, Emilie Kothe, Simon Long, Joachim Pohl and Martin Wermelinger from the Investment Division, Rena Hinoshita from the Centre for Responsible Business Conduct, Andrew Auerbach from the Centre for Tax Policy and Administration, James Drummond and Mike Pfister from the Directorate for Public Governance, Andrea Goldstein from the Economics Department, Jeremy Faroi and Cecilia Tam from the Environment Directorate, and Massimo Geloso Grosso from Global Relations.

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Abbreviations and acronyms

AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
ACIA	ASEAN Comprehensive Investment Agreement
ADB	Asian Development Bank
AI-CEPA	Australia-Indonesia Comprehensive Economic Partnership Agreement
AMDAL	Environmental Impact Assessment
AMNE	Analytical Activities of Multinational Enterprises
ASEAN	Association of South East Asian Nations
ASEAN PAC	ASEAN Parties Against Corruption
BADPSKI	Construction Dispute Arbitration and Alternative Dispute Resolution Institution
BAL	Fundamentals of Agrarian Affairs
BANI	Indonesian National Board of Arbitration
BAPPENAS	Ministry of National Development Planning
BDS	Business Development Service
BI	Bank of Indonesia
BIT	Bilateral Investment Treaty
BKF	Fiscal Policy Agency
BKPM	Indonesian Investment Coordinating Board
BPN	National Land Agency
BSSN	National Cybersecurity Agency
CEFIM	Clean Energy Finance and Investment Mobilisation
CETA	Comprehensive Economic and Trade Agreement
CIT	Corporate Income Tax
CLMV	Cambodia, Lao PDR, Myanmar and Viet Nam
COVID-19	Coronavirus Disease 2019
CPTPP	Comprehensive and Progressive Trans-Pacific Partnership Agreement
CSR	Corporate Social Responsibility
DKI	Special Capital Region
DNI	Negative Investment List
DPI	Investment Priority List
DPMPTSP	Regional Co-ordinating Investment Agencies
EMMP	Environmental Management and Monitoring Program
EPA	Economic Partnership Agreement
ESCAP	United Nations Economic and Social Commission for Asia and the Pacific
ESG	Environmental, Social and Governance
EU	European Union
EURASIA	Eastern Europe, Southern Caucasus and Central Asia
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FTA	Free Trade Agreement
FTZ	Free Trade Zone

GDP	Gross Domestic Product
GVC	Global Value Chain
IBL	Indonesia Business Links
ICT	Information and Communication Technology
IDR	Indonesian Rupiah
IEA	International Energy Agency
IFC	International Finance Corporation
IIPC	International Investment Promotion Centre
ILO	International Labour Organization
IMF	International Monetary Fund
IOM	International Organization for Migration
IP	Intellectual Property
IPA	Investment Promotion Agency
IPR	Investment Policy Review
ISDS	Investor-State Dispute Settlement
ISIC	International Standard for Industrial Classifications
ISPO	Indonesian Sustainable Palm Oil
ITF	International Transport Forum
JETRO	Japan External Trade Organization
KADIN	Indonesian Chamber of Commerce and Industry
KAPET	Integrated Economic Development Zones
KBLI	Standard Classification of Indonesian Business Fields
KEK	Special Economic Zone Programme
KPK	Corruption Eradication Commission
KPPOD	Regional Autonomy Implementation Monitoring Committee
KPPU	Indonesian Competition Commission
LAC	Latin America and Caribbean
M&A	Merger & Acquisition
MENA	Middle East and North Africa
MFN	Most Favoured Nation
MNE	Multinational Enterprise
MoF	Ministry of Finance
MSME	Micro, Small and Medium Enterprise
MST	Minimum Standard of Treatment
NAP	National Action Plan
NDC	Nationally Determined Contribution
NGO	Non-governmental Organisation
NIB	Company Identification Number
NT	National Treatment
OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of the Islamic Conference
OGP	Open Government Partnership
OHCHR	Office of the United Nations High Commissioner for Human Rights
OJK	Financial Services Authority
OMP	One Map Project
OSS	Online Single Submission
PFI	Policy Framework for Investment
PISA	Programme for International Student Assessment
PMA	limited-liability Company with Foreign Shareholding
PT	Limited-liability Company
PTSP	One-stop Integrated Services Centre
R&D	Research & Development
RBC	Responsible Business Conduct

RCEP	Regional Comprehensive Economic Partnership
RDTR	Local Land Use Planning
SDG	Sustainable Development Goal
SEZ	Special Economic Zone
SKPD	Specific Technical Agency
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprise
SPIPISE	Electronic Information and Licensing Service System
SSDS	State-to-State Dispute Settlement
STAR	Sustainable Textile of Asian Region
TiVA	Trade in Value Added
TFP	Total Factor Productivity
TRIPS	Trade-Related Aspects of Intellectual Rights
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference for Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
US	United States
USAID	United States Agency for International Development
USD	United States Dollar
USMCA	United States Mexico Canada Agreement
USTR	United States Trade Representative
VAT	Value-Added Tax
VNR	Voluntary National Review
WEF	World Economic Forum
WIPO	World Intellectual Property Organization
WTO	World Trade Organization
WWF	World Wide Fund

Executive summary

Indonesia has made remarkable economic, political and social progress over the past two decades through ambitious reforms. Steady economic growth, sound macroeconomic policies and progress in social protection have raised living standards and reduced poverty in both rural and urban areas. The COVID-19 pandemic has halted this progress and plunged Indonesia into a severe recession with dire economic and social consequences.

Private investment, both foreign and domestic, can contribute strongly to Indonesia's recovery from the pandemic. Foreign direct investment (FDI) has dropped significantly during the crisis and will be needed to achieve the country's sustainable development objectives. Foreign firms in Indonesia are more productive, have higher employment ratios and pay higher wages than domestic firms. They also export a higher share of their production and generate important multiplier effects on the domestic economy. While the government has put business environment reforms high on its agenda, it has the opportunity to build a sound, transparent and responsible investment environment to support the economic recovery from the pandemic and ensure investment benefits are widely shared and environmentally sustainable.

Policymakers have yet to demonstrate their intention to establish a clear role for FDI in Indonesia's development ambitions. Already before the outbreak, Indonesia was failing to live up to its potential as a host to FDI, despite its numerous attributes. On the one hand, there is a desire to protect the local economy from foreign investment, on the other a willingness to undertake deep reforms to further benefit from FDI. Government efforts on transparency, the rule of law and the quality of institutions have been notable but insufficiently consistent to improve investor confidence and ensure responsible business practices by foreign and domestic companies. Roles and responsibilities across ministries are sometimes unclear and uncoordinated. And while decentralisation came with new opportunities, it also makes it challenging to conduct consistent investment policymaking. The Omnibus Law on Job Creation enacted in October 2020 is a major reform package seeking to address many of these challenges. While it is premature to analyse its full impact, the law presents opportunities to improve the investment climate but may also pose some risks to society.

Despite past liberalisation efforts, Indonesia's approach towards FDI remains restrictive, with many primary and services sectors still partly off limits to foreign investors. A range of discriminatory policies apply across the board, such as higher minimum capital requirements for foreign-invested companies and stringent conditions on employing foreigners in key management positions. Local content requirements are also widespread, adding to the hurdles of carrying out foreign investments. A bold and comprehensive reform package to significantly reduce FDI barriers could increase the stock of FDI by up to 85%. Indonesia should consider prioritising liberalisation of FDI in services sectors due to their economy-wide productivity implications, eliminating discriminatory requirements against FDI in horizontal regulations and preserving the current 'negative list' approach to ensure transparency.

Indonesian law provides core protections to investors relating to non-discrimination, expropriation and free transfer of funds. These protections generally provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are robust. An overarching regulatory framework for cybersecurity and data protection would better help Indonesia meet its objective of developing the digital economy. In terms of dispute resolution, the Indonesian court system lacks transparency and impartiality, with many firms preferring to use alternative dispute resolution. Fighting corruption in all levels of society has also been a top priority for many years but efforts to build a culture of integrity in the public sector could be reinforced. A comprehensive review of investment treaties was conducted in 2014-16, but priorities with respect to investment treaty policy could continue being reassessed, clarified and updated.

Indonesia was one of the first countries to integrate corporate social responsibility within the legal framework and has recently promoted responsible business conduct (RBC), notably in sustainable finance and business and human rights. Indonesia's ambition to introduce transparency of beneficial ownership information is also notable. A more strategic approach to promoting RBC across sectors by the government may be warranted, particularly in light of the social impact COVID-19 has had on Indonesia's manufacturing sector and the high environmental costs that growth so far has brought. Embracing RBC would help the government ensure ongoing industrial strategies are fit-for-purpose for today's global economy and help re-orient the financial sector toward sustainable finance. Greater focus could be given to existing business operations in sectors where risks are high, and incorporating RBC in state-owned enterprises would give a signal to the market.

Recent business environment reforms include the establishment of an online single submission system to harmonise the business licensing process, which still suffers from inefficiencies and implementation issues. The Omnibus Law on Job Creation seeks to address the ease of doing business in a structural manner, but wide-ranging consultations are needed to ensure its implementation is both successful and beneficial. The pandemic has also revealed that reinforced aftercare services supporting established investors are crucial in times of uncertainty. In parallel, as the pipeline of new FDI projects is likely to drop, a more focused investment promotion strategy would be well-advised in recovery efforts. Indonesia's tax incentives are among the most generous in the region and could be used more judiciously in investment promotion. The gradual shift to cost-based incentives is a positive development. Efforts have also been made to increase transparency and communicate incentives more clearly, but the wider tax incentive scheme remains complex.

Ambitious decentralisation reforms since 1998 have shaped regional development and the geography of investment across the country. Regional governments have the authority to develop and implement their own investment-related regulations, in accordance with higher-level national regulations. Despite the establishment of regional one-stop integrated services centres, the lack of co-ordination between the central and subnational governments, the unclear division of authority and overlapping regulations remain important challenges. Investment policymaking has been increasingly recentralised to improve the business climate, but subnational governments should be involved in the decision-making process and gradually build their capacity to ensure a sustainable approach in the longer-term.

1. Assessment and recommendations

This chapter starts with an overview of Indonesia's development path and summarises the main findings and recommendations of the Investment Policy Review.

Introduction

Indonesia has made remarkable economic, political and social progress over the past two decades, as the government has embarked on ambitious reforms to modernise the country. A founding member of the Association of South East Asian Nations (ASEAN) and of the G20, which it will chair in 2023, Indonesia plays an ever more influential role in the regional and global landscape. While it was slowly on the road to become a high-income economy, the COVID-19 pandemic has plunged Indonesia into a major crisis.

Sound macroeconomic policies and progress to develop the social protection system have allowed the country to increase living standards and reduce poverty in both rural and urban areas. Underpinned by prudent macroeconomic policies, gross domestic product (GDP) per capita has risen by 70% during the past two decades with a GDP growth of approximately 5% per year since 2013 (OECD, 2018a). Recognising that the private sector is essential for prosperity and development, measures to improve the business environment have also been high on the agenda of successive governments.

Meanwhile, the health crisis spurred by the COVID-19 outbreak is generating dramatic economic and social turmoil. Growth projections for 2020 have been significantly revised downwards by the government and international organisations. The OECD expects a severe recession with GDP projected to contract by 3.3% in 2020 (OECD, 2020a). Amid social containment measures, in April 2020 economic activity dramatically contracted and the recovery has been very slow and incomplete. Tourism and manufacturing are the most affected sectors and job losses have exceeded 2.8 million since mid-March (OECD, 2020b). The government took a series of well-coordinated monetary and policy measures to respond to the crisis, although their impact has been less supportive than expected.

Foreign direct investment (FDI) has traditionally played a key role in raising employment and productivity and in generating exports in Indonesia, which has historically been a relatively important FDI destination in ASEAN. The largest share of FDI during 2009-18 went to manufacturing, although the share is declining and services have received increasing flows. The primary sector also attracts a large share of FDI due to the country's rich endowment of natural resources. Yet, already before the pandemic, the authorities' efforts to improve the investment climate were not sufficient to fully exploit the country's FDI potential. FDI inflows have recently declined as a share of GDP and Indonesia's share in FDI flows into ASEAN has fallen in the past few years. Additionally, with global FDI flows expected to plummet by more than 30% in 2020 (OECD, 2020c), Indonesia has not been spared. Cross-border equity flows have already dropped significantly during 2020 relative to 2019, as companies have put merger and acquisition (M&A) deals and greenfield projects on hold due to rising uncertainty.

Private investment, both foreign and domestic, will need to play an important role in the recovery. Before the pandemic outbreak and following President Joko Widodo's re-election in 2019, the government set ambitious targets for the year 2045 when Indonesia will celebrate its 100th anniversary as an independent nation. It aims at breaking out of the middle-income trap, to become a developed economy and enter the world's top five economies with a GDP worth over USD 7 trillion, while also substantially reducing greenhouse gas emissions. In order to achieve these goals, the government has placed private sector development at the centre of its reform agenda and identified the following priorities for the next five years: infrastructure development; human capital development; simplification of regulations; bureaucratic reforms; and economic transformation.

The Indonesian government has an opportunity to further strengthen its reform efforts, in order to build a sound and transparent investment environment that supports a sustainable and inclusive economic recovery from the COVID-19 pandemic. Based on an updated version of the *Policy Framework for Investment,* this second *OECD Investment Policy Review of Indonesia* identifies several potential areas for reform and provides policy recommendations for the government to consider. After an overarching background of Indonesia's development path and summary of the main findings and recommendations (Chapter 1), the review analyses the trends and impacts of FDI on the Indonesian economy and society

(Chapter 2), options to re-think the country's FDI regime (Chapter 3), investment protection and dispute settlement (Chapter 4), policies to promote and enable responsible business conduct (Chapter 5), measures and institutions to promote and facilitate investment, including tax incentives (Chapter 6) and investment policy and regional development in decentralised Indonesia (Chapter 7).

The Policy Framework for Investment

The Policy Framework for Investment (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate. The PFI was first developed in 2006 by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. Designed by governments to support international investment policy dialogue, co-operation, and reform, it has been extensively used by over 25 countries as well as regional bodies to assess and reform the investment climate. The PFI was updated in 2015 to take this experience and changes in the global economic landscape into account.

The PFI is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in 12 policy areas: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; promoting responsible business conduct; human resource development; infrastructure; financing investment; public governance; and investment in support of green growth. Three principles apply throughout the PFI: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

The value added of the PFI is in bringing together the different policy strands and stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It does not provide ready-made reform agendas but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and for various purposes by different constituencies, including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions.

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising the economic and social returns. Quality matters as much as the quantity as far as investment is concerned. It also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small. The objective of a good investment climate is also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

For more information on the PFI, see: www.oecd.org/investment/pfi.htm.

Overview of Indonesia' development path

Democratisation and decentralisation have progressed albeit not without challenges

Since the end of the Suharto regime in 1998, Indonesia has been a transparent and accountable democracy. The presidential election held in 2019 was the largest ever, recording an 81% participation rate and the decentralisation process is also continuing with regional development policies now very much in the hands of the four sub-national tiers of government.

From the early 2000s, Indonesia embarked upon a profound and long-lasting decentralisation process, which involved transferring both decision-making and financial resources for the delivery of basic services, such as the provision of transport infrastructure, to local governments. Policymaking started to be shared vertically between central and local governments and decision-making on health, primary and middle-level education, public works, environment, transport, agriculture, and manufacturing shifted to the local level (OECD, 2010).

The speed of the devolution has meant that the required accompanying skills, technical capacities, resources and oversight have sometimes been lacking. As a result, while good progress has been made nationally along a number of dimensions, outcomes in health, education, infrastructure, good governance and the provision of other social services have not improved as quickly as was expected, and the variance in results across regions has been enormous (OECD, 2018a). Conflicting and overlapping laws and regulations across levels of government are also inhibiting regional development by obstructing private business development and investment.

Indonesia has been actively fighting corruption since the early 2000s and good governance has gradually improved as a consequence, but it remains a massive endeavour. Indonesia ranked 85th out of 198 countries on Transparency International's Corruption Perception Index in 2019, gradually improving its position from 137th in 2005, 110th in 2010 and 88th in 2015. The Corruption Eradication Commission (KPK) was created in 2002 to investigate and prosecute corruption cases and to monitor the governance of the state. Although KPK's resources and institutional capacities are largely concentrated at the national level, thus leaving the fight against local corruption primarily in the hands of local governments, it has enjoyed a significant degree of autonomy and has been recognised as a leading and successful player in reducing corruption. A new KPK law was passed in September 2019, however, which has the potential to jeopardise the influence and independence of the commission.

Until the pandemic, economic growth had been solid and steady

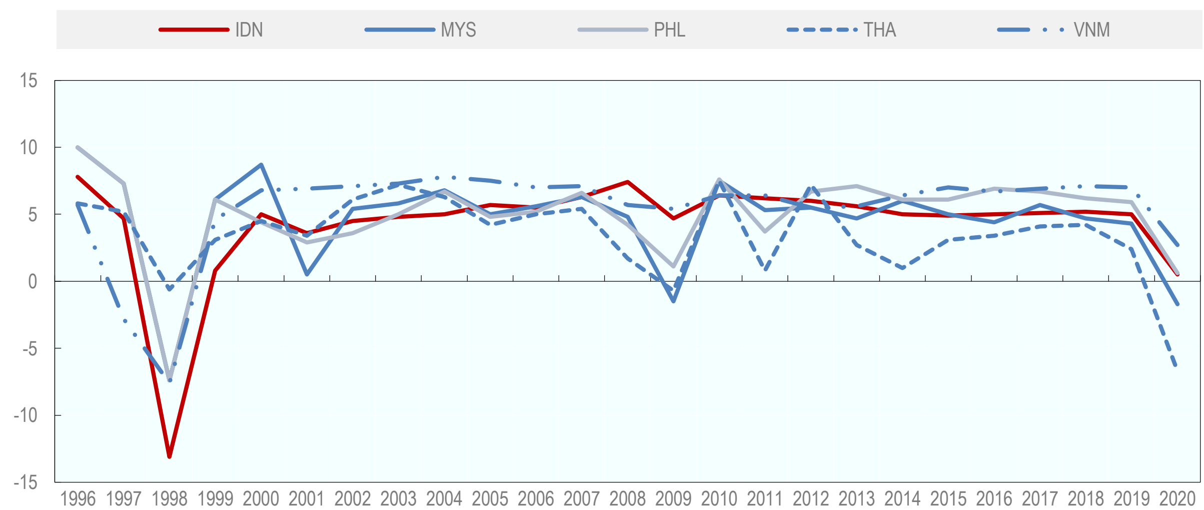
Until the COVID-19 outbreak, Indonesia's economic growth record had been strong over the past decades and achieved a significant degree of stability. GDP growth averaged 7% between 1966 and 1996 and approximately 5% in the 2000s and since the global financial crisis (Hill, 2018).

Prudent macroeconomic policies and progress in structural reforms have been driving this strong and continued economic growth. Following the 1998 Asian financial crisis, the government pressed on with economic reforms without resorting to protectionist responses. The number of laws introduced after the crisis was unprecedented. Beyond those covering regional autonomy, new laws were introduced in almost all areas of economic activity, including: investment, labour, arbitration, bankruptcy, company law, competition, tax administration, human rights, mining, oil and gas, geothermal and other energy, and in other infrastructure sectors (OECD, 2010). GDP started to recover in 2000, admittedly less than other Asian countries such as India (7.2%) or Viet Nam (6.5%), accelerating from 2001 to 2005, and then fluctuating until reaching a peak in 2007.

The 2008 global financial crisis did not significantly affect the country, as the growth rate decreased to 4.6% in 2009 but quickly recovered in 2010 to reach 6.2% (Figure 1.1). The remarkable macroeconomic stability since then was possible thanks to a strong macroeconomic policy framework implemented by the government. Prudent fiscal policy has been underpinned by a commitment to a fiscal deficit of no more than 3% of GDP and public debt no higher than 60% of GDP (OECD, 2018a). Bank Indonesia has the mission to stabilise the value of the rupiah and pursue its inflation target, which has until recently been low, maintained at around 3%.

Figure 1.1. Real GDP growth in five ASEAN countries, 1996-2020

Annual %



Note: Data for 2020 are IMF projections.
Source: IMF DataMapper.

Macroeconomic stability is also dependent on the capacity to finance its current account deficit, which has been a challenge for Indonesia. The current account has been in deficit since 2012, averaging 2.5% of GDP over 2012-19. Tax revenues remain low, including due to the large informal economy (see below) with one of the lowest tax/GDP ratio across countries of the same income category (OECD, 2018a). Low government revenues limit spending, notably on education, health and social protection.

While national and international observers announced encouraging growth prospects for 2020, notably due to the gradual easing of international trade tensions and the renewed political stability, the sudden and dramatic outbreak of the COVID-19 is taking a heavy toll on the world economy, thus affecting Indonesia's development outlook. The government has mentioned two possible scenarios: a baseline one with GDP growth down to 2.3% and a worst-case scenario with a contraction of 0.4%. The OECD estimates that a severe recession will affect the country with GDP projected to contract by 3.3% in 2020 (OECD, 2020a).[1] Employment and income losses are holding back consumption and the socio-economic consequences of the crisis are severe for lower middle class groups. The hardest hit sectors are tourism, retail trade and manufacturing.

As in many OECD countries and beyond, the government swiftly responded with comprehensive and substantial policy actions during the first half of 2020 to support purchasing power and businesses. Bank of Indonesia decided to cut interest rates and the President signed on 1 April a regulation lifting a Constitutional cap on the budget deficit for three years. Successive stimulus packages included the expansion of social protection schemes, strengthening the health sector, food assistance and electricity tariff discounts, tax breaks and incentives for industries, capital injections to state-owned enterprises (SOEs) and liquidity support for the banking industry, among others.

The manufacturing sector has been steadily declining as a share of GDP, but there is a gradual shift from the extractive industry to services

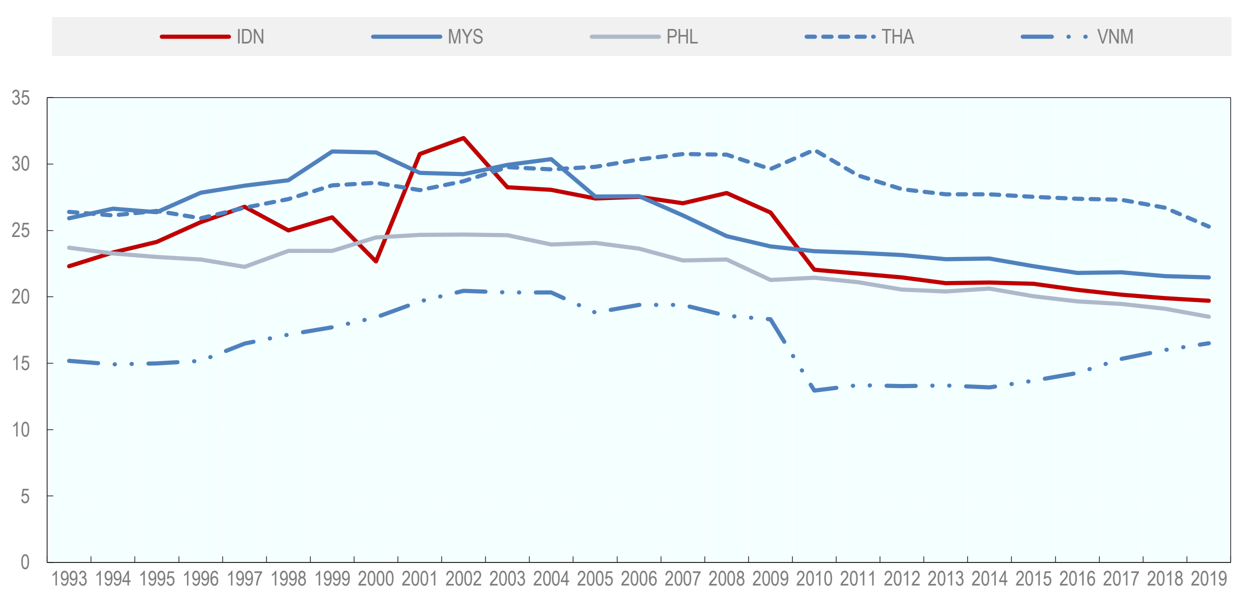
The evolving structure of the economy reflects the country's natural resource endowment and its current development path. Despite a faster growth of services compared to the primary and secondary sectors, the Indonesian economy is still characterised by a low share of services: 43.4% of national value added in 2018, compared to 70.7% in OECD countries (in 2017) and 53.8% of GDP in other middle-income countries. Industry – including construction, manufacturing and mining – accounted for almost 39% in 2019.

Indonesia is a natural resources rich economy and agriculture thus remains a key contributor to GDP, accounting for 13% in 2019. With 30% of the total workforce, the primary sector remains the greatest employer (Lewis, 2020). Indonesia is the world's largest producer of palm oil and provides about half of the world's supply. It is also the second-largest rubber producer in the world. When counting mining products as well (e.g. coal, copper, oil), natural resources accounted for 20% of GDP and 50% of exports in 2017 (OECD, 2019a). Both the productivity level and productivity growth rate in the primary sector are low, however.

The value added of manufacturing[2] in Indonesia steadily increased from 1985 until the Asian financial crisis, thanks to the government's efforts to stimulate investment, including FDI, which generated strong economic growth (ADB, 2019a). The sector then suffered from the crisis, unlike in some other ASEAN countries and its contribution to GDP has thus been declining since then (Figure 1.2). It dropped from over 27% of GDP in 2005 to less than 20% in 2018, which represents an important drop for a middle-income economy. As the manufacturing sector is still undiversified, the country exports relatively few products with comparative advantage (ADB, 2019a). Currently, the manufacturing sector – particularly the textile industry – is one of the most hit by the COVID-19 crisis. In April 2020, only one third of manufacturing firms and workers were operational (OECD, 2020b). Throughout all economic sectors, job losses since mid-March have exceeded 2.8 million.

Figure 1.2. Manufacturing value added in five ASEAN countries, 1993-2019

% of GDP



Source: World Bank Development Indicators.

Indonesia's exports are driven by minerals and food products, as well as textiles and apparel. Exports have stagnated since 2007, both in absolute terms and as a share of GDP, and represent a declining segment of the economy.[3] In the face of the pandemic, international trade figures are not as alarming as in other countries, as Indonesia is less exposed to the disruption of global value chains. Manufacturing companies are, however, heavily reliant on inputs imported from China (OECD, 2020b).

Manufacturing growth is also hampered by the comparatively small size of firms in Indonesia. The majority of firms are small and medium-sized enterprises (SMEs) (92-99%), which employ the bulk of the domestic workforce (58-91%). Yet they represent only about a third of total value added and their contribution to trade remains limited (Lopez-Gonzalez, 2017). The number of large enterprises in Indonesia (5 066 in 2016) is low given the size of the economy, contrasting with 7 156 large enterprises in Thailand and 13 813 in Malaysia (OECD, 2018b). This is even stronger in the manufacturing sector – 99% of manufacturing firms being micro and small enterprises – which is an impediment to the technological transformation of the Indonesian economy, as such firms suffer lower productivity and have little capability to adopt and use new and digital technologies (ADB, 2019b).

Recognising the challenges of the manufacturing sector and the opportunities provided by new technologies, the government recently developed a strategy called *Making Indonesia 4.0* aimed at revamping the industrial sector and increasing labour productivity. It focuses on technology and productivity upgrades in five manufacturing industries: food and beverages, textiles and garments, automobiles, electronics, and chemicals. With the service sector gradually playing a more important role, Indonesia seeks to increase the digitalisation of all economic sectors and to position itself as a regional hub for the digital economy. This has become an even stronger trend in the context of the COVID-19 crisis.

Continued growth has reduced poverty, but improving the quality and competitiveness of human resources is necessary

Indonesia's recovery from the 1997 Asian financial crisis and its solid growth since then has led to an impressive reduction in poverty. Poverty rates fell sustainably from 19% of the population in 2000 to just over 9% in 2019 (World Bank, 2019b). A significant improvement in living standards has also been recorded since the Asian crisis, as GDP per capita has risen by 70% during the past two decades and per capita income has increased by almost 4% annually (OECD, 2018a). Efforts by the government to expand social assistance programmes, deployed since 2000, also contributed to those achievements.

The decline in poverty slowed significantly after 2010, however, with 38% of the population remaining poor or vulnerable in 2016 (OECD, 2019c). Inequality, as measured by the Gini coefficient, also rose over the past decades, from 30 points in 2000 to 41 in 2015, then declining to 38.2 at the beginning of 2019 (World Bank, 2019a). Despite this recent slight decline, Indonesia continues to record greater inequalities than Thailand (36.4 in 2018) and Viet Nam (35.7). Regional inequalities are also significant in Indonesia, as the five poorest provinces are located in the east, and their poverty rates in 2016 were, on average, 18 percentage points higher than the average for the five wealthier provinces (OECD 2019c). These inequalities in population and regions are likely to increase due to the COVID-19 crisis.

The Indonesian economy remains dominated by a large informal sector accounting for approximately 70% of national employment and more than 90% of total businesses (OECD, 2018b). While labour productivity is above the ASEAN average,[4] the extent of the informal sector leads to low quality jobs with lower productivity. Informal workers (and their families) often find themselves in the "missing middle" of social protection coverage, whereby they are ineligible for poverty-targeted social assistance but excluded from employment-based contributory arrangements.

While Indonesia's elderly population is expected to grow rapidly, its youthful population is an opportunity. Half of the population is under 30 years old and the demographic dividend is still adding to economic growth. Since 2002, Indonesia embarked on a deep reform of the educational system. Indonesia's spending on education has been increasing over time (from 2.8% GDP in 2010 to 3.6% in 2015 according to UNESCO) and is now comparable to other emerging markets such as Malaysia, South Africa and Thailand. Indonesia is approaching universal completion of primary school (OECD, 2018a).

Despite those achievements in terms of coverage, low quality of education remains a concern, as it is holding back growth in Indonesia, with many students lacking basic skills. The OECD's 2018 Programme for International Student Assessment (PISA) results put Indonesia near the bottom, with a deterioration compared to 2015 (OECD, 2019b). Indonesian 15 year-old students ranked in the bottom 10 out of the 79 countries tested in mathematics, reading and science. Teachers are often poorly qualified and absenteeism is high. Unemployment rates of medium and high-skilled 20-29 year-olds are 6 percentage points higher than for the low skilled. This can be largely explained by the poor quality of education (OECD, 2016; OECD/ADB, 2015). It contributes to informality, as workers do not have the skills for higher-paying formal sector jobs, which is also fuelled by the relatively strict employment regulation. In this context, the government recently passed the Omnibus Law on Job Creation, which, among other objectives, seeks to introduce more flexibility in the labour market; however, its concrete implementation and outcomes remain uncertain. It will be particularly important to consider social impacts of business operations in the context of the new Omnibus Law on Job Creation as well (see below).

Improving the business environment stands high on the government's agenda

Indonesia has been seeking to make the private sector, both domestic and foreign, the engine of growth and sustainable development. The government has been active in improving the business environment since the late 1990s – and increasingly so since President Widodo took office. In the 2000s, efforts focused predominantly on legislative changes. The number of new laws increased dramatically in all economic areas, including investment. The 2007 Investment Law unified the previously distinct foreign and domestic investment laws and increased the transparency of Indonesia's policy framework for investment, including by clarifying which sectors are closed to foreign or domestic investors (OECD, 2010).

More recently, since President Widodo's re-election in 2019, there is an even bigger push for business climate improvements, as the simplification of regulations and de-bureaucratisation have been placed among the top five priorities of the newly-formed Cabinet. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms aiming at easing the process of starting and operating a firm. Successive measures were implemented to improve transparency, streamline licences and facilitate the process to start a company.

The establishment of regional one-stop integrated services centres (i.e. PTSPs), and, later on, the introduction of the Online Single Submission (OSS) system were steps in the right direction to improve the business licensing process throughout the country. The authorities also took measures to improve regulations related to business competition, including through the Indonesian Competition Commission (KPPU). In 2019, KPPU focused on reforming procedural law, easing notification of merger and acquisition transactions, and improving legal protection for SMEs. Reflecting these improvements, the country ranked 73rd out of 190 economies on the World Bank Ease of Doing Business indicator in 2020. Its position in the Starting a Business category remained much lower, however, at 140th place.

In October 2020, the Parliament enacted the Omnibus Law on Job Creation, which aims to streamline the current regulatory framework for investment and includes key measures ostensibly lifting restrictions and conditions placed on FDI, centralising and simplifying business licensing and land acquisition procedures, significantly reforming Indonesia's labour market and relaxing certain environmental regulations. The law, which is repealing 76 laws and over 1000 articles, is perceived by the government as critical to strengthen economic competitiveness, revitalise the manufacturing sector and ultimately pave the way for Indonesia to avoid the so-called 'middle income trap'.

While it is premature to analyse the full impact of the law until implementing regulations are finalised, the law encompasses significant business-friendly reforms, such as liberalising FDI and easing the process to start and operate a business. It has nevertheless also drawn criticism from environmental and social groups about its effects on the environment and the labour market, including concerns about how environmental permits would be structured as well as the extent of deregulation affecting working conditions and pay. In addition to non-governmental organisations and trade unions, some institutional investors called on the government to support the conservation of forests and peatlands; uphold human rights and customary land rights of indigenous peoples; hold proper consultations with environmental and civil society groups and investors on the law and its implementation; and take a long-term approach to recovery from the pandemic.

The government seeks to addresses infrastructure gaps impeding business environment improvements

Infrastructure gaps remain a major development challenge in Indonesia and rank high on the government's agenda. According to the previous medium-term plan (2015-19), infrastructure needs are equivalent to 7% of GDP each year. Indonesia ranks 72 out of 141 countries in terms of infrastructure development in the World Economic Forum (WEF)'s Global Competitiveness Report 2019, behind other ASEAN countries including Singapore (1st), Malaysia (35th) and Thailand (71st) (WEF, 2019). This index reveals large gaps in various types of infrastructure: road connectivity is very poor (109th) and so is utility infrastructure (89th). On the other hand, air transport infrastructure performs well (5th in terms of airport connectivity), although the capacity at the two main airports is fully utilised. Access to electricity is still constrained and gaps also remain in waste, water, sanitation and sewerage facilities.

The government is aware of the importance of the quality and quantity of infrastructure in fostering inclusive growth. It set targets in the 2020-24 plan in terms of infrastructure for drinking water, sanitation facilities as well as infrastructure to support economic development (toll roads, roads, bridges) and to improve connectivity. In Jakarta, infrastructure improvement actions are being implemented to ease congestion and reduce pollution, such as the March 2019 inauguration of the first metro line.

Although the government puts both infrastructure development and the improvement of the business environment high on its agenda, the private sector does not yet play an important role in filling the infrastructure gap (OECD, 2018a, 2019a). Infrastructure investment relies heavily on public finance, with the government accounting for 55% of total infrastructure investment in 2015 while the private sector contribution declined to 9% over 2011-15 (OECD, 2019a).

Additionally, while SOEs operate in almost all sectors of the economy – ranging from manufacturing and construction to agriculture and finance – they play a particularly important role in infrastructure, notably transport (OECD, 2018a). Listed SOEs represent almost one-quarter of equity market capitalisation. SOEs have been hard hit by the pandemic and the National Economic Recovery programme includes new injections of capital into certain SOEs, including SOEs operating in infrastructure, to prevent them from defaulting on their debt obligations.

As Indonesia addresses the infrastructure gap, it will also be important to integrate due consideration of possible negative environmental and social impacts of projects in the risk calculus, and not only remain at the level of financial risks. Responsible business conduct principles and standards are of particular relevance in this regard.

Despite a recent reduction of the deforestation rate, pollution and deforestation still threaten sustainability

As the most populous country and the largest economy in Southeast Asia, Indonesia faces the complex challenge of improving living conditions for its growing population while addressing environmental pressures that, if left unchecked, could deter growth and development (OECD, 2019a). Indonesia faces serious environmental challenges related to air and water pollution, waste management, climate change, biodiversity loss and depletion of natural resources, which result from its rapid economic development, urbanisation and the rising global demand for commodities. While private investment – both domestic and foreign – can, in some cases, be at the source of pollution problems, especially if conducted without due diligence, it can also be a significant conduit for the transition to a low-carbon and energy efficient economy. In this context, it will be important to consider environmental impacts of business operations in the context of the new Omnibus Law on Job Creation.

Although deforestation has slowed since 2015 in Indonesia, intensive fires in peat lands continue to be used to clear large tracts of forest, including for the development of oil palm plantations, pulp and paper industry as well as logging. This has contributed to Indonesia losing forest cover rapidly, declining by 7% between 2005 and 2015, the second highest forest loss worldwide after Brazil (OECD, 2019a). A moratorium on new concessions for plantations and logging of primary forests and peatlands has been in place since 2011, but experts consider that it has not been fully effective (Austin et al., 2017; Busch et al., 2015). In 2018, the President signed a three-year moratorium on new licences for oil palm plantations. More recently, the COVID-19 pandemic has been worsening deforestation in Indonesia, as the lockdown did not allow sufficiently active forest monitoring and management. It is estimated that 1300 square kilometres of forests were lost in March 2020, an increase by 130% as compared to the average of the March months in 2017-19 (WWF, 2020).

Indonesia is among the world's ten largest greenhouse gas emitters and its emissions continue to be on the rise (OECD, 2019a). The government aims to play an important role in addressing climate change. Nevertheless, the current five-year plan (2020-24) sets the targets for greenhouse gas emissions: 29% unconditional reduction and 41% reduction relative to baseline with international support by 2030. Transport, especially by road, and coal-fired power generation are major drivers of the surge in emissions (Yudha, 2017). The number of vehicles in use almost tripled over 2005-15 while Jakarta has become the third-most congested city in the world (OECD 2019a). Rapid deforestation is also exacerbating greenhouse gas emission, as the land-use sector accounted for about half of the country's total emissions over the past decade.

Marine plastic waste has also increased markedly. Indonesia is the second largest contributor to seaborne plastic pollution and 70% of its coral reefs (18% of the world total) are in moderate (35%) or bad (35%) condition (OECD, 2019a). Additionally, the high concentration of population and economic activity on the island of Java (around 56% of the population and 7% of the land area) creates environmental and infrastructure challenges. Excessive subterranean water extraction in Jakarta is causing land subsidence and increasing the risk of flooding; traffic jams and urban air pollution are amongst the worst in the world (OECD, 2019a). This has prompted the government to embark upon the ambitious project to move the capital city from Jakarta to Kalimantan.

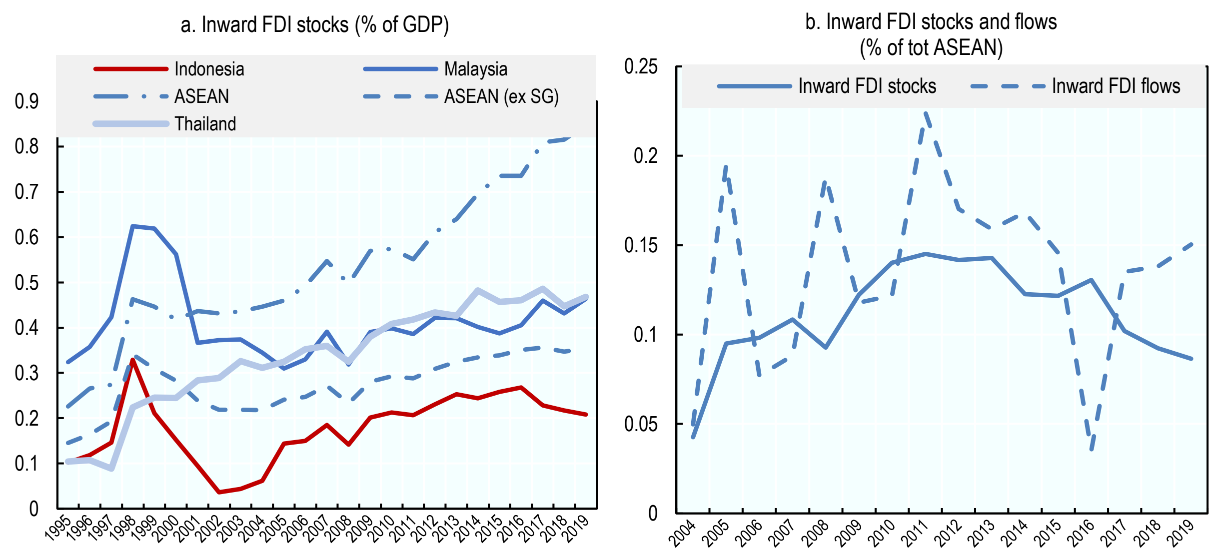
FDI has played an important role in Indonesia but can further contribute to sustainable development

Besides providing a source for financing, FDI may bring significant advantages to the host country. It can raise productivity, support integration in global value chains (GVCs), create decent jobs, contribute to the development of human capital and the diffusion of cleaner technologies, and bring gender-inclusive work practices. Recognising the specific role played by foreign investment in economic development, the government of Indonesia has been increasingly seeking to attract FDI to respond to the country's most pressing needs in terms of unemployment, regional disparities, infrastructure, human resource development and economic transformation.

Indonesia has the potential to be a key FDI destination in ASEAN, but investment climate reforms will make it more competitive

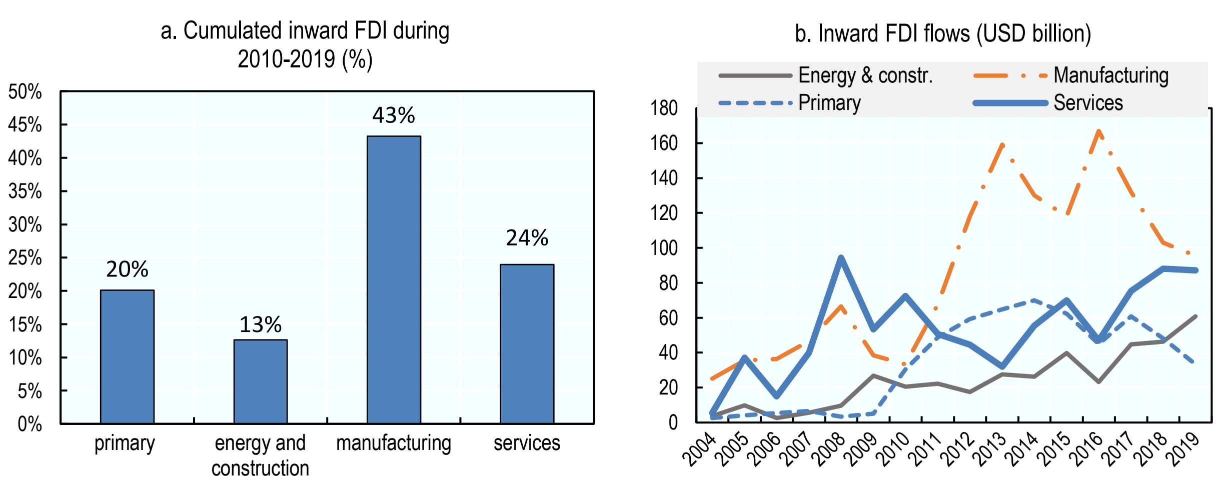
FDI as a share of GDP in Indonesia has fluctuated over time, reflecting changes in both domestic and external conditions. Since 2004, FDI as a share of GDP has grown significantly, although it has declined recently. Being by far the region's largest economy, Indonesia has historically been a relatively important FDI destination in ASEAN, however its share in the region's FDI inflows has fallen in the past few years (Figure 1.3). Rising global uncertainties have contributed to lower FDI inflows, which are expected to decline further due to the COVID-19 pandemic and ensuing global economic crisis. Cross-border equity flows in Indonesia have already dropped significantly during 2020 relative to 2019, as companies have put some M&A deals and greenfield projects on hold due to rising uncertainty.

Figure 1.3. FDI as a share of GDP and in total ASEAN



Source: OECD elaboration based on UNCTAD and the World Bank.

Figure 1.4. FDI flows by sector



Note: Oil and gas, banking and non-bank financial services are excluded.
Source*:* OECD elaboration based on Indonesia Investment Coordinating Board (BKPM).

The largest share of FDI during 2010-19 went to manufacturing, although the share is declining and services have received increasing flows (Figure 1.4). The primary sector also attracts a large share of FDI due to the country's rich endowment of natural resources. Greenfield FDI projects are prevalent in manufacturing, while M&A deals are mainly concluded in the primary and services sectors. The bulk of FDI to Indonesia originates in Singapore and Japan. Investment from Singapore is, however, likely to be inflated, as foreign enterprises, including from OECD countries, may choose to invest through their Singapore affiliates.

FDI contributes to sustainable development but its impact can be enhanced

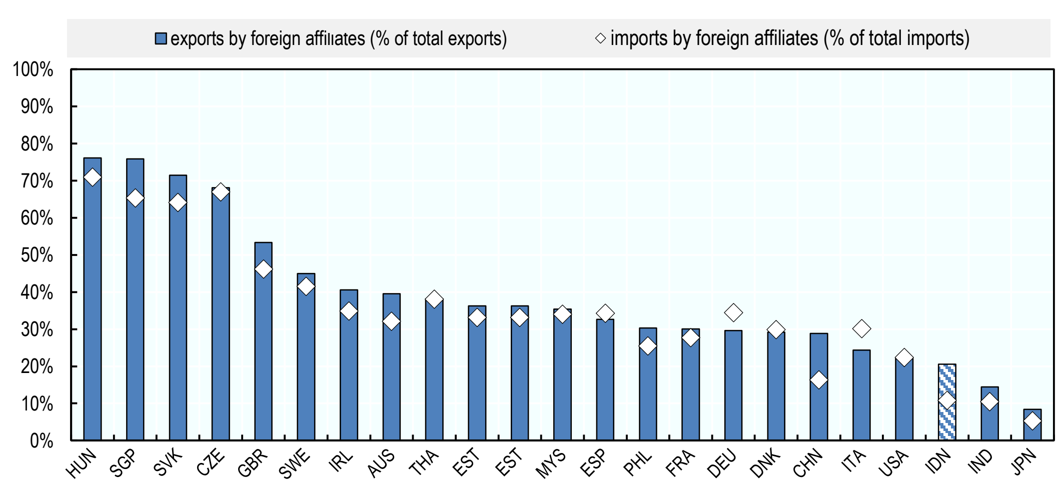
The first OECD *Investment Policy Review* of Indonesia released in 2010 showed that FDI played a major role in raising employment and productivity and in generating exports in Indonesia prior to the global financial crisis. FDI could thus make an important contribution to a sustainable and inclusive recovery of Indonesia in the aftermath of the COVID-19 pandemic and resulting social and economic crisis. Long term development priorities to build a more resilient and sustainable economy include boosting productivity and innovation; strengthening skills; creating more and better jobs; enhancing gender parity; and the transition to a low-carbon and energy efficient economy.

This second *OECD Investment Policy Review of Indonesia* finds that foreign firms directly contribute to several sustainable development objectives of Indonesia. They are more productive, have higher employment ratios, and pay higher wages than Indonesian firms. They also export a higher share of their production and generate important multiplier effects on the domestic economy.

While foreign firms usually participate in GVCs, Indonesia is less integrated in GVCs than other countries in the region. It has a lower export orientation and a lower share of foreign value added in gross exports, and foreign firms contribute less to domestic value added relative to other countries. Its level of GVC participation is nevertheless similar to that of other economies with large domestic markets, such as India, China and the United States, or rich in natural resources like Australia. Additionally, foreign firms in Indonesia contribute less to gross exports and imports in comparison with other countries in the region (Figure 1.5). This is due to fact that Indonesia attracts a large share of resource-based and market-seeking, as opposed to export-oriented, FDI.

Figure 1.5. Foreign firms in Indonesia contribute less to international trade

Exports and imports of foreign affiliates (% of total), 2016

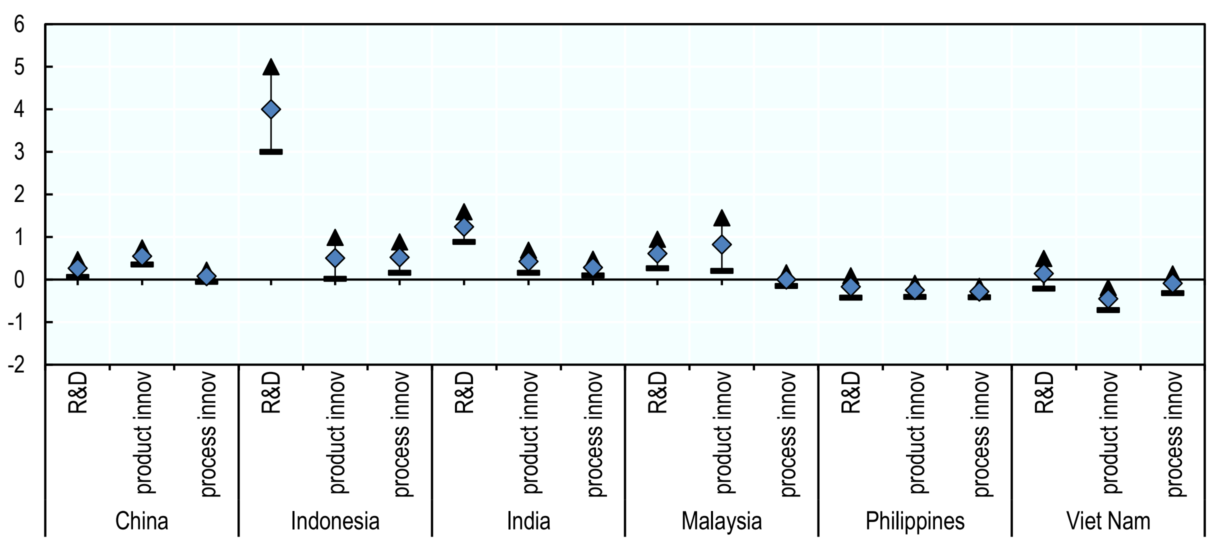


Source*:* OECD AMNE database.

FDI supports productivity gains within the economy. It is concentrated in sectors that are relatively more productive, namely mining, energy, transport services and chemicals. Across most sectors, foreign firms are more productive and are more likely to invest in research and innovation (R&D) or to introduce a new product or process innovation relative to their domestic peers (Figure 1.6). While this confirms the direct contribution of FDI to sustainable development, it also points to gaps in domestic capabilities, which reduce the chances for technology transfer from foreign to domestic firms and positive productivity spillovers. On the other hand, business linkages between foreign and domestic firms are significant. Although the large extent of linkages observed in Indonesia is partly explained by local content requirements in a variety of sectors, including mining, transport equipment and electronics, this could suggest that the potential for productivity spillovers is high.

Figure 1.6. Foreign manufactures are more innovative across most sectors in Indonesia

Are foreign manufacturers more likely to invest in R&D or to introduce a product/process innovation than their domestic peers? yes > 0; no < 0

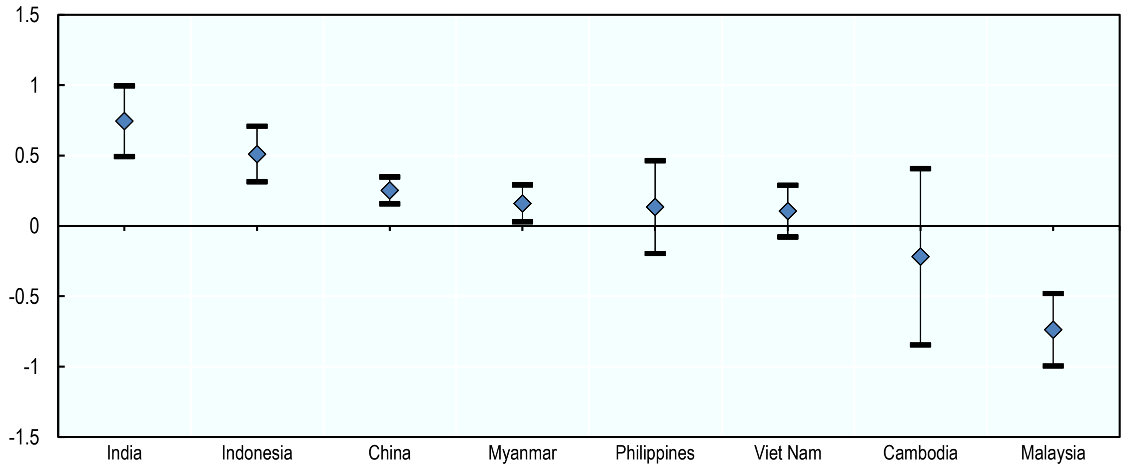


Note: See Chapter 2 for a description of the methodology. Data for Indonesia refers to 2015.
Source: *OECD elaboration based on World Bank Enterprise Survey.*

FDI influences different labour market outcomes in opposite ways. FDI is concentrated in sectors with relatively higher wages (mining, energy, transport services), but with lower levels of female participation. In most sectors, foreign firms pay higher salaries than domestic firms (Figure 1.7). They are also more gender-inclusive, as they employ a larger share of female workers and are more likely to be run or owned by women. Foreign and domestic firms employ comparable levels of skilled labour and report similar difficulties in hiring qualified labour.

Figure 1.7. Foreign firms pay higher wages than domestic firms

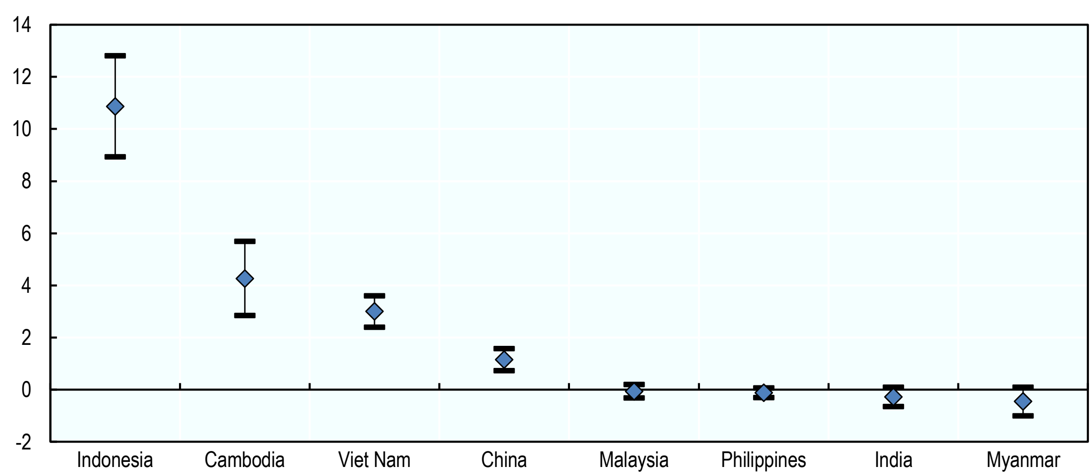
Do foreign firms pay higher wages than domestic firms? Yes>0, no<0



Note: See Chapter 2 for a description of the methodology. Data for Indonesia refers to 2015 and covers the manufacturing sector.
Source*: OECD elaboration based on the World Bank Enterprise Survey.*

FDI also contributes to Indonesia's environmental targets in contrasting ways. Foreign investors tend to locate in sectors that are more polluting in terms of CO_2 emissions, but they are more energy-efficient than domestic firms (Figure 1.8). While the share of FDI in renewable energy is still comparatively low, inflows in clean energy infrastructure are increasing rapidly.

Figure 1.8. Foreign firms are more energy efficient than domestic firms



Note*: See Chapter 2 for a description of the methodology and data. Energy efficiency*: sales over electricity and fuel cost.
Source*: OECD based on World Bank Enterprise Surveys.*

Key findings and recommendations to improve Indonesia’s investment climate

Considerable and steady economic and social progress has been achieved in recent years. This has laid the foundation for further steps to foster investment climate reforms in support of Indonesia’s ambitious national development targets and to achieve a resilient economic recovery from the COVID-19 pandemic. But these policies have yet to demonstrate the intention to establish a clear role for FDI in Indonesia’s economic, social and environmental development ambitions, and make it an attractive destination for investors in the aftermath of the pandemic. This is a similar story when it comes to private sector contributions to the sustainable development goals.

Divergent forces are trying to influence the policy choices. On the one hand, there is a desire to protect the local economy from foreign investment, on the other a willingness to undertake deep reforms to further benefit from FDI. Resource nationalism is still prevalent in public opinion, and SOEs continue playing an important role in economic development.[5] Government efforts on transparency, the rule of law and the quality of institutions have been notable, but they have not been sufficiently consistent to improve investors’ confidence and ensure responsible business practices by both foreign and domestic companies. Roles and responsibilities across ministries on investment issues tend to be unclear and sometimes lack co-ordination. The decentralisation dimension makes it even more challenging to conduct consistent and efficient investment policymaking, as well as to address the environmental and social impacts of business operations.

Based on an updated version of the *Policy Framework for Investment*, this second OECD *Investment Policy Review of Indonesia* identifies several potential areas for reform to build a sound and transparent investment environment to support a resilient recovery from the COVID-19 pandemic. The section that follows summarises the findings and assessments from each of the subsequent policy chapters of this *Review*. The numerous policy options mix concrete measures that can be implemented relatively quickly and more aspirational recommendations, which will require more fundamental changes in the way the government goes about its business. Some measures can only be implemented over a long time horizon, while the government is already considering others. The aim is to provide a list of policy options for the Indonesian government to consider as it reforms it investment climate.

Indonesia’s approach towards FDI needs to be more open

Indonesia has a number of attributes that makes it a naturally coveted destination for FDI: the largest consumer market of Southeast Asia in one of the world’s fastest-growing regions, abundant natural resources and a large and relatively young workforce. Yet, it has never really taken off as a leading location for FDI, especially considering the increasing importance of Southeast Asia as a global investment destination. Foreign investors have been somewhat timorous of Indonesia’s complex business environment, not least because of remaining FDI restrictions and entry conditions. The recent Sino-US trade tensions, which led to the relocation of some export-oriented investments out of China, once again drew attention to Indonesia’s challenges in attracting FDI although more recently some factories have announced plans to relocate production to Indonesia (JETRO, 2020; Nomura, 2019; Jakarta Post, 2020a, 2020b). The situation prompted a strong reaction from President Joko Widodo, who called out members of his cabinet for the country’s failure to capture a ‘fair share’ of such relocations (Jakarta Globe, 2019; Katadata, 2019).[6]

Increasing foreign investments and improving the ease of doing business became a key priority for the current administration, which enacted in October 2020 the Omnibus Law on Job Creation aimed at streamlining and repealing dozens of overlapping regulations considered to be hampering investments and job creation. The law was passed despite strong opposition by labour unions, regional administrations and civil society, who expressed concerns over the law’s amendments to the 2003 Labour Law, the recentralisation of administrative power in the hands of the executive and the lack of public hearings among other things – seeks to lift restrictions and conditions placed on FDI, centralise and streamline business licensing and land acquisition procedures, including by adopting a risk-based approach to business licensing and making it a more transparent and fully online process, and significantly reform Indonesia's labour market. Implementing such an 'all-in-one' law reform package will be a challenge, and possibly not all of its content is truly desired (see also Chapter 5) despite the compelling arguments for revising the current FDI regulatory regime once the pandemic is controlled.

Over time, Indonesia has significantly liberalised its foreign investment regime, although it is still one of the most restrictive countries to FDI as measured by the OECD *FDI Regulatory Restrictiveness Index*, with many primary and services sectors still partly off limits to foreign investors (*e.g.* agriculture, fisheries, oil & gas, power, construction, hospitality, distribution, transport, telecommunications insurance and other financial services). Beyond extensive sector-specific foreign equity restrictions, it maintains a range of discriminatory policies that apply across the board, such as higher minimum capital requirements for foreign-invested companies, stringent conditions on the employment of foreigners in key management positions, limitations on branching and access to land by foreign legal entities and preferential treatment accorded to Indonesian-owned entities in public procurement. Indonesia also makes extensive use of local content requirements, which add to the hurdles of carrying out foreign investments in Indonesia. It remains to be seen how the recently enacted Omnibus Law on Job Creation will change the situation.

In addition to diverting potential FDI away from Indonesia and depriving the country of a relatively more stable source of capital and foreign exchange for financing a structural current account deficit than is provided by portfolio investments, these restrictions contribute to holding back potential economy-wide productivity gains (OECD, 2018c; Duggan et al., 2013; Rouzet and Spinelli, 2016). As can be seen in Chapter 3, manufacturing industries in Indonesia are among the most affected worldwide by restrictions to FDI in services sectors. By limiting competition and contestability, notably in services sectors, they prevent access to world class services inputs by downstream industries and consumers. In the modern context of intensified regional and GVCs, FDI policies can no longer treat services and manufacturing separately.

Beyond these more fundamental reasons, tapping into a larger pool of FDI than previously the case might be ever more critical for the economic recovery following the pandemic, which is projected to significantly weaken Indonesia's real GDP growth (see Figure 1.1). Typically larger and more geographically diversified and productive, foreign-owned firms are overall more resilient to crisis. Therefore, they could potentially be an asset to reignite recovery earlier or faster. In addition, at a time of record-high portfolio capital outflows from emerging markets, FDI could help to ease any possible financing pressure on Indonesia's current account deficit, which is projected to widen once again on the back of sluggish tourism exports and commodity markets.

A comprehensive overhaul of Indonesia's FDI regime may not be easy to achieve, but only a bold and comprehensive reform package would allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness as an investment destination. Out of six hypothetical FDI reform scenarios simulated using the OECD *FDI Regulatory Restrictiveness Index,* only the elimination of all sector-specific foreign shareholding restrictions, all other restrictions held constant, could bring Indonesia significantly closer to OECD levels of openness. The impact of substantial FDI liberalisation can be sizeable (Mistura and Roulet, 2019). Indonesia's inward FDI stocks, for instance, could be 25% to 85% higher if it were to reduce the level of FDI restrictiveness to the 50^{th} and 25^{th} percentile levels of the OECD *FDI Regulatory Restrictiveness Index,* all else held equal. Stringent barriers to FDI also imply that reforms which ease the costs of doing business may not bring about the intended benefits.

While revisiting the FDI regime is certainly warranted, the Omnibus Law on Job Creation should also ensure that past achievements are preserved. The transparency of Indonesia's policy framework for investment improved with the adoption, pursuant to the 2007 Law on Investment, of a 'negative list' approach for listing sectors that remained closed or open with certain conditions to foreign or domestic investors. A shift to a 'positive list', as it has sometimes been reported by the media, would represent a setback to transparency and on-going and future efforts of maintaining an open business environment if technically implemented. The authorities, however, have confirmed during this review that the ‘negative list’ approach will continue to be used for the regulation of market access. Improvements could thus be considered on the institutional setting and procedures for its formulation. Greater transparency and technical support, as well as a more inclusive consultation and institutional setting could help to broaden the information-base supporting discussions and deliberations in this regard.

The current global economic downturn might perhaps work in favour of pushing reforms forward. The pace of Indonesia’s FDI reforms has historically been largely shaped by crises. If it were not for the current unique situation, past perspectives about FDI liberalisation reforms would be comforting in suggesting a pick-up in FDI activity. But this time, even holding on to existing FDI may prove difficult given the expected negative impact of the pandemic on global FDI activity (see Chapter 2). ASEAN as region is likely to remain well positioned to compete for investments, which could also benefit Indonesia. Without reforms, however, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI in the aftermath of the pandemic may be slim.

Main policy recommendations

- In view of Indonesia’s ample list of activities restricted to foreign investment: undertake a comprehensive regulatory impact assessment of existing restrictions on FDI, including assessments of potential alternative, non-discriminatory policies where relevant, and subject the assessment to ample stakeholder scrutiny to identify priority areas for reform and inform policymaking in the context of the omnibus reform on job creation and further implementing regulations.
- In advancing FDI reforms, consider prioritising further liberalisation of FDI in services sectors due to their economy-wide productivity implications. In the current context of GVCs and the intensified ‘servicification’ of manufacturing activities, restrictions on FDI in service sectors end up discriminating against domestic manufacturing producers and consumers, who may have to pay relatively higher prices for quality-adjusted services inputs. Accompanying reforms to behind-the-border services regulations should go hand in hand with FDI liberalisation for these to fully bring about their potential benefits.
- Eliminate discriminatory requirements against foreign direct investors in horizontal regulations to support enhanced competitiveness and efficiency and ensure a level playing field for all investors in Indonesia. In this respect:
    - Align the general minimum capital requirement for foreign-invested companies with capital requirements for domestic investors. The current discriminatory minimum capital policy is particularly stringent for investors in less-capital intensive activities. Worldwide, where minimum capital requirements still exist, they are rarely discriminatory – in 2012 only eight countries out of 98 assessed in the World Bank’s Investing Across Borders imposed a discriminatory minimum capital requirement – and typically much lower than what is required from foreign investors in Indonesia (about 17 times lower for the average OECD economy). This is the case even across economies with a level of income per capita much greater than that of Indonesia.
    - Promote a more level playing field in public procurement for foreign direct investors by eliminating preferential treatment accorded to Indonesian-owned entities, notably in the procurement of services. According preferential treatment to resident enterprises in public procurement is relatively common, but discriminating against foreign-owned firms established in the procuring jurisdiction is rather exceptional. As for other discriminatory measures, these might hinder competition and contestability in the affected markets and may drive up costs of goods and services procured by the government.

    - Reconsider the use of local content requirements for developing local industries and supporting domestic investors. Stringent local content requirements in some sectors add to the hurdles of carrying out foreign investments in Indonesia. By establishing hard to achieve local requirements, it may restrain competition and potential short-term gains in targeted industries and can act as a drain on the rest of the economy. In pursuing such objectives, horizontal policies addressing deficiencies of the business and regulatory environment, trade and investment barriers, innovation policy, and infrastructure development, can offer an alternative to local content policies and have less negative economy-wide effects on output, exports and jobs.

- Preserve and improve Indonesia's current 'negative list' approach to regulating market access and treatment accorded to foreign investment in the on-going Omnibus law reform. Such an approach provides greater clarity and security for investors than the alternative 'positive list' approach sometimes mentioned in the context of the on-going reform. Investors have at times expressed discontent with the pace of liberalisation in past years and questioned the capacity of the 'negative list' revision process to encourage liberalisation, but this would likely be more challenging under the alternative 'positive list' proposal. Improvements could be considered, instead, on the institutional setting and procedures for the regular revision of such a 'negative list'. In these respects:
    - Continue to allow foreign investment without discrimination unless designated as restricted in a separate 'negative list' indicating a complete list (without carve-outs and exceptions) of activities closed to private investment (foreign or domestic), activities closed only to foreign investors, and activities where foreign investment is permitted under discriminatory conditions. Such a list should be clear and concise, describing any imposed condition with clarity and specifying where appropriate the relevant underlying provisions in national laws and regulations. Explicit reference to an international standard industry classification (on top of Indonesia's standard industrial code (KBLI) as currently the case) for accurate documentation of closed or restricted activities is also recommended. As currently the case, it should continue to be placed in an executive-level order for ease of amendments over time. It should also be immediately updated whenever any relevant underlying legislation is introduced or modified to make sure every new or modified restriction and condition is not enforceable until appropriately reflected in the 'negative list'.
    - Strengthen the process for assessing and revising the 'negative list' on a regular basis including by consulting more amply and systematically with relevant stakeholders, relying more on technical assessments by independent qualified institutions and publicising relevant documents supporting deliberations. A broader involvement of relevant stakeholders, as well as more transparency and technical inputs to the formulation of the 'negative list' would help to broaden the information-base supporting discussions and deliberations and facilitate dialogue with interested stakeholders, ultimately contributing to improved policy-making.

Indonesia's investment protection and dispute resolution have improved but need further reforms to build investor confidence

Rules that create restrictions on establishing and operating a business in Indonesia are an important part of the broader legal framework affecting investors. Protections for property rights, contractual rights and other legal guarantees, as well as efficient enforcement and dispute resolution mechanisms, are equally important elements.

Indonesian law provides a number of core protections to investors relating to non-discrimination, expropriation and free transfer of funds. Most of them are found in the Investment Law (Law 25/2007) and have not changed significantly in recent years. These protections are generally in line with similar provisions found in other regional investment laws and provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are also seen to be robust. Some incremental improvements may be possible to bring these provisions closer in line with international good practices, including further specification of the provisions on expropriation.

Clarifications may also improve the existing legal frameworks to protect investors' intellectual property and land tenure rights, which are comprehensive in many respects. The government has not made significant updates to land laws in Indonesia in several decades. While foreigners are now able to own land, these rights are relatively limited and interactions between formal land laws and customary land rights remain complex and subject to interpretation. Initiatives to accelerate land registration and the use of electronic databases for land administration have yielded promising initial results but sustained momentum is needed for these changes to be durable in the long term. Investors also report some issues with the legal framework for intellectual property rights, notably with respect to restrictive patentability criteria, but in the main these laws are well-developed, have been periodically improved through amendments and comply with international standards in five core areas: trademarks, patents, industrial designs, copyrights and trade secrets. Some problems nonetheless persist in practice. Online piracy and counterfeiting are widespread, and efforts to implement and enforce laws is poor or inconsistent in several areas. The government is pursuing a range of different initiatives that seek to address these well-known shortcomings.

In terms of dispute resolution, the Indonesian courts have a reasonable record concerning the rule of law and contract enforcement when compared to similar economies. Despite important reforms to establish an independent judiciary and improve court services, however, some stakeholders still cite concerns with the lack of transparent and fair treatment in the Indonesian court system. The effectiveness of the courts is hampered by some long-standing negative perceptions. For these reasons, many firms prefer to use alternative dispute resolution rather than litigation to settle their disputes. Law 30/1999 on Arbitration and Alternative Dispute Resolution provides a solid framework to support arbitration in Indonesia and works reasonably well in practice. The government is not considering any major reform proposals in this area but it may wish to investigate amending some provisions of the law to improve legal certainty.

Other areas attracting attention from the top levels of government are data protection and cybersecurity, the fight against corruption and public sector reforms. The government has taken significant strides towards making cybersecurity a national policy priority. It established a national cybersecurity agency in 2017 and stepped up its international engagement on these issues, but there is still no overarching regulatory framework in Indonesia for cybersecurity or data protection. Fighting corruption in all levels of society has also been a top priority for many years. KPK has played a major role in building public awareness and trust through impressive results, including conviction of high-ranking government officials. A wide range of public sector reforms introduced in recent years to improve transparency, reduce bureaucracy, and encourage public engagement in the policy cycle are also contributing to strengthening public integrity. The causes of corruption are deep-rooted, however, and may only be overcome in the long term, which the government recognises and seeks to address.

The government has also substantially revised its investment treaty policies in recent years. Indonesia's investment treaties grant protections to certain foreign investors in addition to and independently from protections available under domestic law to all investors. Domestic investors are generally not covered by these treaties. Indonesia is a party to 37 investment treaties in force today. Like investment treaties signed by many other countries, these treaties typically protect investments made by treaty-covered investors against expropriation and discrimination. Provisions requiring "fair and equitable treatment" (FET) are also common, providing a floor below which government behaviour should not fall. While there are some significant recent exceptions, investment treaties often enforce these provisions through access to investor-state dispute settlement (ISDS) mechanisms that allow covered investors access to impartial international arbitration that awards monetary damages in an effort to depoliticise such disputes.

Investment protection provided under investment treaties can play an important role in fostering a healthy regulatory climate for investment. Expropriation or discrimination by governments does occur. Investors need some assurance that any dispute with the government will be dealt with fairly and swiftly, particularly in countries where investors have concerns about the reliability and independence of domestic courts. Government acceptance of legitimate constraints on policies can provide investors with greater certainty and predictability, lowering unwarranted risk and the cost of capital. Investment treaties are also frequently promoted as a method of attracting FDI which is an important goal for many governments. Despite many studies, however, it has been difficult to establish strong evidence of impact in this regard (Pohl, 2018). Some studies suggest that treaties or instruments that reduce barriers and restrictions to foreign investments have more impact on FDI flows than bilateral investment treaties (BITs) focused only on post-establishment protection (Mistura et al., 2019). These assumptions continue to be investigated by a growing strand of empirical literature on the purposes of investment treaties and how well they are being achieved.

The government's comprehensive review of its investment treaties in 2014-16 led to the termination of at least 23 of its older investment treaties. But like many other countries, Indonesia still has a significant number of older investment treaties in force with vague investment protections that may create unintended consequences. Many countries, including Indonesia, have substantially revised their investment treaty policies in recent years in response to these concerns as well as increased public questioning about the appropriate balance between investment protection and sovereign rights to regulate in the public interest and the costs and outcomes of ISDS. The government is well aware of these ongoing challenges. It is taking a leading role in multilateral discussions on ISDS reform in UNCITRAL's Working Group III and updating its model investment treaty in light of recent treaty practices. Experiences with the COVID-19 pandemic may further shape how the government views key treaty provisions or interpretations and how it assesses the appropriate balance in investment treaties.

Notwithstanding the potential benefits of having signed international investment agreements, they should not be considered as a substitute for long-term improvements in the domestic business environment. Any active approach to international treaty making should be accompanied by measures to improve the capacity, efficiency and independence of the domestic court system, the quality of a country's legal framework, and the strength of national institutions responsible for implementing and enforcing such legislation.

Main policy recommendations for the domestic legal framework

- Amend Article 7 of the Investment Law to provide further specification on investor rights to protection from unlawful expropriation and the government's right to regulate. Issues for possible clarification include whether investors are protected from indirect expropriation, exceptions to protect the government's right to regulate in the public interest, and the valuation methodology for determining market value of expropriated property. This is not necessarily urgent but the government may wish to identify an appropriate opportunity to propose incremental improvements to this and other aspects of the Investment Law.
- Consider updating and modernising existing land laws. Land policy is one of the few areas affecting investors where the government has not enacted significant new legislation in recent decades. The existing system for land tenure is based primarily on legislation enacted in 1960. New laws could clarify existing categories of land tenure rights and reduce conflicts between customary and formal laws. Efficient land administration services go hand-in-hand with clear legal rights. The government should also allocate sufficient funds, institutional capacity and political backing to consolidate on early successes for ongoing initiatives to achieve universal land registration, improve the quality of land data and expand digital solutions and online accessibility for land administration.

- Continue to prioritise efforts to improve the regime for intellectual property (IP) rights, especially enforcement measures. Investors continue to report concerns with widespread online piracy and counterfeiting, long-standing market access issues for IP intensive sectors, high numbers of bad faith registrations of foreign trademarks by local companies and restrictive patentability criteria that make effective patent protection particularly challenging. The government is well aware of these concerns and is designing initiatives to address them. Improvements in implementation and IP enforcement measures will help to build overall investor confidence in this area.
- Rethink existing approaches to reforming the court system. The government and the Supreme Court have taken significant strides towards ensuring judicial independence, creating specialised courts and judges, establishing a system for legal aid and expanding e-court services. Bold thinking may be required to dismantle certain negative perceptions regarding the effectiveness of the courts and revitalise the core institutions. The government may wish to consider commissioning a thorough review of the existing civil procedure rules, redesigning the system for judicial appointments to ensure integrity and encouraging the Supreme Court to propose, in consultation with civil society organisations and other stakeholders, more wide-ranging initiatives to promote transparency and greater public scrutiny of court functions.
- Evaluate potential amendments to Law 30/1999 on Arbitration and Alternative Dispute Resolution. It may be prudent for the government to take stock of court decisions and user experiences under the law over the past two decades to assess the merits of potential amendments to improve legal certainty, user experiences and the attractiveness of arbitration in Indonesia. Areas for possible legislative clarification include the scope of the law vis-à-vis international arbitrations conducted in Indonesia, whether contract disputes involving claims based on tort or fraud are arbitrable and the public policy ground for refusing enforcement of an arbitral award under Article 66 of the law.
- Maintain data protection and cybersecurity as a national policy priority. Comprehensive laws that draw on international good practices need to be enacted and effectively implemented in these areas. As with all legislation, the government should consult widely on the existing drafts of these laws and encourage input from business and civil society organisations. The government should also account for considerable, additional work once laws are in place to raise awareness among the private sector and other users, and nurture effective mechanisms to deal with security and data breaches.
- Sustain momentum for building a culture of integrity in the public sector and throughout all levels of society. Among other initiatives, the KPK has made significant inroads into concerns regarding corruption through some impressive results, which have transformed it into an important symbol of the government's commitment to fighting corruption. The government should continue to allocate sufficient resources to the KPK and other anti-corruption institutions and vigorously defend their independence.

Main policy recommendations for investment treaty policy

- Continue to reassess and update priorities with respect to investment treaty policy. An important issue for period reassessment is how the government evaluates the appropriate balance between investor protections and the government's right to regulate, and how to achieve that balance in practice. Indonesia's model BIT, which the government is currently updating, should reflect the government's current assessment of the appropriate balance and inform negotiations for new investment treaties. It is more difficult for governments to update their existing treaties to reflect current priorities. Depending on whether the parties wish to clarify original intent or revise a provision, it may be possible to clarify language through joint interpretations agreed with treaty partners. If revisions, rather than clarifications of original intent are desired, then treaty amendments may be required. Replacement of older investment treaties by consent may also be appropriate in some cases.

- Continue to participate actively in inter-governmental discussions on investment treaty reforms at the OECD and at UNCITRAL. Many governments, including major capital exporters, have substantially revised their policies in recent years to protect policy space or to ensure that their investment treaties create desirable incentives. Consideration of reforms and policy discussions on frequently-invoked provisions such as FET are of particular importance in current investment treaty policy. Emerging issues such as the possible role for trade and investment treaties in fostering responsible business conduct as well as ongoing discussions about treaties and sustainable development also merit close attention and consideration.
- Conduct a gap analysis between Indonesia's domestic laws and its obligations under investment treaties with respect to investment protections. There are differences between the Investment Law and Indonesia's investment treaties in some areas. Identifying these differences and assessing their potential impact may allow policymakers to ensure that Indonesia's investment treaties are consistent with domestic priorities.
- Continue to develop ISDS dispute prevention and case management tools. Whatever approach the government adopts towards international investment agreements, complementary measures can help to ensure that treaties are consistent with domestic priorities and reduce the risk of disputes leading to international arbitration. The government should continue to participate actively in the work of UNCITRAL's Working Group III, the OECD and other multilateral fora on these topics. It may also wish to consider ways to promote awareness-raising and inter-ministerial co-operation regarding the government's investment treaty policy and the significance of investment treaty obligations for the day-to-day functions of line agencies. Developing written guidance manuals or handbooks for line agencies on these topics could encourage continuity of institutional knowledge as personnel changes occur over time.

Embracing promotion of responsible business conduct can lead to far-reaching and strategic successes in attracting FDI and promoting a more sound and sustainable investment climate

Promoting and enabling responsible business conduct (RBC) is of central interest to policy-makers wishing to attract and keep investment and ensure that business activity contributes to broader value creation and sustainable development. RBC expectations are prevalent throughout global value chains and refer to the expectation that all businesses – regardless of their legal status, size, ownership structure or sector – avoid and address negative consequences of their operations, while contributing to sustainable development where they operate. RBC is an entry point for any company that wishes to contribute to the Sustainable Development Goals (SDGs) or to achieve specific economic and sustainability outcomes.

The COVID-19 crisis has exposed significant vulnerabilities in company operations in global value chains, including as related to disaster preparedness and supply chain continuity and resilience. Evidence has already shown that companies that are responsible have been better able to respond. An RBC lens can help them make more balanced decisions, while ensuring that further risks to people, planet and society are not created or contribute to further destabilising supply chains down the line.

Indonesia has historically promoted corporate social responsibility (CSR) and was one of the first countries to integrate CSR and corporate philanthropy within the legal framework during the previous decade. Recent efforts have looked to expand more toward RBC, notably in sustainable finance and business and human rights. A notable effort has also been Indonesia's ambition to introduce transparency of beneficial ownership information. RBC-related activities in Indonesia have also been undertaken by the private sector and civil society.

These activities are positive and should be encouraged; however, a more strategic and coherent approach to promoting implementation of RBC across sectors by the government may be warranted, particularly in light of the heavy social impact COVID-19 has had on Indonesia's manufacturing sector and the high environmental costs that growth so far has brought. International RBC standards, which address responsibility throughout the whole supply chain, can provide a useful framework for finding solutions to mitigate the worst impacts of COVID-19 in the short term and to help stakeholders avoid making harmful unilateral decisions. In the medium- and long-term, benchmarking sustainability efforts with international RBC standards can lead to more clarity in the market and promote trade and investment.

The *Review* suggests a bold policy direction where RBC can help ensure ongoing industrial strategies are stronger and fit-for-purpose for today's global economy; reframe the conversation around existing business operations in sectors where risks are high; help re-orient the financial sector toward sustainable finance; give a signal to the market by directing SOEs on RBC and ensuring future growth does not exacerbate existing challenges; lead by example in key structural sectors like infrastructure; and fighting corruption and promoting integrity.

Main policy recommendations on responsible business conduct

- Promote RBC and communicate clearly to businesses and investors government expectations on RBC in the context of the main national policies such as the 2015-2035 Master Plan of National Industrial Development and the efforts to promote the SDGs (in particular the follow up efforts to the 2019 Voluntary National Review and actions by the National Coordination Team for SDGs Implementation).
- Promote broad dissemination and implementation of the practical RBC tools and instruments, such as the OECD due diligence guidances which were designed to support businesses. Support and facilitate collaborative industry and stakeholder initiatives on RBC.
- Integrate explicit references to and expectations on RBC due diligence in *Making Indonesia 4.0* strategy (including as related to the implementation of sectoral objectives) and promote industry alignment with global practice through the cross-sectoral national initiative to improve sustainability standards.
- Ensure that the implementing regulations for the Omnibus Law on Job Creation include due consideration of environmental and social impacts of business operations and that streamlining of administrative procedures does not come at the expense of labour and environmental protection and an inclusive and sustainable development pathway. Consider making RBC due diligence a standard operating procedure in this context. Broad consultations with a wide range of stakeholders and at national and regional levels, including trade unions, civil society, affected stakeholders, and academia in addition to the business community, should be early, systemic, meaningful, and transparent.
- Prioritise action on RBC in key sectors, notably agriculture, mining and garment and footwear sectors. Consider undertaking an alignment assessment of the Indonesian Sustainable Palm Oil standard with the *OECD-FAO Guidance for Responsible Agricultural Supply Chains.*
- Accelerate efforts to promote environmental, social and governance (ESG) and RBC in the financial sector in line with international standards. Assess in particular the extent of barriers for integrating these factors in the market, notably when it comes to long-termism and quality of reporting and rating frameworks.
- Pursue the development of the *National Action Plan on Business and Human Rights* in line with international best practice and with inter-ministerial involvement and consultation. Ensure that the scope of the plan is broad enough to capture the most relevant RBC-related issues. Ensure that the process supports a wide consultation with stakeholders.
- Direct SOEs to establish and undertake RBC due diligence, publicly disclose these expectations and establish mechanisms for follow-up.

- Lead by example and ensure integration of RBC in the high-profile Indo-Pacific Infrastructure and Connectivity strategic objectives. RBC due diligence should be a baseline and entry point for businesses wishing to participate in these efforts.
- Strengthen implementation of the UN Convention against Corruption and closer alignment with the OECD Convention on combating Bribery of Foreign Public Officials in International Business Transactions by criminalising bribery of foreign public officials and enacting corporate liability for corruption offences.

Investment promotion and facilitation measures are a key component of Indonesia's recovery from the COVID-19 crisis and need to be scaled up

Investment promotion and facilitation policies, including well-designed tax incentives for investment, can contribute to the competitiveness of a country by attracting quality and innovative investors and by making it easier for businesses to establish or expand their operations. Such initiatives are particularly important to respond to the crisis provoked by the COVID-19 pandemic, which poses significant challenges to public authorities. The economic contraction, drop of FDI, pressure on public budgets and the need to deliver on sustainable development goals are just some areas that will have an impact on institutions in charge of promoting and facilitating investment in Indonesia. Investment promotion and facilitation measures can not only support a sustainable recovery by creating an attractive economy, but also by helping ensure that foreign investments support national development objectives and generate positive spillovers through the development of less developed areas, linkages with local companies and skills transfer. It is important, however, that investment tax incentives are used cautiously due to increased pressure on public budgets. Investment promotion and facilitation efforts should also complement – and not replace – measures to ensure a sound investment policy framework.

Within Indonesia's institutional framework governing investment, the Indonesian Investment Coordinating Board or BKPM (for *Badan Koordinasi Penanaman Modal*), is the government's implementing arm on investment promotion, facilitation and regulation. BKPM is a large organisation with a large number of official mandates, more than in many other investment promotion agencies (IPAs) around the world. Its regulatory and policy-oriented characteristics have been dominating the agency's mind-set and strategic orientations over the past decades, and have been instrumental in increasingly establishing a business-friendly environment in Indonesia, including for FDI.

BKPM aims to play a co-ordinating role within a multifaceted and fragmented institutional landscape, where multiple public entities have a say on investment policies or on their implementation. These different roles and tasks across government actors can sometimes be complementary but can also overlap or be inconsistent with each other. This complexity at the central level is amplified by the important role played by local governments in investment promotion and facilitation.

Improving the business environment has been a top priority of the President since he took office in 2014 and which was then further emphasised at the beginning of his second term. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms aiming at improving transparency, streamlining licences and creating mechanisms to ease the business creation process. One of these recent reforms is the OSS, an online business licensing system, which is meant to make the licensing process more efficient and more transparent.

In practice, however, investors have still been relying on too many procedures and requirements that cannot be processed by the OSS and that has hampered the efficiency of the system. Additionally, the OSS, by replacing a system that was put in place only a few years earlier and still well-established in certain cities and districts, is not without implementation problems and local resistance. The government is thus seeking to standardise further the licensing process by providing increased authority to BKPM. In parallel, it has prepared two omnibus laws – one on job creation and one on taxation – which are seeking to modernise the regulatory framework. The Omnibus Law on Job Creation, enacted on 5 October 2020, seeks to ease and harmonise the business licensing process by amending laws related to a wide array of economic sectors and limiting the role of local authorities. Its effective implementation remains nonetheless to be seen. In the future, the government may consider adopting the reverse sequencing of reforms: starting with assessing the regulatory stock and burden for businesses, then cutting unnecessary licences and administrative requirements, and finishing by implementing a top-notch online mechanism to start a business.

These reforms are taking place in an environment where stakeholder consultations are vital. While BKPM takes its role as an intermediary between the government and the private sector very seriously and organises business consultations on a regular basis, a key challenge lies precisely in reconciling sometimes conflicting views on investment-related matters across different market participants.

In terms of FDI attraction goals, the government has progressively taken a more proactive stance on investment promotion over the past years, but remains relatively less advanced than some of its peers. Led by BKPM, the government has collegially developed a strategy with priority sectors based on some well-defined criteria, but the focus remains too wide for BKPM's investment generation activities to be impactful and measurable. A large part of the agency's efforts are still dedicated to image building, while more specific targeting and attraction activities would be necessary, as is the case in more modern fully-fledged IPAs that are seeking to achieve similar goals. As the pipeline of new FDI projects is likely to drop due to the pandemic, an effective prioritisation strategy for investment promotion is an important success factor in the government's recovery efforts.

Tax reform is another pillar of Indonesia's strategy to enhance the investment climate and to promote the country as an attractive investment destination. In recent years, significant changes have been introduced through the gradual review and expansion of Indonesia's tax incentives. Broader tax reforms are also planned under the Omnibus Law on Taxation. The policy response to the COVID-19 economic crisis accelerated some reforms planned under the law to provide tax relief to affected businesses.

Indonesia's tax incentives are among the most generous in the region. Tax incentives' potential to attract investment, create jobs, acquire knowledge, skills and technology, and boost economic growth must be weighed against the resulting costs in terms of tax complexity, neutrality and revenue forgone. In Indonesia, tax incentives for investment continue to be at the core of the strategy to improve the business environment, but substantial changes have been introduced since 2018 in their design and in the targeted activities.

New cost-based incentives were introduced to promote labour-intensive sectors and activities with socio-economic spillovers, such as R&D and vocational training, which has been a positive development. At the same time, previously existing incentives were also expanded to include new priority sectors under both the tax holiday and investment allowance schemes. The successive expansion of prioritised sectors (under the so-called *pioneer* and *certain* industries policies) make the intended policy objective less clear, however. For example, the 30% investment allowance was expanded to additional sectors and all new investment projects (rather than limited to newly registered firms), which creates unequal competition among firms that are granted incentives and those that are not.

The wider tax incentive scheme continues to be complex due to multiple – in some cases, overlapping – incentives and the density of the current legal framework. Tax incentives in Indonesia are introduced through multiple legal instruments, including laws and regulations. They can be modified by further regulations – for example, introducing additional requirements – that amend prior ones, which makes it difficult for investors to have a full overview of how incentives apply. While relevant regulations are available online, official English translations are not always available, which can create additional uncertainty. Significant efforts have nevertheless been made to increase transparency and communicate incentives more clearly. Investor guides provide a good overview but cannot capture some of the details and complexities of the regulations.

Main policy recommendations on investment promotion and facilitation

- Ensure BKPM's leadership role on investment promotion and facilitation is well recognised and that it has the means to co-ordinate the dialogue between all parties. While it has been an interesting development to integrate increased licensing responsibilities within the agency, its exact role within government remains sometimes unclear.
- To conclude ongoing discussions in the cabinet on the status of BKPM, decide whether to fully upgrade BKPM to ministerial level or to keep it as an operational agency. The first option would allow it to better fulfil its co-ordinating role and drive policy reform. If the second option is maintained, consider providing it with more autonomy, to reduce the number of mandates and to provide more responsibility to its Investment Committee. The committee could be upgraded to a board, to align it with good IPA international practices, and should include business representatives from all segments of the economy as well as representatives of academia and civil society.
- Given the rapid pace of ongoing reforms to facilitate investment, notably the establishment of the OSS and the Omnibus Law on Job Creation, ensure that officials in the national and regional administrations have sufficient and adequate resources, capacities and information to properly implement the new regulations and adapt to the new tools. This would help overcome the operational challenges of the OSS and make it more efficient. A review of the implementation and impact of reforms could be envisaged to understand whether these measures achieved their objectives.
- Provide clear rules and guidelines to investors on the use of the OSS and consider establishing information services. The implementing regulations of the Omnibus Law on Job Creation that relate to business licensing and forthcoming changes to the OSS also need to be well-communicated in advance. Ensure that increasing predictability and transparency in investment procedures – including to reduce corruption risks – continue driving ongoing and new investment facilitation reforms.
- Continue streamlining redundant and overly burdensome business licences and administrative procedures to provide a healthy business environment to both incoming and already-established investors. This, however, should not come at the expense of much needed labour and the environmental protection safeguarding a more inclusive and sustainable development pathway (see also Chapter 5 on responsible business conduct). In this light, while the preparation of the Omnibus Law on Job Creation seeks to ease the process of doing business, the reform should not be limited to amending sectoral laws, but focus on systematically identifying business regulations that could be eliminated and those that need to be preserved.
- Ensure that ongoing investment climate reform efforts, including implementing regulations of the Omnibus Law on Job Creation, are accompanied by wide-ranging and meaningful stakeholder consultations and communication campaigns. Involve all relevant stakeholders, including trade unions, civil society, affected stakeholders, and academia in addition to the business community, more systematically and as early as possible in policy design, even if conflicting views sometimes occur, to maintain a constructive dialogue and reach an environment of trust. Diversify the number of interlocutors and ensure all the spectrum of stakeholders, including at the local levels, are involved and represented. Ensure that consultation remains transparent and that information on how stakeholder inputs were used is publicly available.
- In the context of its aftercare services, BKPM could strengthen its business matchmaking programme to foster the creation of linkages between foreign affiliates and domestic firms. In addition to matchmaking services, the programme could include the preparation of suppliers' databases, which, on the one hand, may reduce foreign firms' transaction costs and, on the other, can help provide opportunities for local firms. Greater co-ordination with similar initiatives across

government would avoid overlaps and reinforce the efficient implementation and monitoring of the linkage programme.

- In terms of investment promotion efforts, continue moving away from costly image building campaigns and adopt a more focused approach. BKPM could consider better prioritising its FDI attraction measures to complement the recent and ongoing improvements conducted to facilitate inward investments. Proactive FDI attraction should focus on targeted sectors and projects, which support the country's sustainable development goals and an inclusive and resilient recovery from the pandemic. Focus should be given to industries where foreign investments' performance is proven to be higher than domestic ones in terms of productivity and innovation, wages and skills development, and environmental preservation.

Main policy recommendations on tax incentives for investment

- Monitor effects of tax reform on Indonesia's tax base. Lower tax revenues can constrain government spending on infrastructure and social services, which in turn can hamper progress toward improving the business environment in the long-run.
- Continue to shift towards cost-based tax incentives. New tax incentives introduced since 2018 have all been cost-based, but profit-based incentives (tax holidays) remained in place or were expanded to additional industries. The authorities could consider limiting profit-based incentives to high priority investments. In the medium-term, once recovery from the COVID-19 crisis strengthens, consider reducing the number of promoted *pioneer industries*.
- More clearly define the policy objective for the 30% investment allowance to *certain industries*. Authorities could consider more clearly communicating the policy's key objectives and how they differ from other sector-based incentives (i.e. *pioneer industries* incentives). The latest restructuring of the incentive has significantly expanded the qualifying industries under this tax incentive, which risks creating an uneven playing field relative to non-promoted ones.
- Consolidate tax incentive regulations in the relevant tax law. In Indonesia, tax incentives are introduced and regulated through multiple legal instruments: laws, government, Ministry of Finance and BKPM regulations. Consolidating tax incentive regulations can increase transparency and reduce policy overlaps.
- Facilitate foreign investors' access to implementing regulations. BKPM could consider producing additional in-depth guides on how incentives apply, explaining differences between incentive regimes. Official translations of all relevant regulations and business segment lists (that include industry codes of eligible industries under each incentive) can also enhance transparency.
- Introduce sunset clauses on tax incentives to promote regular policy reviews. These can help identify new sector priorities as well as incentives that are no longer needed.
- Continue to conduct and publish annual tax expenditure reports and expand their analysis to include new tax incentives and forgone tax revenues within special economic zones (SEZs).
- Continue to engage in regional and international dialogue on taxation. Regional forums provide a space for discussion on potentially harmful tax competition, as well as sharing information on good practice examples from other regions. Regional dialogue and tax co-operation will be even more important in the COVID-19 context, as a way to avoid tax disputes that could harm economic recovery.

Decentralisation comes with opportunities and challenges on the investment climate and regional development

Indonesia has embarked on ambitious decentralisation reforms since 1998, which have shaped regional development and the geography of investment across the country. Decentralisation was seen as a vital complement to the democratisation process and a reaction to the inherently centralised approach of the previous government in a country with 17 000 islands and strong cultural and linguistic diversity, as well as stark regional inequalities. Local governments were handed large responsibilities for providing public services and shaping economic policy, including investment policy, along with extensive fiscal transfers.

Two decades after the beginning of the process, decentralisation is still an unfinished policy agenda. After the massive transfer of authority in the 2000s, Indonesia has been struggling to find the right balance in the sharing of investment policy responsibilities across different tiers of government. To simplify an overly complex investment environment and reduce legal and regulatory uncertainties, the central government has enacted successive policy measures modifying the responsibilities devolved to subnational governments. In this quest, the central government has adjusted the legal framework for local governance several times, through back and forth movements of decentralisation and recentralisation.

Hastened devolution of responsibilities has led local governments to manage their regions without the required accompanying skills, technical capacities, resources and oversight (OECD, 2016). As a result, decentralisation did not lead to significant reductions in regional inequalities, which continue to be high across the country. Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia's economy and, to some extent, more than in other emerging countries. Improvements in some policy areas have been made, but the capacity of subnational governments to produce public goods, generate inclusive growth and boost productivity has not always increased, even with rising transfers from the central to subnational governments. The COVID-19 outbreak, and the resulting crisis, may further exacerbate existing regional disparities.

Regional disparities in the levels of education, infrastructure, health and governance have narrowed but they are still high and weigh on the ability of less developed regions to attract investment other than commodity extraction. After decades of concentration on the island of Java, the observed catching-up in the level of investment by the other islands is partly driven by foreign exploitation of natural resources. The catching-up has not reached all regions, including urban areas with relatively high human capital and entrepreneurial activity. Resource-scarce and least developed regions, which are often at the periphery, continue to attract little investment after regional autonomy.

Regional governments have the authority to develop and implement their own investment-related regulations (*perda*), in accordance with higher-level national regulations. The establishment of regional one stop integrated services centres, PTSPs, and, later on, the introduction of the OSS system were steps in the right direction to improve the business licensing process throughout the country. Regulatory, technical and governance challenges continue to deter the efficacy of these initiatives, however, creating room for regulatory capture by local government. Not all local bodies in charge of delivering permits related to environment standards or land use co-operate with the PTSP, arguing that the establishment of foreign investors is imposed by the central governments. They may also lack the capacity to properly deliver such permits and can be more prone to corruption.

Overlapping regulations, if not contradicting investment policies, is another challenge behind the unclear division of authority between the central and subnational governments. For instance, some regions set their own regulations to restrict foreign investment in specific activities. Over the last two years, there has been a strong push for business climate improvements through a recentralisation of investment policymaking. Some reforms, such as the Omnibus Law on Job Creation, was initially put on hold to focus on the response to the COVID-19 pandemic. The law, which was eventually passed in October 2020, seeks to harmonise central and regional regulations and ease the investment process. If the law is to reduce the level of legal uncertainty by withdrawing regulatory power from the regions, the government should ensure that implementation at the subnational level takes place as the proposed reduction in powers may create ground for a constitutional challenge. To avoid that outcome, it is critical to have ex ante solid consultation mechanisms to ensure that subnational government views are taken on board.

The rationale of centralising investment policymaking and business licensing is, in part, because remote and less developed regions do not always have the institutional and technical capacities. Local bodies may be well-placed to assess business opportunities and risks, however, and at the very least should have a clear role in this process, even if ultimately the decision-making process is re-centralised. Building gradually their capacity can be a more sustainable approach in the longer-term, and an approach that promotes shared responsibilities across tiers of government over top-down governance. At the same time, higher levels of government lack the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors, and avoid a possible race to the bottom in environmental or other sustainability standards across regions.

One priority for the central and regional government is to strengthen their efforts in order to create a predictable investment environment that supports a resilient, sustainable and inclusive economic recovery from the COVID-19 pandemic. These efforts are more than ever needed in less developed and poorer regions of the archipelago, where higher levels of uncertainty may delay much-needed investments in infrastructure and human capital development. The pandemic has revealed that aftercare services can be crucial in times of high uncertainty and subnational investment agencies are well-placed to deliver specific and targeted support to established investors. On the regulatory front, uncertainty on the content of the 'negative investment list' (DNI) and the related restrictions on foreign investment in sectors like maritime transport may delay or prevent new foreign projects in infrastructure.

Another priority for all levels of government is to boost regional development by attracting more diversified, sophisticated and sustainable investment. Regional investment agencies should upgrade their investment promotion tools, in co-ordination with the national investment promotion agency, BKPM, and its international investment promotion centre overseas offices. Previous zone-based policies to attract productivity-enhancing foreign firms into lagging regions had no conclusive impact. The Special Economic Zone programme aspires to overcome previous shortcomings by involving subnational governments in the decision-making process and granting non-fiscal incentives. Fiscal incentives consist of both tax holidays and investment tax allowances. The latter are preferable to preserve fair competition between firms inside and outside of zones.

Main policy recommendations

- The central government could further clarify investment policy responsibilities assigned to different government levels to reduce duplication and overlaps. Responsibilities should be balanced across levels of government, sufficiently funded, explicit, mutually understood and clear for all actors. Clarifying responsibilities is particularly important when they are shared, such as in the case of investment facilitation and promotion. The implementation of the Omnibus Law on Job Creation could be an opportunity to clarify responsibilities. Higher levels of government should ensure that subnational government views are taken on board through inclusive consultation mechanisms.
- Higher levels of government should continue building the capacity of investment and investment-related institutions, particularly of PTSPs and technical agencies delivering operational permits. They should assess capacity challenges in regions on a regular basis and prioritise those with the most pressing needs (e.g. poor and remote areas). The central government should ensure that PTSPs can operate effectively the OSS and that they can produce most, if not all, investment permits.
- The process of recentralisation of investment responsibilities should go hand in hand with building the capacity of local bodies and sharing responsibilities across levels of government. Ongoing recentralisation reforms should provide higher levels of government with legal levers to limit regulatory capture and asymmetries in information between local administrations and investors, and ensure that national environmental or other sustainability standards are well-respected across regions.

- Regional investment agencies could seek to upgrade their core investment functions, in close co-ordination with BKPM. Regional agencies could take a more pro-active role in promoting foreign investment and tailor their promotion tools to focus on relevant investments for their region, in co-operation with BKPM overseas offices. Collecting comparative information on foreign competitor regions can be useful in refining local investment promotion tools such as investment generation activities. To reduce uncertainty generated by the COVID-19 pandemic, regional agencies could also strengthen their after-care services to respond to requests of existing investors.
- Regional investment agencies could reinforce their co-operation with other local bodies such as business development services in order to better align the production of local suppliers with the needs of foreign firms. Central and regional government could also support strengthening local firms' absorptive capacity by raising awareness about business development services and easing procedures to get the adequate support.
- Incorporate the investment aims of zone-based policies into investment promotion and regional development strategies. Experiment in SEZs with different non-tax regulatory incentives. Cost-based incentives such as investment tax allowances should be favoured over tax holidays. To streamline wider zone-based policy, phase-out zone types that have not achieved their objectives. Otherwise, convert them to SEZs.
- Promote regional development policies that reduce disparities in infrastructure, the quality of local governance, and education:
  - The impact of the recently introduced firm-level incentives on skills development should be monitored to assess impacts.
  - In light of the high relevance of maritime transport for the connectivity of the archipelago, the central government could explore whether easing restrictions in this sector could help to attract foreign projects which support inter-island connectivity.
  - Increase the presence of the anti-corruption agency, KPK, in provinces, especially in those with business sectors at high risk of corruption.
- The central government could develop investment environment indicators to benchmark provinces, provide them with technical assistance where needed and monitor impacts of reforms. Performance-monitoring systems of decentralised investment environments need to be simple, with a reasonable number of standardised indicators. Higher-level governments should be able to monitor subnational performance of governments below them.

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Notes

[1] Estimates of the impact of COVID-19 on Indonesia vary across international organisations.

[2] Manufacturing of textiles, cement, chemical fertilisers, electronic products, rubber tyres.

[3] https://atlas.cid.harvard.edu/countries/103.

[4] Labour productivity (GDP per worker) in Indonesia was USD 26 000 in 2017, behind Singapore (USD 142 300), Malaysia (USD 60 000) and the ASEAN6 average (USD 30 600), but above the Philippines (USD 20 600) and the ASEAN average (USD 25 000) (APO, 2019).

[5] Resource nationalism refers to a nationalist stance by the government on natural resources, particularly mining, translated into policy measures geared toward greater state control of resource extraction and increased restrictions on foreign investment. Resource nationalism was particularly prevalent in Indonesia during the global commodity boom from 2000 to 2014 (Warburton, 2017).

[6] In response, according to the authorities, the government has plans to form a special inter-ministerial task force to handle investment reallocation, in accordance with Presidential Instruction (Inpres) No. 7 of 2019 concerning Acceleration of Ease of Doing Business. BKPM has already started to give priority to the investment reallocation plan of 40 foreign companies (with future potential projections of 300 companies) in China originating from the United States (US) and Japan. As reported by the authorities, the task force's work would include (1) detecting companies that will be relocating in the near term; (2) checking the facilities provided by competing jurisdictions, and (3) entering into and making decisions in negotiations.

2. Trends and impacts of FDI in Indonesia

This chapter examines the evolution of foreign direct investment (FDI) in Indonesia over the past two decades, its sectoral composition and origin. It also investigates how FDI contributes to key sustainable development priorities, namely global value chain integration, productivity, wages, skills, gender equality and the greening of the economy. The performance of Indonesia is assessed against a group of comparator countries.

Summary and policy directions

The first *OECD Investment Policy Review* of Indonesia conducted in 2010 showed that, in the years preceding the global financial crisis, FDI played a major role in raising employment and productivity and in generating exports in Indonesia. This suggests that FDI, in addition to domestic investment, could make an important contribution to a sustainable and inclusive recovery of Indonesia in the aftermath of the COVID-19 pandemic and resulting social and economic crisis. Besides providing a source for financing, FDI may bring significant advantages to the host country. It can raise productivity; support global value chain (GVC) integration; create more decent jobs; contribute to the development of human capital and the diffusion of cleaner technologies; and bring more gender-inclusive work practices. Indonesia has increasingly incorporated sustainable development targets in national and subnational development planning. Long term development priorities to build a more resilient and sustainable economy include boosting productivity and innovation; strengthening skills; creating more and better jobs; enhancing gender parity; and transitioning to a low-carbon and energy efficient economy.

Foreign direct investment (FDI) as a share of gross domestic product (GDP) in Indonesia has fluctuated over time, reflecting changes in domestic policy conditions. Since 2004, FDI as a share of GDP has grown significantly but has declined recently. Indonesia was historically a key FDI destination in ASEAN, but its share in the region's FDI inflows has fallen in the past few years. Rising global uncertainties have contributed to lower FDI inflows, which are expected to decline further due to the COVID-19 pandemic and ensuing global economic crisis. Cross-border equity flows in Indonesia have already dropped significantly during 2020 relative to 2019, as companies have put some mergers and acquisitions (M&A) deals and greenfield projects on hold due to rising uncertainty.

The largest share of FDI during 2010-19 went to manufacturing, although the share is declining as services have received increasing flows. The primary sector also attracts a large share of FDI due to the country's rich endowment of natural resources. Greenfield FDI projects are prevalent in manufacturing, while M&A deals are mainly concluded in the primary and services sectors. The bulk of FDI to Indonesia originates in Singapore and Japan. Investment from Singapore is, however, likely to be inflated due to the tendency of some foreign multinationals to invest through their Singapore affiliates.

Foreign firms directly contribute to several sustainable development objectives of Indonesia. They are more productive, have higher employment ratios and pay higher wages than Indonesian firms. Additionally, they export a higher share of their production. Foreign firms also generate important multiplier effects on the domestic economy. For instance, an increase of 1% in foreign sales is found to increase the total expenses for wages and salaries by 0.4% through the creation of new jobs. This additional labour income, in turn, is expected to generate a positive multiplier effect on the domestic economy through its impact on domestic consumption.

Foreign firms favour participation in GVCs, but Indonesia appears to be less integrated in GVCs than other countries in the region. It has a lower export orientation and a lower share of foreign value added in gross exports, and foreign firms contribute less to domestic value added relative to their peers in other countries. Its level of GVC participation is nevertheless similar to that other economies with large domestic markets, namely India, China and the United States, or rich in natural resources like Australia. Foreign firms in Indonesia also contribute less to gross exports and imports in comparison with other countries in the region since Indonesia attracts a large share resource-oriented and market-seeking, as opposed to export-oriented, FDI.

FDI supports productivity gains within the economy, as it is concentrated in sectors that are relatively more productive, namely mining, energy, transport services and chemicals. Across most sectors, foreign firms are more productive and are more likely to invest in research and development (R&D) and innovate. While this foreign performance premium confirms the importance of the direct contribution of FDI to sustainable development, it also points to gaps in domestic capabilities, which reduce the chances for technology transfer from foreign to domestic firms and positive productivity spillovers. Business linkages between foreign and domestic firms are significant, suggesting that the potential for productivity spillovers is high. In 2016, intermediate goods sourced domestically by foreign firms accounted for 36% of their output. The large extent of domestic linkages observed in Indonesia is also partly explained by local content requirements in a variety of sectors, including mining, transport equipment and electronics. FDI influences different labour market outcomes in opposite ways. It is concentrated in sectors with relatively higher wages (mining, energy, transport services), but with lower levels of female participation. In most sectors, foreign firms pay higher salaries and are more gender-inclusive than domestic firms: they employ a larger share of female workers and are more likely to be run or owned by women. Foreign and domestic firms employ comparable levels of skilled labour and report similar difficulties in hiring qualified labour, particularly in relation to IT, foreign language proficiency and technical skills.

Lastly, FDI contributes to Indonesia's environmental targets in contrasting ways. Foreign investors tend to locate in sectors that are more polluting in terms of CO_2 emissions, but they are more energy-efficient than domestic firms. While the share of FDI in renewable energy is still comparatively low, inflows in clean energy infrastructure are increasing rapidly.

Main policy directions

Some policy directions are formulated based on the results presented in this chapter. They will be further discussed in other chapters of this review.

- Due to the COVID-19 pandemic and resulting economic turmoil, FDI flows are expected to decline further in 2020. Policies to retain investment will play a key role in the recovery phase to minimise economic and social costs such as loss of jobs and tax revenue (Chapters 6 and 7). Additionally, removing remaining FDI restrictions and creating a level playground for both domestic and foreign companies (Chapter 3) will be key to attract investors and enhance positive FDI spillovers.
- The share of FDI in manufacturing has declined in the past few years. Among other constraints, foreign manufacturing firms report difficulties in finding workers with the required skills. Enhancing the attractiveness of Indonesia as a manufacturing location for foreign investors requires actions in multiple areas, including addressing inefficiencies and rigidities in the labour market, improving the quality of the education system, and liberalising services FDI (Chapter 3).
- FDI is highly concentrated in terms of origin: the bulk of FDI in Indonesia originates in Asia, of which more than two-third comes from Singapore and Japan. While there is evidence that some OECD and EU multinationals invest in Indonesia through their operations in Singapore, reliance on FDI from a small group of investors increases Indonesia's exposure to changes in macroeconomic conditions in those countries. Targeting FDI from other countries, especially from other regions, is therefore crucial to reduce the country's vulnerability to external shocks (Chapter 6).
- Affiliates of foreign firms established in Indonesia tend to outperform domestic firms: they are more productive, spend more on R&D, and innovate more. While a foreign performance premium is observed in many countries, it is especially large in Indonesia, particularly in some sectors (e.g. non-metallic minerals, food, chemicals). The observed gaps between domestic and foreign firms may indicate a lack of domestic capabilities. Consequently, domestic firms may not have the capacity to benefit from the presence of foreign firms, such as through the adoption of foreign technology. Strengthening domestic firms' capabilities requires policy efforts in different areas, including improving human capital development, boosting research and innovation, and engaging in responsible business conduct (Chapter 5).
- Foreign firms in Indonesia are prevalent in male-dominated sectors but are more gender-inclusive than domestic firms. Specifically, they employ higher shares of women, and they are more likely to be run or owned by women. Closing the gender gap could bring about significant benefits for

Indonesia, and the results suggest that the country could leverage FDI to promote more gender-inclusive outcomes in the labour market. Chapter 5 touches upon responsible business conduct practices in relation to gender equality in Indonesia.

- FDI is prevalent in sectors that emit more CO_2, but foreign firms are more energy-efficient than domestic firms. Furthermore, Indonesia's share of FDI in renewables is growing fast. The results show that there is the potential to enhance the environmental performance of Indonesian firms, for instance by encouraging the diffusion and adoption of cleaner technologies brought by foreign firms. Responsible business practices of foreign multinational companies in Indonesia in relation to the environment are discussed in Chapter 5. The findings also suggest that Indonesia could benefit in terms of a reduced environmental impact by attracting FDI in a wider variety sectors by lifting FDI restrictions (Chapter 3).

FDI can support Indonesia's sustainable development agenda

The first OECD *Investment Policy Review of Indonesia* released in 2010 shows that FDI has historically contributed little to gross fixed capital formation and that investment, both domestic and foreign, has been inadequate to meet the development needs of the country. At the same time, the review highlights that FDI in Indonesia has played a major role in raising employment and productivity and in generating exports, especially in the years preceding the global financial crisis of 2008 (OECD, 2010).

The COVID-19 pandemic is likely to have long lasting and disruptive economic and social consequences in many countries, including Indonesia. In light of the rapid deterioration of the economic and social situation, the Indonesian government is expected to further strengthen efforts to support a sustainable and inclusive economic recovery from the pandemic and resulting economic crisis. Indonesia's experience in the years preceding the global financial crisis suggests that FDI could make an important contribution in the aftermath of the COVID-19 pandemic.

Besides providing a source for financing, FDI may bring significant advantages to the host country. It can raise productivity, ultimately leading to an improvement in standards of living; support GVC integration; create jobs; contribute to the development of human capital and to the diffusion of new technologies. FDI can also support social and environmental goals, for instance by bringing more gender-inclusive work practices in the host country and by increasing energy efficiency through the diffusion of cleaner technology.

The impact of FDI can be both direct and indirect. Direct impacts stem from foreign firms' operations abroad, whereas indirect impacts (or spillovers) arise from foreign firms' interactions with domestic firms.[1] The effects of FDI in promoting sustainable and inclusive growth are however not automatically positive. FDI affects different segments of the population and regions unevenly and, thus, may exacerbate existing income and territorial disparities.[2] Domestic policies and institutions are crucial for enabling FDI benefits while curbing potential adverse impacts.

Indonesia has been one of the first Asian countries to incorporate sustainable development targets, or the Sustainable Development Goals (SDGs) in national and subnational development planning (Republic of Indonesia, 2019a). While in the short run, the government may reorient its policy priorities in response to the COVID-19 crisis, key objectives reflected in current strategic development planning will remain important to build a more resilient and sustainable economy. These priorities include boosting productivity and innovation; strengthening skills; creating more and better jobs; enhancing gender parity; and the transition to a low-carbon and energy efficient economy.

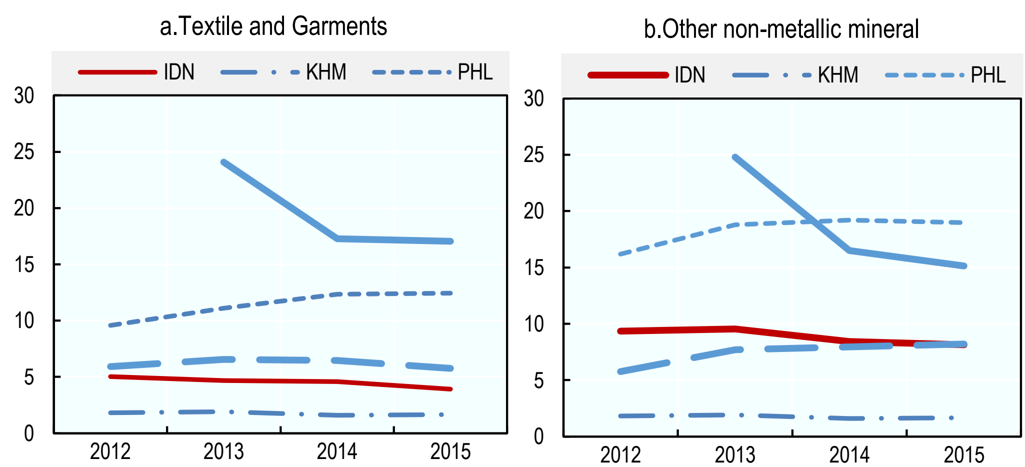
Boosting productivity

Recent trends in labour productivity show that Indonesia lags behind most countries in the region. OECD estimates show that, even in diverse industries, such as labour-intensive textile and garments and capital-intensive non-metallic minerals, Indonesia's labour productivity is below the regional average (Figure 2.1). Poor productivity performance of Indonesian firms is one of the reasons behind the country's loss of competitiveness in global markets (ADB, 2019a, 2019b; World Bank, 2018).

Boosting productivity and competitiveness in global markets is high on Indonesia's sustainable development agenda. The 2015-2019 National Medium-Term Development Plan (Republic of Indonesia, 2019a) sets nine guiding principles for government action to support the country's sustainable development agenda. Improving productivity and competitiveness in the international market is one of those guiding principles. 'Making Indonesia 4.0' initiative (Republic of Indonesia, 2019b), designed to revitalise the manufacturing sector through the diffusion of 4th generation technologies (artificial intelligence, machine learning, robotics, and so on), includes explicit targets on export, productivity and innovation. The strategy aims at returning the industry net export rate to 10%; doubling the labour productivity rate over labour costs; and allocating 2% of GDP to R&D and technology innovation fields. To reach these ambitious targets, the government has formulated ten national priority strategies. One of the strategies focuses on attracting FDI to close the technology gap and encourage technology transfer to local companies.[3]

Figure 2.1. Indonesia is less competitive than some regional peers in various sectors

Labour productivity (in bln USD)



Note*:* Labour productivity: value added per employee
Source*:* OECD elaboration based on OECD Input-Output Tables and ILO.

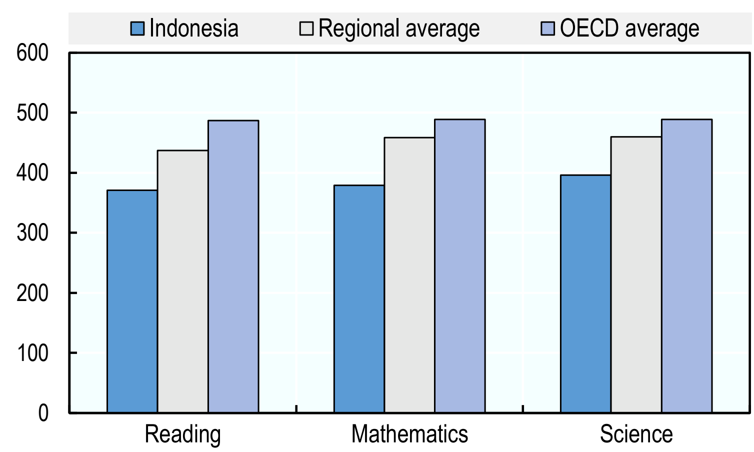
Existing evidence suggests that FDI, in addition to domestic investment, can support Indonesia in achieving its productivity targets. Foreign firms generate value added and jobs, and therefore directly contribute to aggregate domestic productivity. They may also affect productivity via spillovers on domestic firms. Business linkages with foreign firms are a key channel of FDI spillovers, as they facilitate the transfer of technology and skills and help domestic business tap into global value chains. Positive FDI spillovers are more likely to occur when domestic firm capabilities are closer to the foreign firm frontier. At the same time, FDI may have a negative impact on domestic productivity. FDI can crowd out local enterprises, for instance by increasing competition for inputs or local skills. Accordingly, FDI spillovers can be uneven across domestic firms, and potentially have a negative impact on domestic productivity.

Creating more decent jobs, improving skills and enhancing gender equality

Indonesia faces several labour market challenges, including limited decent employment opportunities, poor quality of the labour force, and labour market segmentation. Recent estimates by the OECD show that around half of all dependent employees and 70% of all workers in Indonesia are in informal jobs (OECD, 2018). These jobs tend to be associated with low wages and poor working conditions. Scarcity of skills, particularly of high-skilled professionals and managers, is a key concern for businesses (ADB, 2016). The lack of adequate skills in the labour market is consistent with the need to improve the quality of the domestic education system. According to the OECD Program for International Student Assessment (PISA), Indonesian students score lower than the OECD average and many other countries in the region in reading, mathematics and science (Figure 2.2). In addition, Indonesian women still do not participate equally in the labour market. Women tend to be concentrated in the informal economy, are paid less and face worse working conditions (ILO, 2020).

Figure 2.2. Indonesian students underperform their regional and OECD peers in all PISA assessment areas

Students' average scores in reading, mathematics and science



Note: The regional average is based on China, Singapore, Malaysia, Thailand, Indonesia and the Philippines.
Source*:* OECD, PISA 2018 Database

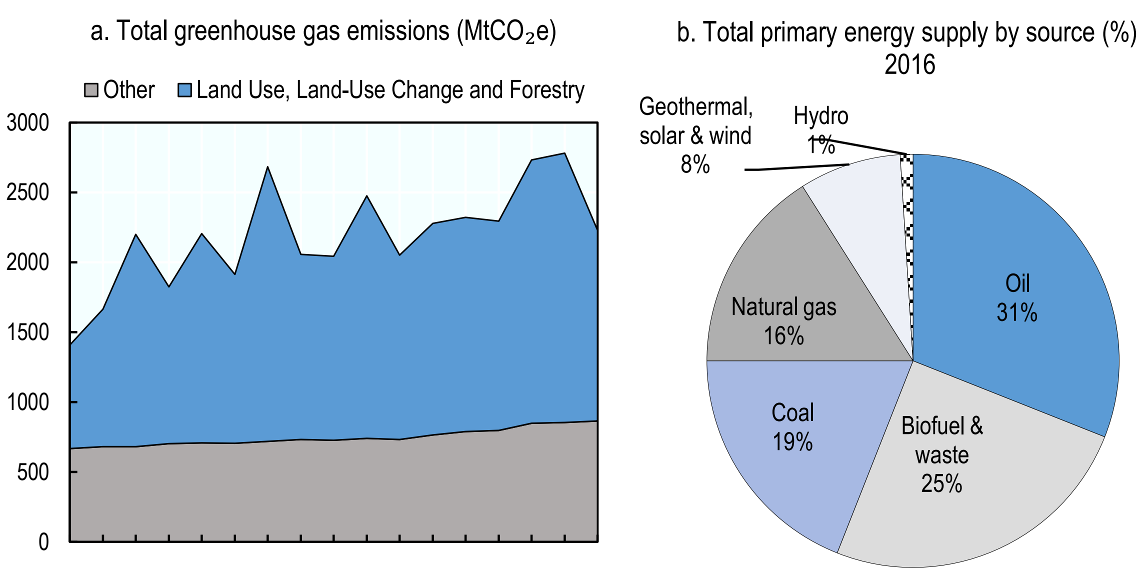
The 2015-19 Medium Term Development Plan integrates objectives and policies to expand decent employment opportunities and social protection for workers in vulnerable categories, such as informal workers, those with disabilities and elderly people. The plan also includes a number of measures to improve the quality of human resources through improving access to, and quality of, higher education and vocational training. It also contains objectives to enhance the role and representation of women in political and economic life. Enhancing the quality of human resources is one of the ten priorities identified in 'Making Indonesia 4.0' to accelerate the development of the manufacturing sector. The strategy states that Indonesia will work with industry players and foreign governments to improve the quality of training centres and develop skills that meet the needs of businesses.

Several studies suggest that Indonesia could leverage FDI to address crucial labour market challenges. The establishment of a foreign investment or the takeover of a domestic firm by a foreign investor causes changes in the local demand for labour, thereby affecting domestic employment, wages and the labour force composition (e.g. the gender balance or skill intensity). Foreign firms may affect labour market outcomes directly, for instance by paying salaries to local employees, or indirectly through spillovers on domestic firms. For example, foreign firms may compete for labour with domestic firms in the local labour market, which in turn may result in higher wages.

Transition to a low-carbon and energy efficient economy

Indonesia faces increasing environmental challenges associated with rapid urbanisation and economic growth. In the future, the country is expected to be increasingly affected by climate change with significant implications for the safety and prosperity of its communities. Indonesia is one of the main global emitters of greenhouse gasses. Up to 60% of its total emissions, which have grown over time, are caused by deforestation, forest degradation and peatland conversion (panel a, Figure 2.3). Energy demand has also accelerated, underpinned by strong demand for transport services and rising domestic incomes. Growing demand for energy poses additional challenges to climate change mitigation. Energy transition from fossil fuels to renewables has therefore become critical to curb emissions. Recent estimates by the International Energy Agency (IEA) show that Indonesia's share of renewable energy sources such as hydro, geothermal, solar, and wind (excluded biofuel and waste) in total primary energy supply remains modest (panel b).

Figure 2.3. Greenhouse gas emissions are increasing, while the share of renewables remains modest



Note*:* Total greenhouse gas emissions including land use, land-use change and forestry; panel b: Primary energy supply is defined as energy production plus energy imports, minus energy exports, minus international bunkers, then plus or minus stock changes.
Source*:* OECD elaboration based on Climate Watch (panel a) and IEA World Energy Statistics and Balances: Extended world energy balances (panel b)

Indonesia's climate pledge ("nationally determined contribution", or NDC) targets a 29-41% reduction in emissions by 2030, compared to "business as usual".[4] The high end of this range, conditional on support from international cooperation, would require emissions in 2030 to remain at or below current levels. Benefits in terms of additional GDP growth are estimated to be substantial under both scenarios (Indonesian Ministry of Development Planning, 2019). Energy transition from fossil fuels to renewables is also a key pillar of Indonesia's plan to decarbonise its economy. The National Energy Policy (Kebijakan Energi Nasional, KEN) launched by the government in 2014 (Government Regulation No. 79/2014) sets a renewable energy target of 23% by 2025.[5]

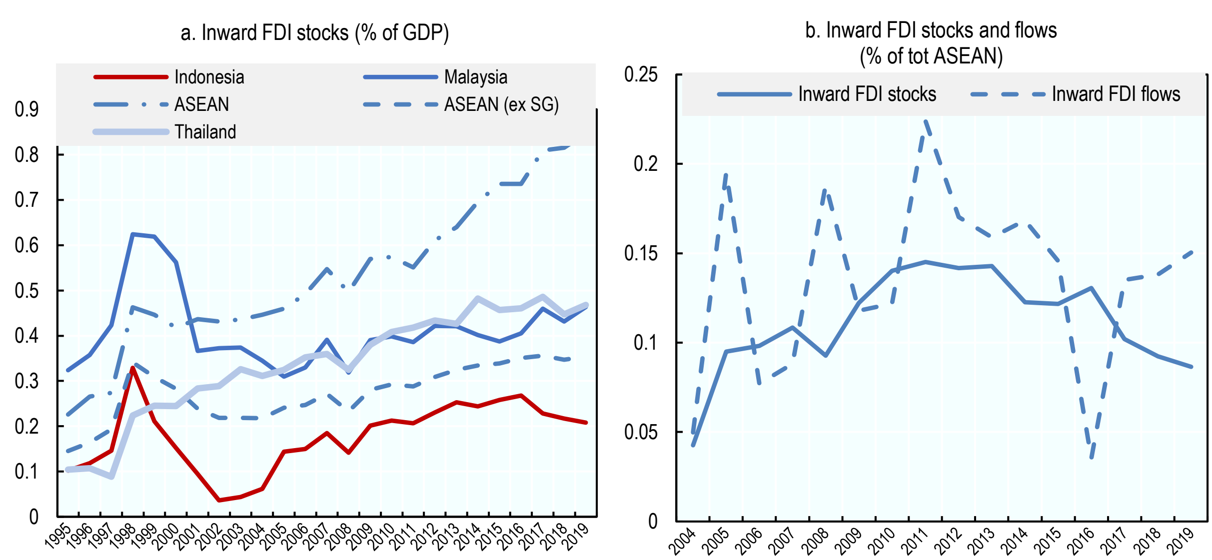
Growing evidence shows that FDI may have sizeable environmental impacts in host countries. It can affect a country's footprint through different channels: by expanding the *scale* of economic activity, by changing the *structural composition* of economic activity and by bringing *new techniques* of production.[6] The scale effect is expected to increase CO_2 emissions, since an increase in the size of an economy implies more production and, in turn, more emissions. Conversely, the 'new techniques' effect often results in a reduction of emissions by helping diffuse cleaner or energy-saving technologies. The composition effect refers to changes in the industrial structure driven by FDI and its impact on emissions varies based on the type and level of specialisation of a country. The net impact of FDI on CO_2 emissions depends on several factors, including the stage of development and the policy context. Under the right market conditions, FDI may also contribute to reducing emissions by financing renewable infrastructure. Foreign firms play an important role in the diffusion of renewable energy technology across borders. Investment in renewable energy is critical in the context of mitigating CO_2 emissions, especially in emerging countries where the demand for energy is growing rapidly.

FDI trends

Recently FDI as a share of GDP has fallen

Over the past two decades, FDI as a share of GDP in Indonesia has fluctuated, reflecting changes in domestic policy conditions (panel a, Figure 2.4). Major policy reforms brought a surge in FDI in the mid-1990s. During this period, a large amount of export-oriented FDI flowed into labour-intensive manufacturing sectors, making Indonesia one of the main FDI destinations in the region. In 1995, FDI corresponded to 10% of GDP. By 1998, FDI as a share of GDP had reached 33%, its historically highest point.

Figure 2.4. FDI as a share of GDP and in total ASEAN is declining



Source: OECD elaboration based on UNCTAD and the World Bank.

Indonesia was hit hard by the Asian financial crisis of 1997-98, which caused massive outflows of FDI from the country. FDI as a share of GDP fell dramatically during this period, going down to 4% in 2003. Indonesia's economic recovery was slower than other countries in the region, also due to a period of political instability. FDI as a share of GDP started to pick up only after 2004, boosted by several liberalisation reforms put in place by the government to meet the conditionality attached to IMF loans and facilitate restructuring of the corporate sector. Consequently, foreign ownership shares increased in many domestic companies who suffered from financial difficulties in the aftermath of the crisis (OECD, 2010). Between 2004 and 2007, FDI as a share of GDP tripled, passing from 6% to 18%.

During the global financial crisis of 2008-09, inflows remained generally robust by historical standards and in comparison with the fall in FDI in OECD countries (OECD, 2010). FDI as a share of GDP fell in 2008, but recovered sharply in 2009. Since 2016, FDI as a share of GDP has declined, partly owing to sluggish cross-border M&A sales and significant divestments by foreign multinational companies (UNCTAD, 2017). Mounting global uncertainties such as rising trade tensions and protectionism, China's economic slowdown, and tightening US monetary policy (and the resulting shifts of capital from low interest rate to the high interest rate countries) have contributed to lower FDI inflows. At the same time, there is some evidence that Indonesia may have benefitted from the US–China trade tensions. Recent analysis shows that the US–China trade war is likely to have contributed to trade and FDI diversion effects, where companies operating in China relocated operations away from China, especially to neighbouring countries in Southeast Asia, including in Indonesia (World Bank, 2020). Due to the COVID-19 pandemic and resulting global economic crisis, FDI flows are expected to decline further in the course of 2020. The latest data show a significant drop in equity flows in Indonesia, as well as in ASEAN, already in the first quarter of 2020 relative to the first quarter of 2019 (Box 2.1). This is because companies have put some M&A deals and greenfield projects on hold in response to mounting economic uncertainty (OECD, 2020).

Being by far the region's largest economy, Indonesia was historically a key FDI destination in the region. In the past few years, however, Indonesia's share in FDI flows to ASEAN has fallen (panel b, Figure 2.4). This is partly explained by the increasing importance of less developed ASEAN countries, namely Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV), as FDI locations in the region. Foreign companies are investing more and more in CLMV, attracted by the competitive labour costs and increasingly open investment and trade regimes of those countries.

Box 2.1. The impact of the COVID-19 pandemic on FDI in Indonesia

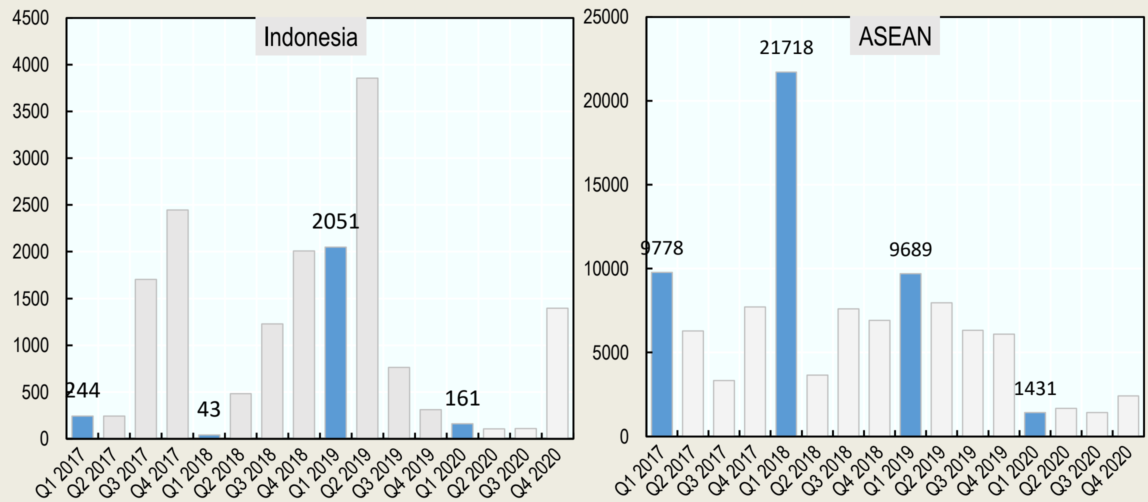
Globally, FDI flows are expected to plummet due to the COVID-19 pandemic and the consequent economic turmoil. OECD projections indicate that even under the most optimistic scenario, global FDI flows will likely drop by at least 30 percent in 2020 compared to 2019 before going back to pre-crisis levels by the end of 2021 (OECD, 2020). The fall in FDI is predicted to be sharper in developing and emerging countries because sectors that have been severely impacted by the pandemic account for a larger share of their FDI. While the immediate effect on FDI will stem from a reduction in reinvested earnings, equity capital flows will also be affected as companies will put some M&A deals and greenfield projects on hold (OECD, 2020).

Data on cross-border M&As from the Refinitiv database show a significant decline in completed deals in the first quarter of 2020 in both Indonesia and ASEAN as a whole (Figure 2.5). In Indonesia, the value of cross-border M&As fell by 92% relative to the first quarter of 2019. A sharp decline is observed also in ASEAN, where the value of cross-border M&A deals dropped by 85% compared to the first quarter of 2019. In Indonesia, a significant drop can be observed also in the second and third quarter of 2020, while completed M&A deals in the fourth quarter are higher.

The latest data on greenfield FDI from the Financial Times' fDi Markets database provide further evidence that investors are more reluctant to explore new investment opportunities due to the pandemic. In Indonesia, the value of greenfield FDI pledges in the first quarter of 2020 dropped by 28% relative to 2019 and by 41% relative to 2018 (Figure 2.6). A sharp decline is observed also in the third quarter of 2020 relative to 2019.[7] Similarly, in ASEAN FDI pledges in the first quarter of 2020 decreased by 31% compared to 2019 and 47% compared to 2018. A sectoral breakdown of greenfield investments shows that in Indonesia infrastructure (construction, energy and ICT infrastructure) and services suffered the largest decline. Conversely, announced projects in manufacturing significantly increased relative to 2019. A similar trend is observed in ASEAN as a whole.

Figure 2.5. Value of completed M&A deals, 2017-2020

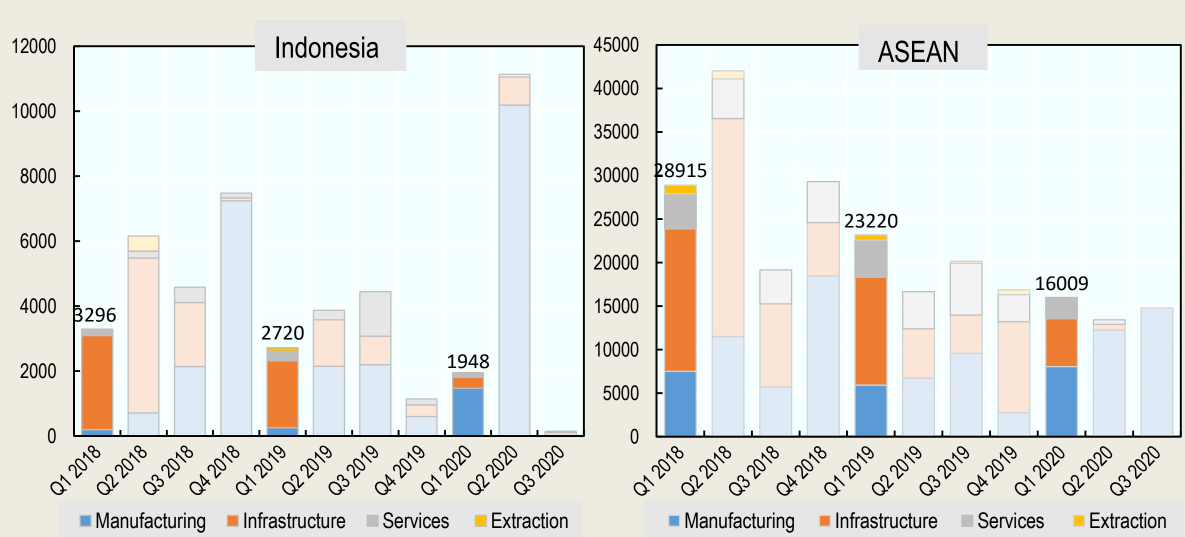
USD millions



Source: OECD based on Refinitiv M&A database

Figure 2.6. Value of announced greenfield investments by sector, 2018-2020

Announced capital expenditure, USD millions



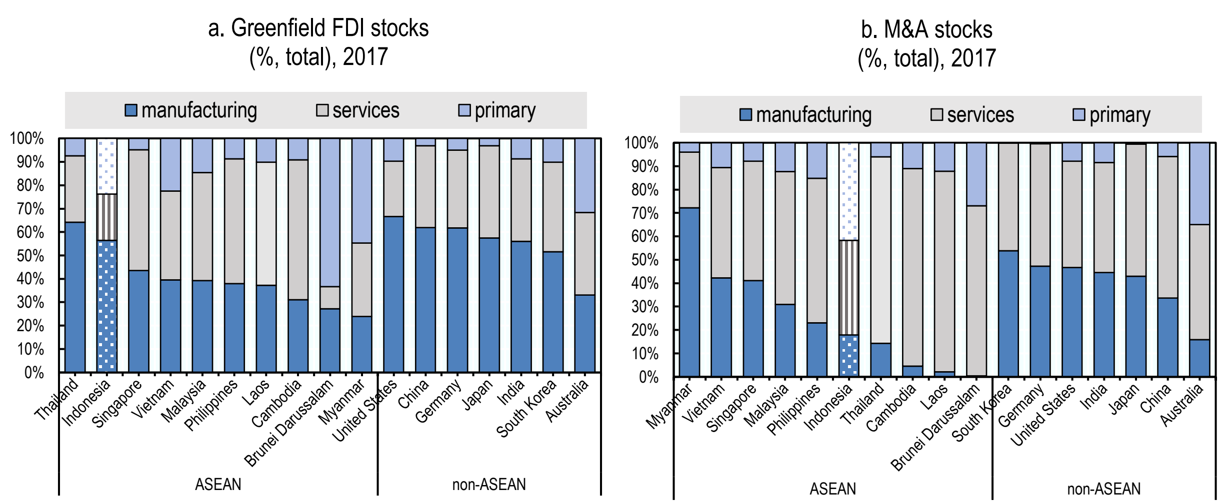
Note: Infrastructure includes construction, energy and ICT infrastructure.
Source: OECD based on Financial Times fDi Markets (2020).

Greenfield investment dominates manufacturing, while M&A deals prevail in the primary and services sectors

Greenfield investment and cross-border M&As are two important entry modes for foreign investors.[8] The *Financial Times* fDi markets database provides cross-border greenfield projects, while Dealogic collects data on cross-border M&A deals. Greenfield FDI data do not cover agriculture; hence, the share of greenfield projects in the primary sector only includes investment in mining. Greenfield FDI data also exclude energy and construction, therefore these two sectors are excluded from the analysis.

The bulk of greenfield investment in Indonesia is destined to manufacturing (panel a, Figure 2.7). Indonesia's share of manufacturing in total greenfield FDI is the second highest in the region (56%) after that of Thailand (64%), and similar to that of other economies including the United States (67%), China (62%) and Germany (62%). Its greenfield FDI share in the primary sector is also significant (24%). Indonesia's share is the third largest in the region, given the country's abundance of natural resources, after that of Brunei Darussalam (63%) and Myanmar (45%). Since Indonesia attracts a large number of foreign multinationals in agriculture, particularly in food crops and plantations, the share of greenfield investment in the primary sector is likely to be underestimated.

Figure 2.7. Greenfield FDI is concentrated in manufacturing, while M&A deals are prevalent in the primary and services sectors



Note: Energy and construction are not covered by greenfield FDI data, hence these two sectors are not shown. Moreover, greenfield FDI data do not cover agriculture; thus, the share of greenfield FDI in the primary sector might be underestimated.
Source*:* OECD based on Financial Times's fDi markets and Dealogic.

Foreign M&A deals are mainly concentrated in the primary and services sectors. Indonesia's share of M&A contracts in the primary sector is the highest in the region (42%) and similar to that of other resource-rich-countries like Australia (35%). Within the primary sector, the majority of M&A deals were concluded in mining (60%), although M&A contracts in agriculture account for a significant share (40%). A large number of M&A deals are also reported in services (40%), but the share is one of the lowest in the region. Finally, Indonesia's share of M&A deals in manufacturing is modest (18%). While the share of M&A deals in manufacturing is low in most ASEAN countries, Indonesia's share is below the regional average.

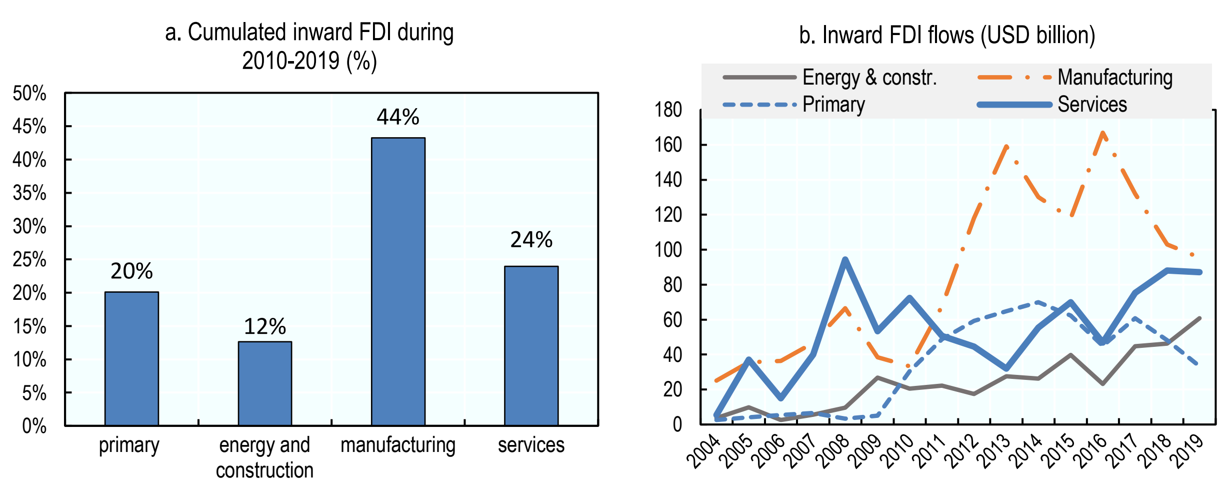
Manufacturing FDI accounts for the largest share but is declining

FDI data from the Indonesian Investment Coordinating Board (BKPM) are used to examine changes in structural distribution of FDI over time.[9] BKPM's FDI statistics differ from those of other domestic sources, such as Bank of Indonesia, by excluding oil and gas and financial services, by deviating from the standard FDI definition and by the possible inclusion of some domestic equity contributions (Box 2.2).

According to the BKPM's FDI data, the sectoral distribution of FDI in Indonesia is dominated by manufacturing (panel a, Figure 2.8). About 44% of all foreign investments recorded by BKPM over 2009-18 were in manufacturing, 24% in services, 20% in the primary sector, and 12% in energy and construction. As investments in oil and gas and finance are not recorded by BKPM, the shares of primary and services sectors are likely to be underestimated.

The structural distribution of FDI in Indonesia has changed considerably over time. Until the 1980s, FDI was prevalent in extractive and energy activities. Since the early 2000s, FDI flows in the manufacturing sector increased significantly as a result of large greenfield investments in metals, chemicals, motor vehicles and the food industry (panel b, Figure 2.8). Recently, however, FDI flows in manufacturing have fallen, reflecting a loss of competitiveness of the Indonesia's manufacturing sector relative to other countries in the region (ADB, 2019a and 2019b; World Bank, 2018). FDI flows in the primary sector have also grown considerably since 2009. Besides extractive activities, an increasing amount of FDI went to agriculture, especially food crops and plantations. Within the plantation subsector, palm oil is the most important industry for FDI, driven by growing world demand for crude palm oil. Since 2014, however, FDI flows in the primary sector have declined. This drop was driven mainly by the mining sector, where investments have decreased owing to the ban on iron ore exports imposed in 2014. The energy sector has also attracted a growing share of FDI, whereas construction has remained a relatively restricted sector to foreign investors. Finally, FDI in services has been comparatively under-represented in Indonesia, although the country has attracted increasingly higher shares. Transport, storage and communications were responsible for most of the growth in services FDI over the past decade. Recently, hospitality and real estate have also played an important role.

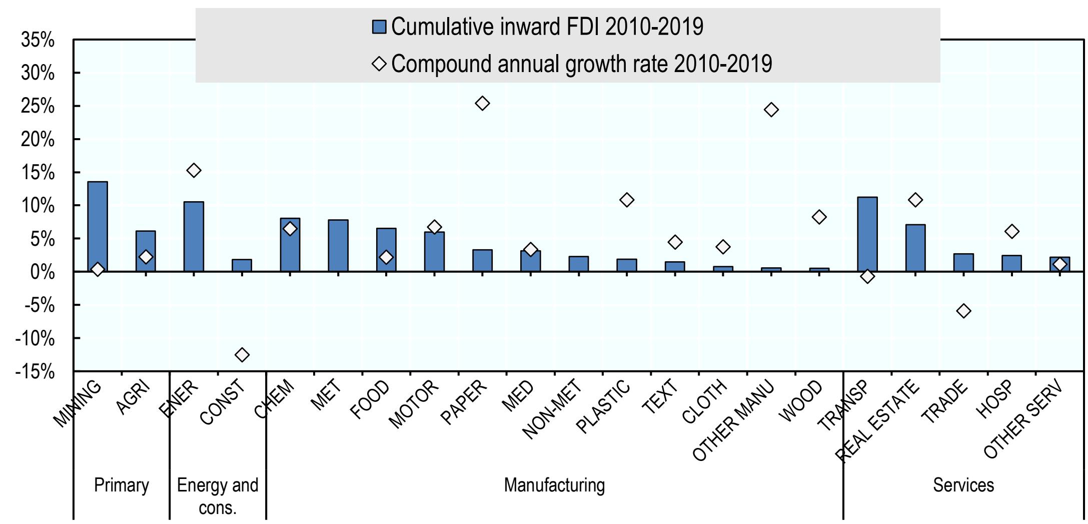
Figure 2.8. Manufacturing accounts for 44% of FDI, but the share is declining



Note: Oil and gas, banking and non-bank financial services are excluded.
Source: OECD elaboration based on Indonesia Investment Coordinating Board (BKPM)

A closer look at the sectoral distribution of FDI during 2010-19 shows that, within manufacturing, the top four host industries are chemicals (8%), metals (8%), food (7%) and motor vehicles (6%). The data shows that FDI flows increased in all manufacturing sectors. Within the services sector, transport, storage and communications (11%) and real estate (7%) are key targets. FDI flows in the transport sector, which increased rapidly during the wave of privatisations that took place after the Asian crisis, declined. Conversely, the importance of sectors such as real estate and hospitality rose. Mining (14%) receives the bulk of FDI in the primary sector. FDI flows to agriculture account for a smaller share (6%), but have increased over the past decade.

Figure 2.9. Mining, transport, energy and chemicals are key targets of FDI



Note: Oil and gas, banking and non-bank financial services are excluded.
Source: OECD elaboration based on Indonesia Investment Coordinating Board (BKPM)

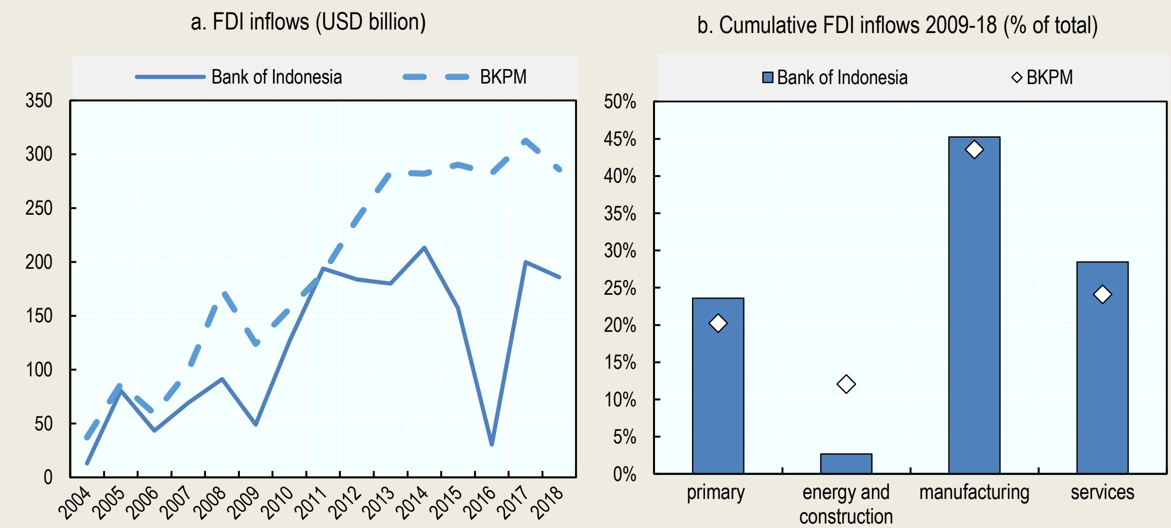
Box 2.2. FDI statistics: BKPM versus Bank of Indonesia

The Indonesian Investment Co-ordinating Board (BKPM) and the Bank of Indonesia are the two main sources of FDI data for Indonesia. (Figure 2.10). BKPM records FDI figures based on issued business licences, while Bank of Indonesia records international capital flows as part of balance of payments statistics. FDI statistics from these two sources, however, differ significantly (panel a of Figure 2.10). Several reasons explain such discrepancy:

- **Definition of FDI**: BKPM classifies all investment realisations made into a PMA company (foreign capital investment company) as FDI, including those below 10% and joint venture with a local partner.[10] Consequently, BKPM's FDI figures may include some equity contributions from domestic partners and investments financed from domestic sources. This practice tends to inflate BKPM's FDI figures. Bank of Indonesia's FDI instead follows the standard FDI categorisation of equity investment, retained earnings and other capital flows.
- **Sectoral coverage:** BKPM records FDI projects based on issued business licenses. Since licences for companies in oil and gas and financial services are issued by other government bodies, these sectors are not covered by BPKM statistics. Conversely, FDI data from Bank of Indonesia cover all sectors of the economy, although they are less granular. Differences in sectoral coverage explain why the share of FDI in the primary and services sectors are underestimated by the BKPM data (panel b, Figure 2.10).

- **Divestment of foreign equity**: Modifications of foreign share ownership of a PMA company are not recorded by BKPM's FDI statistics. This explains why BKPM data do not show the sharp decline in 2016 unlike Bank of Indonesia's FDI data, which record the large divestment by foreign investors (panel a).

Figure 2.10. FDI statistics from BKPM differ significantly from those of Bank of Indonesia



Source: OECD elaboration based on BKPM and Bank of Indonesia

The bulk of FDI to Indonesia originates in Singapore and Japan

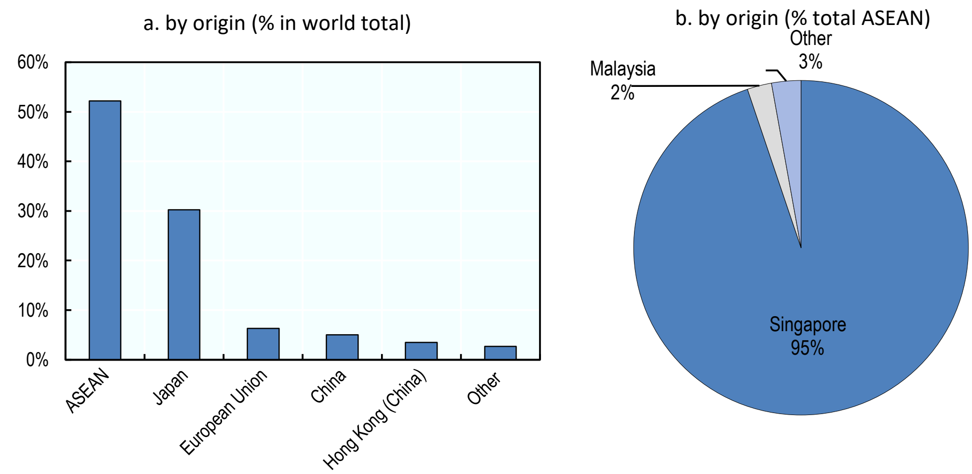
According to the Bank of Indonesia's FDI statistics, FDI flows to Indonesia originate mainly from Asia (panel a, Figure 2.11). 52% of total FDI flows received from 2010 to 2019 came from other ASEAN countries. From the rest of Asia, Japan is the largest investor (30%). Significant shares of FDI came also from the European Union (6%), particularly from the United Kingdom and Luxembourg, China (5%), and Hong Kong (China) (3.5%).

The data also show a considerable amount of divestment, corresponding to 6% of total FDI inflows during this period. Divestments were reported by foreign multinationals from the United States, Germany, Italy and Sweden. About 95% of ASEAN investment to Indonesia comes from Singapore (panel b). Malaysia provides approximately 2%, while other ASEAN countries contribute to the remaining 3%. FDI from Singapore, however, is likely to be overstated, as foreign multinationals, including from non-ASEAN countries, may choose to invest through their affiliates in Singapore (OECD, 2010).

Comparing FDI flows to Indonesia from OECD countries provided by the Bank of Indonesia with those reported by OECD countries shows significant differences between the two series (panel a, Figure 2.12). FDI reported by OECD countries tend to be higher, which is consistent with some OECD multinationals investing in Indonesia through Singapore (OECD, 2010). Over the period 2009-18, FDI reported by OECD countries exceeds that from Bank of Indonesia by 8% (panel b). A much higher discrepancy rate of 50% is observed between FDI reported by EU countries and those recorded by the Bank of Indonesia.

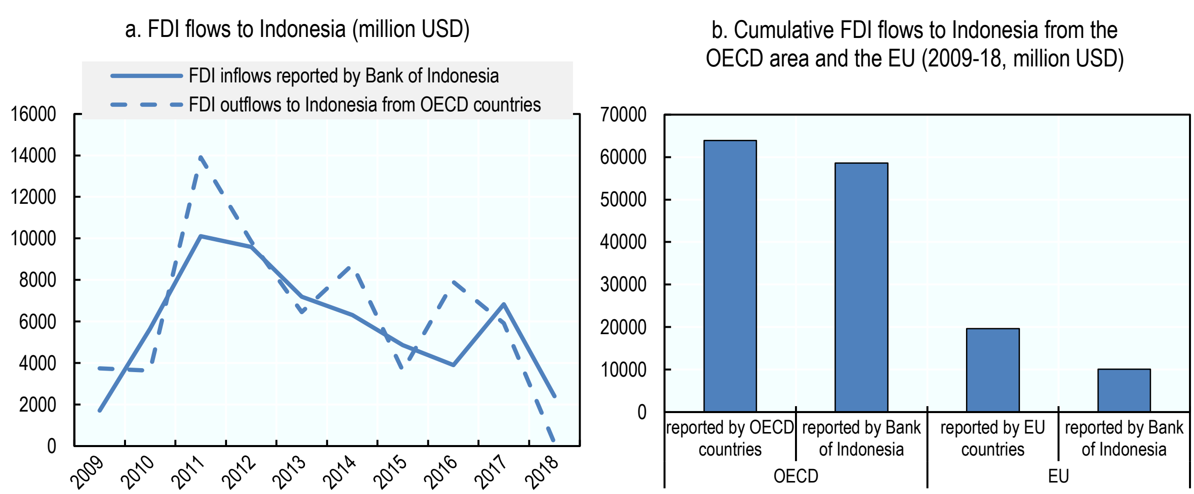
Figure 2.11. The bulk of FDI to Indonesia originates in Singapore and Japan

Cumulative inward FDI flows (2010-2019)



Source: OECD elaboration based on Bank of Indonesia.

Figure 2.12. FDI from OECD and EU countries is underestimated



Note: Aggregates for the EU reported by both EU countries and BI are based on 13 EU member states, namely Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Sweden and the United Kingdom.
Source*:* OECD elaboration based on OECD FDI statistics and Bank of Indonesia

FDI qualities

Using a variety of data sources, including the new OECD FDI qualities indicators (Box 2.3), this section examines how FDI contributes to several aspects of sustainable development in Indonesia. It first provides some insights on the direct contribution of foreign firms to sustainable development outcomes (e.g. productivity, wages) in Indonesia and then highlights the contribution of foreign firms to GVC integration. The third section focuses on the relationship between FDI and productivity and investigates the potential for productivity spillovers through business linkages and the capabilities gaps between domestic and foreign firms. The fourth section examines the link between FDI and selected labour market outcomes, namely wages, skills and gender equality. The last section looks at the contribution of FDI to the greening of the economy.

Box 2.3. The OECD FDI qualities indicators

The OECD FDI Qualities Indicators describe how FDI relates to specific aspects of sustainable development in host countries. An in-depth assessment of all 17 SDGs, and their corresponding targets, was undertaken to identify the full spectrum of FDI Qualities – that is, areas where FDI may contribute to achieving the SDGs. This assessment further considers the extent to which FDI's potential for advancing the SDGs is reflected in the OECD *Policy Framework of Investment* (PFI), including related frameworks and guidelines, such as the OECD *Guidelines on Multinational Enterprises* and the OECD Policy *Guidance for Investment in Clean Energy Infrastructure*.

The FDI Qualities Indicators currently focus on five clusters; namely, productivity and innovation, employment and job quality, skills, gender equality, and carbon footprint. These clusters have been selected in consultation with various stakeholders of the FDI Qualities Policy Network, which includes policymakers, the private sector, the civil society, international organisations and the academia. For each of the five clusters, a number of different outcomes are identified and used to produce indicators that relate them to FDI or activity of foreign multinationals, allowing for comparisons both within and across clusters so as to identify potential sustainability trade-offs.

Taking into account the country-specific context, policymakers can use the FDI Qualities Indicators to assess how FDI supports national policy objectives, where challenges lie, and in what areas policy action is needed. Indicators also allow cross-country comparisons and benchmarking against regional peers or income groups, which, taking into account the country context, can help to identify good practices and make evidence-based policy decisions.

Source: OECD (2019), FDI Qualities Indicators: Measuring the sustainable development impacts of investment, OECD Publishing, Paris, http://www.oecd.org/investment/fdi-qualities-indicators.htm.

Foreign firms generate significant direct economic effects

Foreign firms contribute directly to several sustainable development outcomes in host countries. They generate output and jobs, pay salaries and add to gross exports and imports. Descriptive statistics based on the World Bank Enterprise Survey of Indonesia provide some first insights on the direct contribution of affiliates of foreign firms established in Indonesia. The data based on a sample of 761 domestic and 96 foreign firms show that foreign firms established in Indonesia outperform domestic firms (Table 2.1). Foreign affiliates are on average larger: they report 15 times higher sales and employ almost 4 times more workers. They also pay higher wages, as suggested by their higher (annual) labour cost. However, they employ lower shares of skilled labour: on average, 78% of their workers are skilled, whereas for domestic firms this share is 84%. Finally, foreign firms are 7 times as productive and are more export-oriented than domestic firms, as shown by their higher export intensity.

This foreign premium holds even when comparing firms of the same size and in the same sector. Additional empirical analysis performed on the same sample of domestic and foreign firms shows that foreign ownership is significantly and positively related to labour productivity, export intensity and energy efficiency independent of firm size and sector of activity (Panel a, Figure 2.13). Specifically, foreign ownership is associated with higher productivity (foreign firms are almost 6 times as productive as domestic firms) and higher export intensity (foreign firms' export intensity is almost 5 times as high as that of domestic firms). Nevertheless, foreign ownership has no significant effect on the share of skilled workers, potentially suggesting that firm size and sector-specific factors are more relevant to explain differences in skill intensity between domestic and foreign firms. These findings are in line with the predictions of the theoretical literature: due to sunk cost of investing abroad, foreign firms are more productive and larger than purely domestic companies (Melitz, 2003; Helpman et al. 2004). Evidence of a foreign performance premium has also been found by numerous empirical studies, including for Indonesia (Box 2.4).

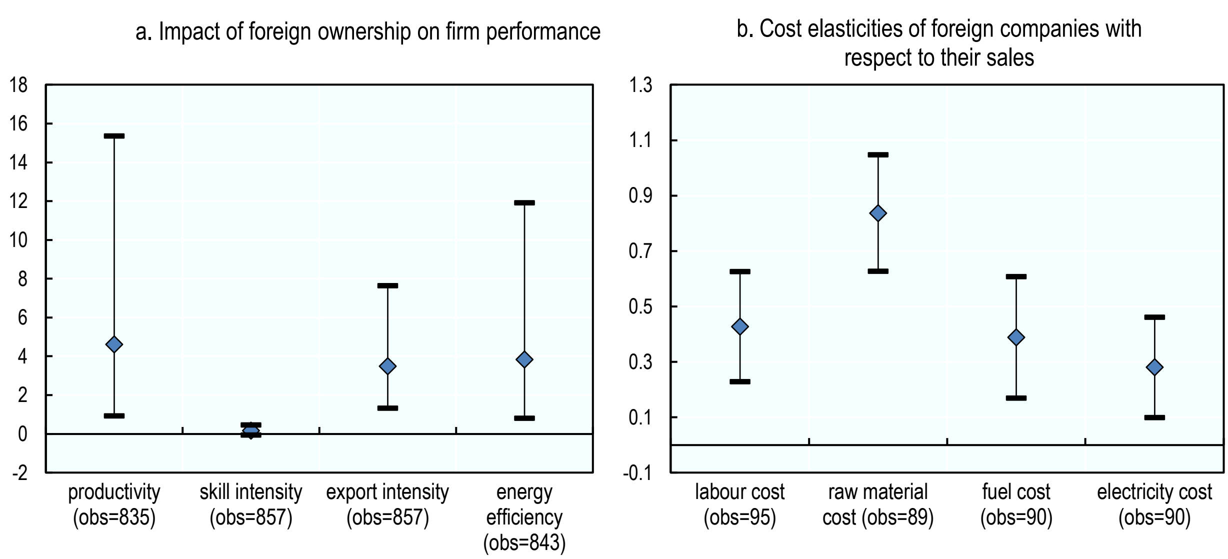
Table 2.1. Foreign affiliates outperform Indonesian firms

Differences between foreign and domestic manufactures in Indonesia, comparative statistics

	Manufacturing (2015)	
	Domestic	Foreign
Sales (in mln USD)	338	5 260
Number of workers	134	494
Average annual cost of labor (in mln USD)	22.1	41.4
Skilled workers (% of total number of workers)	84%	78%
Labour productivity (in mln USD)	808	5710
Export intensity (%)	6%	25%

Note: Labour productivity: value added per employee; Export intensity: share of production that is exported; Annual labour cost: wages, salaries, bonuses, and social security payments. The sample includes 761 domestic companies and 96 foreign companies.
Source: OECD elaboration based on World Bank Enterprise Survey.

Figure 2.13. Foreign firms have a positive impact on firm performance and generate a multiplier impact on the economy



Note: The figures show percentage impacts estimated from regression models and their respective 95% confidence interval. The model in panel a assesses the impact of foreign ownership on firm performance, whereas the model in panel b quantifies cost elasticities of foreign firms with respect to their sales. Dependent variables (e.g. productivity) and foreign sales are in logarithms. Foreign ownership is a dummy variable that takes value 1 if the investor owns directly 10% or more of the ordinary shares or voting power and 0 otherwise. All regressions control for firm size and sector fixed effects.
Source*:* OECD elaboration based on World Bank Enterprise Survey.

Analysis based on the same sample of domestic and foreign companies shows that in Indonesia the multiplier effects of foreign affiliates on the domestic economy are significant. The results indicate that a 1% increase in foreign sales leads to an increase of 0.4% in wages and salaries (labour cost) (Panel b, Figure 2.13). This means that if foreign sales increase by USD 100 000, everything else been equal, the total cost for wages and salaries increase by USD 40 000. In other words, an expansion in the foreign business activity (captured by an increase in foreign sales) would require the use of additional labour input, thereby leading to an increase in the total wages and salaries paid by the company. This additional labour income could then translate into higher aggregate consumption, generating a multiplier effect on the domestic economy. The results also show a similar effect on other elements of the supply chain. For instance, a 1% increase in foreign sales leads to an increase of 0.8% in expenditure for raw materials, 0.4% in expenditure for fuel and of 0.3% of expenditure on electricity. Comparable results are found by a study on the impact of FDI originating from the United States on the Indonesian economy (Ernst & Young, 2013).

Box 2.4. Studies comparing the performance of foreign and domestic firms in Indonesia

Several studies compare the performance of foreign and domestic plants in Indonesia. They differ in terms of performance variable examined (e.g. productivity, wages), time coverage and methodology. All studies conclude that foreign firms have a performance premium relative to domestic firms, regardless of the performance variable under study. A summary of those studies, based on Lipsey and Sjöholm (2010), is shown below.

Table 2.2. Summary of studies comparing the performance of foreign and domestic firms in Indonesia

Study	Year	Performance variable	Results
Arnold and Javorcik (2005)	1983-1996	Total Factor Productivity (TFP)	Foreign ownership leads to significant productivity improvements in the acquired plants. The improvements become visible in the acquisition year and continue in the subsequent periods.
Okamoto and Sjöholm (2005)	1990-95	TFP	TFP growth is higher in foreign firms than in domestic firms.
Takii and Ramstetter (2005)	1975-2001	Labour productivity	Foreign affiliates are more productive than local firms, even after controlling for plant-specific factors.
Takii (2004)	1995	Labour productivity TFP	Foreign plants have high productivity. Wholly foreign-owned plants tend to have higher productivity, while new foreign-owned plants tend to have relatively low productivity levels.
Sjöholm and Takii (2008)	1990-2000	Export	Foreign plants are substantially more likely to start exporting than wholly domestically owned plants.
Sjöholm (2003)	1996	Export	Foreign firms are more likely to export than domestic firms.
Ramstetter (1999)	1990; 1992; 1994	Export intensities	Foreign firms have high export intensities.
Lipsey, Sjöholm, and Sun (2010)	1975-2005	Growth in employment	Foreign firms have high growth in employment.
Lipsey and Sjöholm (2006)	1975-1999	Wages	Foreign firms pay high wages.
Lipsey and Sjöholm (2004)	1996	Wages	Foreign firms pay high wages.

Source: Lipsey and Sjöholm (2010).

Foreign firms favour GVC integration of Indonesia

A greater presence of foreign firms in an economy tends to be associated with higher export orientation and greater integration in GVCs. Participation in GVCs may bring several advantages, such as technology transfer, skills upgrading, and innovation, which in turn may increase efficiency and competitiveness of domestic firms. Data from the OECD TiVA and analytical AMNE database allow to examine the contribution of foreign firms to exports and GVC participation in Indonesia and other comparator countries (see Box 2.5).

Box 2.5. Data and definitions

This section relies on three indicators to study the contribution of foreign affiliates to GVC integration in Indonesia and other comparator countries. Indicators (1) and (2) come from the OECD Trade in Value Added (TiVA) database, while indicator (3) is from the Analytical Activities of Multinational Enterprises (AMNE) database.

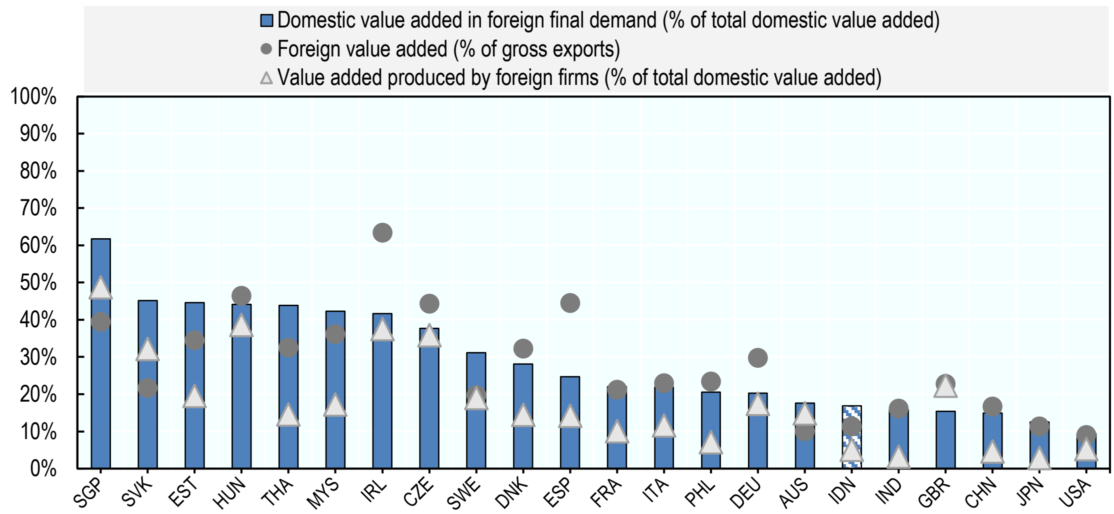
1. **Domestic value added in foreign final demand (% of total domestic value added)**. The indicator shows how much domestic value added is included, via direct final exports and via indirect exports of intermediates through other countries, in the demand of foreign final consumers. The indicator measures the export orientation of a country. Higher values are associated with higher export orientation.
2. **Foreign value added (% of gross exports)**. The indicator captures the value of imported intermediate goods and services that are embodied in the domestic country's export. It assesses the extent to which a country relies on imports for its exports or, in other words, its backward GVC participation. The higher the share of value added embodied in exports, the more integrated a country is in GVCs.
3. **Value added produced by foreign firms (% of total domestic value added):** The indicator measures the contribution of foreign firms to total value added produced in the domestic country.

These three series tend to move in the same direction, as shown in Figure 2.14, meaning that a greater presence of foreign firms in the economy is associated with higher export orientation and greater integration in GVCs. This shows that foreign firms can facilitate a country's integration into GVCs.

The data show that Indonesia has a lower export orientation than regional peers (Figure 2.14). The share of domestic value added in foreign final demand (blue bar) is smaller in Indonesia than, for instance, in Singapore, Thailand, Malaysia and the Philippines. They also indicate that Indonesia is less integrated in GVCs, as shown by its share of foreign value added in gross exports (grey circle), than other countries in the region. Foreign firms' contribution to value added (white triangle) is also lower than in other countries from the region, notably Singapore, Thailand, Malaysia and the Philippines.

Overall, Indonesia appears to be less integrated in GVCs than other countries in the region, although its level of GVC participation is similar to that of other large economies, such as India, China and the United States. Countries with large domestic markets tend to import less as they can rely on a wider array of domestic intermediates. Indonesia's low level of participation in GVCs also reflects the composition of its export basket. Due to its abundant natural resources (e.g. coal, copper, oil), Indonesia's international trade activities tend to be based more on upstream components within value chains.

Figure 2.14. Indonesia is less integrated in GVCs than its regional peers

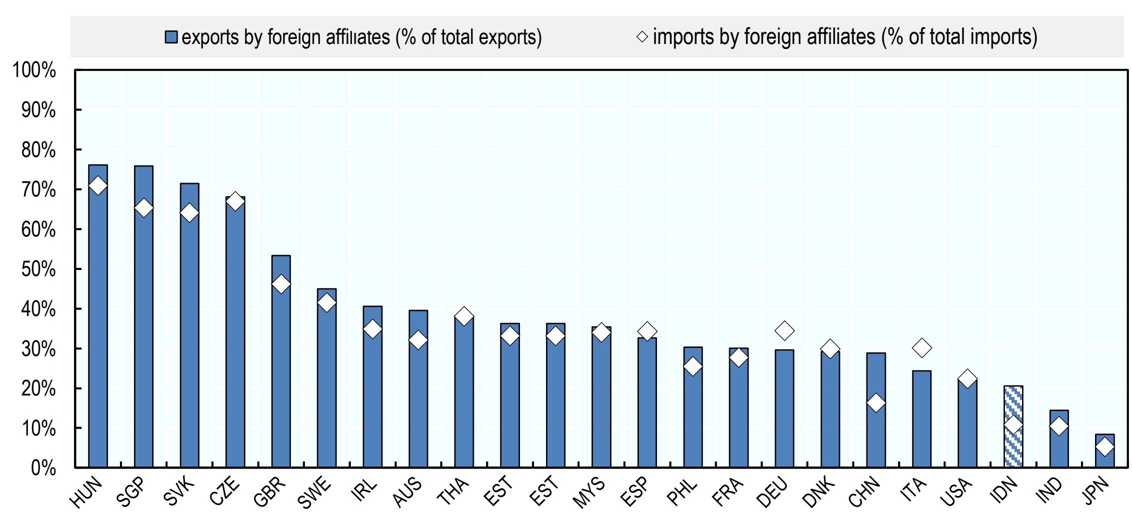


Source*:* OECD Trade in Value Added (TiVA) and OECD AMNE database, data for 2016.

The contribution of foreign firms to gross exports and imports provides another measure of the role played by FDI in a country's GVCs integration (Figure 2.15). In Indonesia, exports by foreign firms account for 20% of total exports. Imports by foreign firms represent 10% of total imports. These shares are lower than in regional peers such as Singapore, Thailand, Malaysia and the Philippines, but similar to those of other large economies including India and China. This is because Indonesia attracts a large share of resource-seeking and market-seeking, as opposed to export-oriented, FDI. In fact, multinational enterprises (MNEs) often choose to invest in Indonesia to extract natural resources or to serve the large domestic market. Even manufacturing FDI is mainly oriented to serve the domestic rather than the global market, as shown by a recent study by the World Bank (2018).

Figure 2.15. Foreign firms in Indonesia contribute less to international trade

Exports and imports of foreign affiliates (% of total), 2016



Source*:* OECD AMNE database

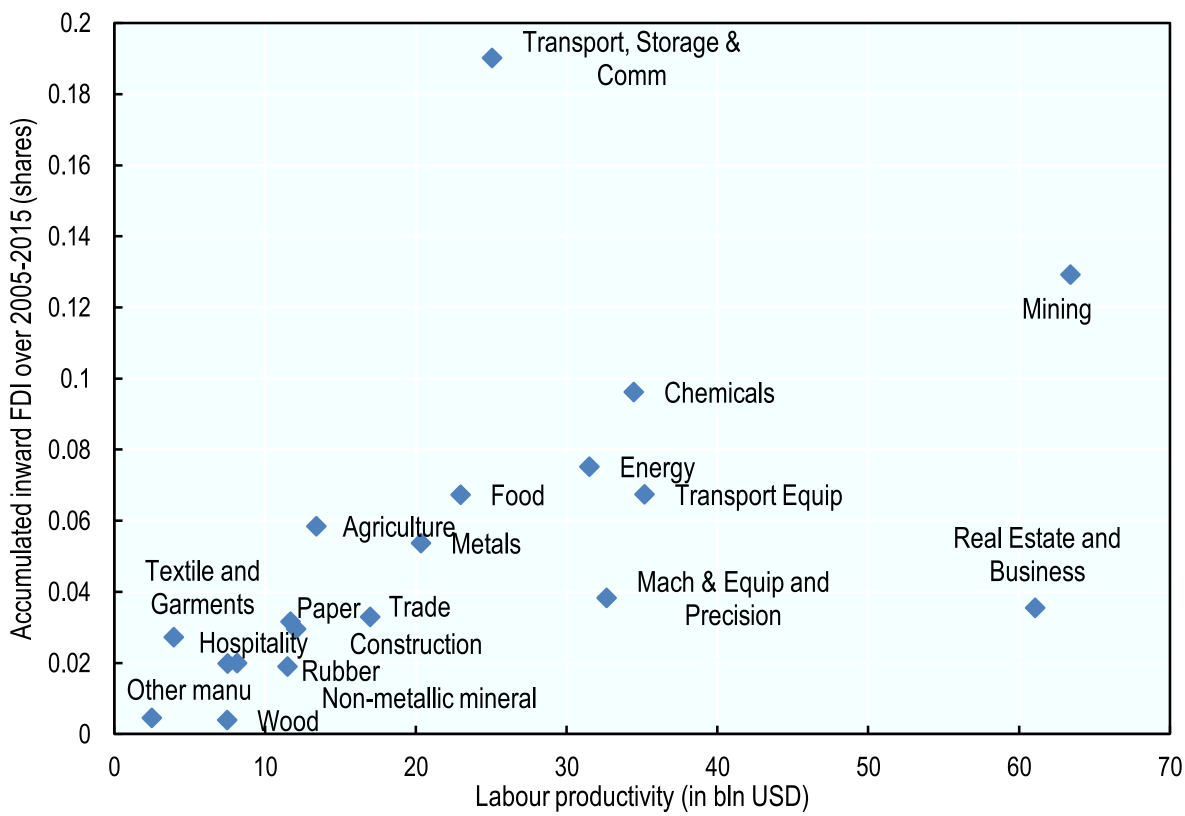
FDI supports productivity gains within the economy

This section examines whether FDI supports shifts of the economy towards more (or less) productive sectors. While available data do not allow to disentangle between FDI direct impacts and spillovers on domestic firm productivity, some indicators shed light on the correlation between FDI and productivity at the sectoral level and on the evolution of the FDI-productivity relationship over time.[11] The section also investigates the potential for productivity spillovers. Research has shown that the extent of spillovers is affected by several factors, including: the 'proximity' to foreign firms, such as through business linkages and the capabilities gap between domestic and foreign firms. This section studies the extent of linkages between foreign and domestic firms and the capacity gaps (measured by the relative productivity and innovation gap) between foreign and domestic firms.

FDI is prevalent in sectors that are more productive

Plotting FDI from BKPM against estimates of productivity based on the OECD input-output tables shows a positive correlation: FDI is concentrated in sectors where workers are, on average, more productive (Figure 2.16). FDI-intensive sectors with relatively higher productivity include many capital-intensive sectors, namely mining, energy, transport services and chemicals, but also in some relatively more productive labour-intensive sectors such as food.

Figure 2.16. FDI is prevalent in sectors that are more productive



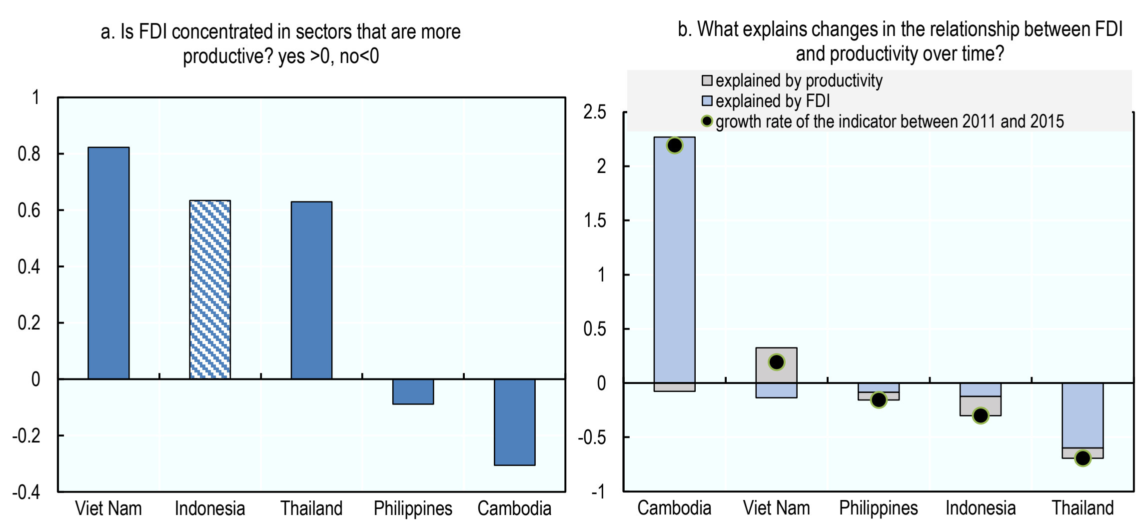
Note*:* Oil and gas, banking and non-bank financial services are excluded. Labour productivity: value added per employee.
Source*:* OECD elaboration based on Indonesia Investment Coordinating Board (BKPM) and OECD Input-Output tables.

Another indicator based on greenfield FDI data from fDi Markets compares Indonesia to other regional peers. The results confirm the positive association between FDI and productivity for Indonesia (panel a, Figure 2.17). The positive relation is explained by a higher concentration of greenfield FDI in relatively more productive sectors, namely mining, metals, chemicals, transport equipment and food. A positive correlation between greenfield FDI and productivity is also observed in other regional peers such as Viet Nam and Thailand. In Viet Nam a large share of greenfield FDI is found in mining, real estate and business activities, which are relatively more productive than sectors with less greenfield projects. Similarly, in Thailand FDI-intensive sectors have higher productive levels. These sectors are machinery and equipment, transport and finance. Conversely, FDI is channelled to less productive sectors in the Philippines (food) and Cambodia (textile and garments, and hospitality).

Looking at the evolution of the above indicator over time shows that several Asian countries, including Indonesia, saw a decline in the FDI-productivity relationship during 2011-15, as the value of the indicator decreased during this period (panel b, Figure 2.17). In order to shed light on the drivers of this decline, the analysis further breaks down the growth rate of the indicator into two components. Specifically, changes in the indicator could be driven by (i) variations in FDI shares in more productive sectors; or (ii) changes in the productivity of sectors that have received the bulk of FDI.

The decomposition of the growth rate of the indicator shows that, in Indonesia, about 58% of the decline was explained by changes in labour productivity in FDI-intensive sectors. Specifically, productivity decreased in sectors that receive large amounts of FDI. These sectors are mining, metals, real estate and business activities, where productivity considerably declined over 2011-15. Shifts in FDI composition from more productive (mining, machinery & equipment, paper) to less productive sectors (non-mineral metal products, rubber) account for the remaining 42% of the change in the growth rate. This means that, during 2011-15, FDI went increasingly to less productive sectors.

Figure 2.17. In Indonesia the positive relationship between FDI and productivity has declined between 2011 and 2015



Note: The chart shows a Type 2 FDI qualities indicator and its decomposition over time. See Annex A for a description of the methodology. Greenfield FDI data do not cover agriculture, energy, construction, and trade.
Source: OECD elaboration based on Financial Times' fDi Markets

Indonesian firms may lack capacity to benefit from FDI positive spillovers

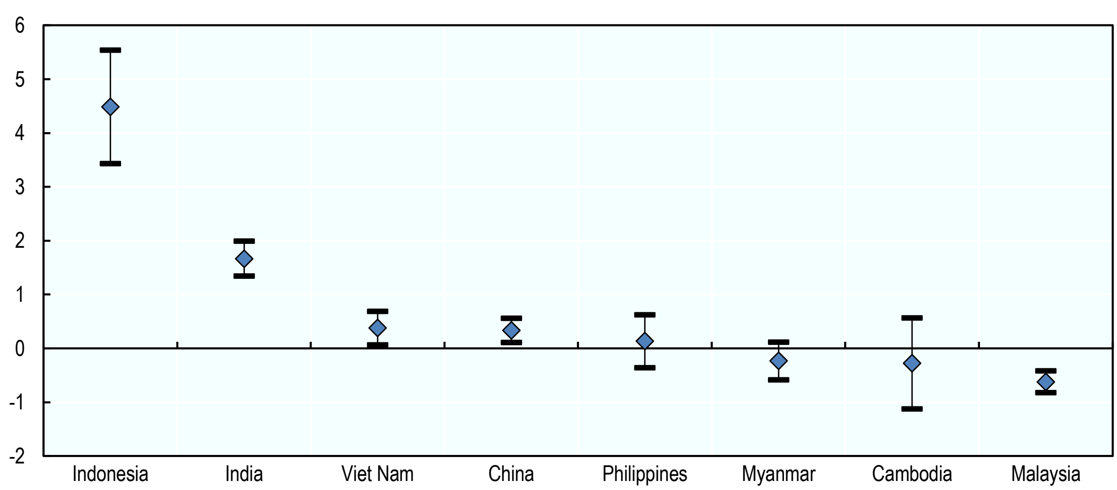
Positive productivity spillovers from FDI to domestic firms are not automatic and might not materialise at all (Smeets, 2008). A key factor enabling FDI spillovers is the capability of domestic firms to absorb and use knowledge from foreign firms. Absorptive capacities are often measured in terms of performance gaps between foreign and domestic firms, including with respect to differences in labour productivity and innovation activities.

An indicator compares labour productivity of foreign firms with that of domestic firms in manufacturing. The indicator shows the extent to which foreign firms have a productivity premium or gap relative to domestic firms, and whether these differences are statistically significant. The results show that in Indonesia foreign manufacturers are, on average, more productive than domestic firms (Figure 2.18). Foreign firms have a statistically significant labour productivity premium over domestic firms also in several regional peers including India, China, and Viet Nam. Results are not statistically significant in the Philippines, Viet Nam and Cambodia, whereas a reverse premium in favour of domestic firms is observed in Malaysia.

A closer look at the data for Indonesia shows that a foreign productivity premium exists in all sectors with the exception of wood (Figure 2.19). The magnitude of the foreign premium varies widely across sectors: in non-metallic minerals, foreign firms are almost 15 times as productive as domestic firms, while in leather they are almost three times as productive.

Figure 2.18. In Indonesia, foreign firms enjoy a significant productivity premium

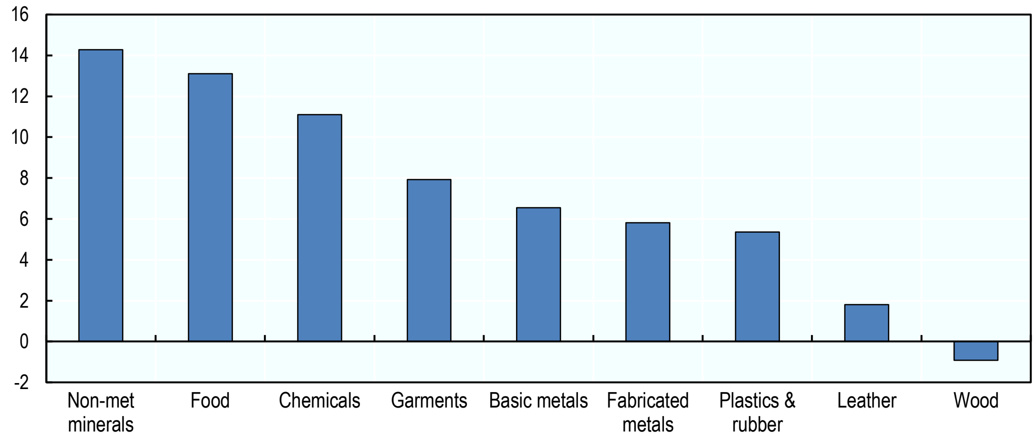
Are foreign manufacturers more productive than their domestic peers? yes > 0; no < 0



Note*:* The chart shows a Type 1 FDI qualities indicator. See Annex A for a description of the methodology. Labour productivity: value added per employee. Data for Indonesia refers to 2015.
Source*:* OECD elaboration based on World Bank Enterprise Survey

Figure 2.19. The foreign premium varies greatly across sectors

Are foreign manufacturers more productive than their domestic peers? yes > 0; no < 0

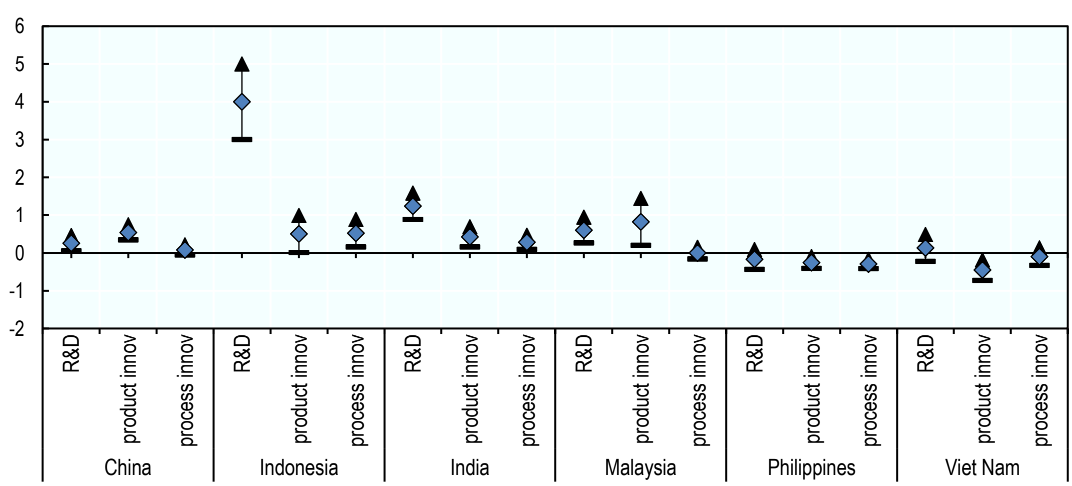


Note*:* The chart shows a Type 1 FDI qualities indicator. See Annex A for a description of the methodology. Labour productivity: value added per employee. Data for Indonesia refers to 2015.
Source*:* OECD elaboration based on World Bank Enterprise Survey

The data also show that in Indonesia foreign manufacturers are more likely to engage in R&D or to introduce a new product or process innovation relative to their domestic peers (Figure 2.20). Foreign firms also engage more in R&D and innovate more in regional peers such as China, India and Malaysia. As for productivity, a foreign premium is observed in most manufacturing sectors, although with varying intensity (Figure 2.21). For instance, in non-metallic minerals foreign firms are 25 times more likely to invest in R&D than their domestic peers, whereas in fabricated metals the probability that foreign firms invest in R&D is only one time higher.

Figure 2.20. Foreign manufactures are more innovative across most sectors in Indonesia

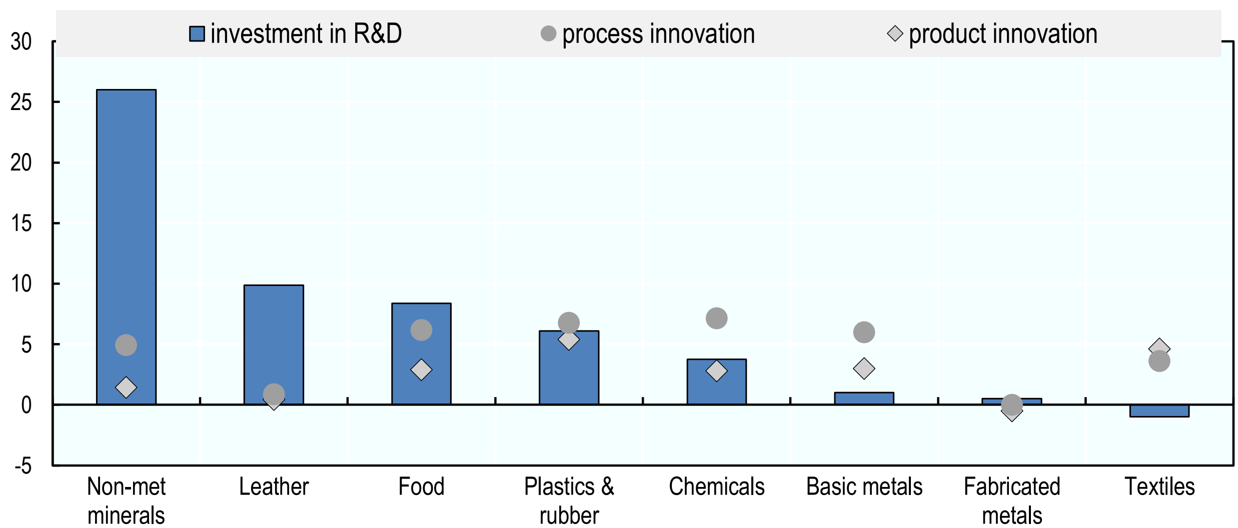
Are foreign manufacturers more likely to invest in R&D or to introduce a product/process innovation than their domestic peers? yes > 0; no < 0



Note: The chart shows a Type 1 FDI qualities indicator. See Annex A for a description of the methodology. Data for Indonesia refers to 2015.
Source*:* OECD elaboration based on World Bank Enterprise Survey

Figure 2.21. The foreign innovation premium differs largely across sectors

Are foreign manufacturers more likely to invest in R&D or to introduce a product/process innovation than their domestic peers? yes > 0; no < 0



Note: The chart shows a Type 1 FDI qualities indicator. See Annex A for a description of the methodology. Data for Indonesia refers to 2015.
Source*:* OECD elaboration based on World Bank Enterprise Survey

Overall, the results suggest that Indonesian firms may lack the ability to benefit from the presence of foreign firms. While foreign firms tend to be more productive and innovative than domestic firms in many countries[12], the foreign premium appears to be particularly large in Indonesia. Additionally, some sectors (e.g. non-metallic minerals) could be affected more than others by the lack of domestic absorptive capacity.

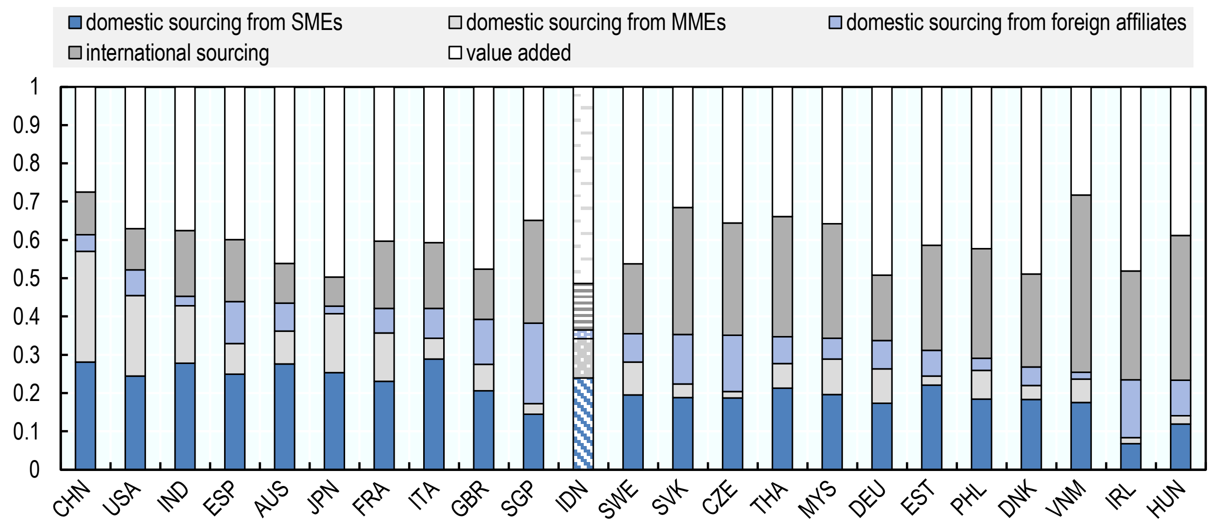
Business linkages with foreign firms are significant

Business linkages between foreign and domestic firms are an important channel of productivity spillovers. Linkages with foreign firms may help domestic firms acquire new technologies, knowledge and skills; improve management practices; expand their market for selling and for inputs; and tap into GVCs. New indicators based on the OECD Analytical AMNE database reveal the extent of linkages with foreign firms in Indonesia and other comparator countries. Domestic buy (or backward) linkages are formed when affiliates of foreign firms purchase intermediate inputs from local companies, i.e. domestic MNEs, domestic SMEs and other foreign affiliates established locally. Conversely, sell (or forward) linkages are forged when foreign affiliates sell intermediate goods to local companies. Both buy and sell linkages encourage the inclusion of domestic firms in the foreign firm's supply chains and their direct and indirect involvement in export activities.

The data show that in Indonesia domestic backward linkages with foreign firms are significant (Figure 2.22). In 2016, intermediate inputs sourced domestically by foreign affiliates accounted for 36% of their output. Furthermore, domestic sourcing of foreign affiliates benefits more Indonesian firms: 34% of domestically sourced inputs were bought from domestic companies, of which 24% from domestic SMEs, 10% from domestic MNEs, and 2% from other foreign affiliates established locally.

Figure 2.22. Foreign affiliates established locally source mainly from Indonesian companies

The sourcing structure of foreign affiliates (% total output), 2016



Note*:* SMEs: small and medium enterprises; SMEs are companies with less than 200 employees. MNEs: multinational enterprises.
Source*:* OECD Analytical AMNE database

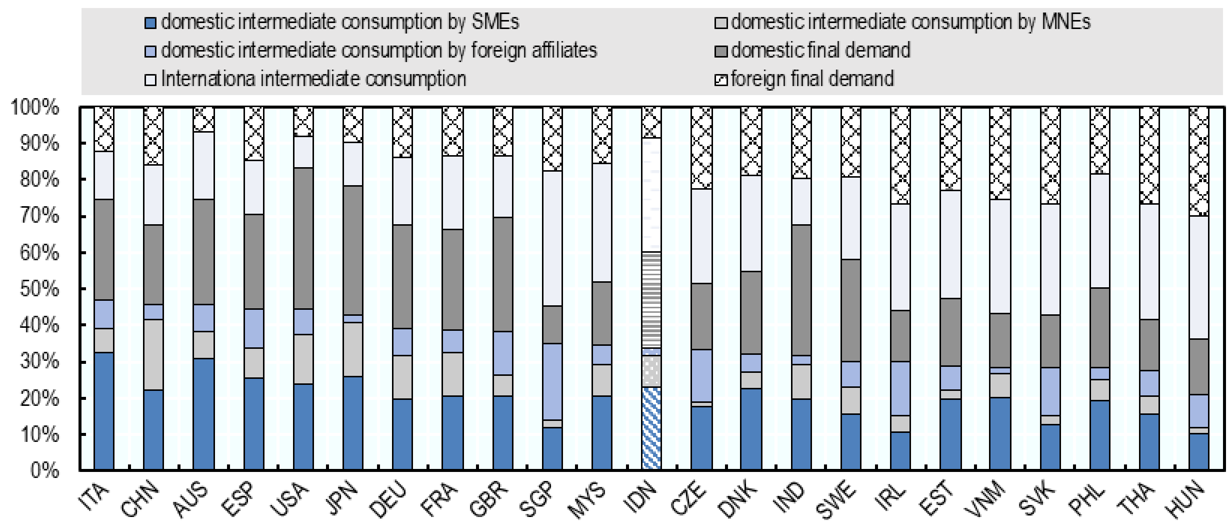
The share of domestically purchased inputs is higher in Indonesia than in other regional peers, namely Thailand, Malaysia, the Philippines, and Vietnam, but similar to that of other countries with large domestic markets for intermediate goods such as China, the United States, Japan and India. Beside a large domestic market for inputs, local content requirements in a variety of sectors with an important presence of foreign MNEs, such as mining, energy, transport equipment, electronics and so on, also explain the significant share of backward linkages observed in Indonesia.[13]

Business linkages developed in the context of local content requirement policies may nevertheless be detrimental for the competitiveness of domestic industries. Local content requirements may increase production costs for foreign investors (OECD, 2017). Especially in industries that do not have a domestic supply side capable of meeting the production needs of foreign companies, these policies may increase prices and thus reduce the competitiveness of the targeted industries, generating negative spillovers to the rest of the economy (Stone et al., 2015).

The data also reveal that domestic forward linkages with foreign affiliates are considerable (Figure 2.23). In 2016, the share of intermediates in total output sold by foreign affiliates in the Indonesian market was close to 34%. Similar shares were sold by foreign affiliates in Singapore and Malaysia, while the extent of forward linkages was lower in other regional peers such as India, Viet Nam, the Philippines and Thailand. As was the case for backward linkages, the size of the economy seems to matter also for forward linkages: countries with larger domestic markets like Japan, Italy and the United States are characterised by more important domestic forward linkages with foreign affiliates (Figure 1.23). Moreover, 32% of intermediates were bought by Indonesian companies (23% by Indonesian SMEs and 9% by Indonesian MNEs), while the remaining 2% was purchased by other affiliates of foreign firms located in the country.

Figure 2.23. The intermediate output of foreign affiliates sold domestically was bought mainly by Indonesian companies

Output use of foreign affiliates, 2016



Note: SMEs: small and medium enterprises; SMEs are companies with less than 200 employees. MNEs: multinational enterprises.
Source: OECD Analytical AMNE database

FDI has mixed effects on labour market outcomes

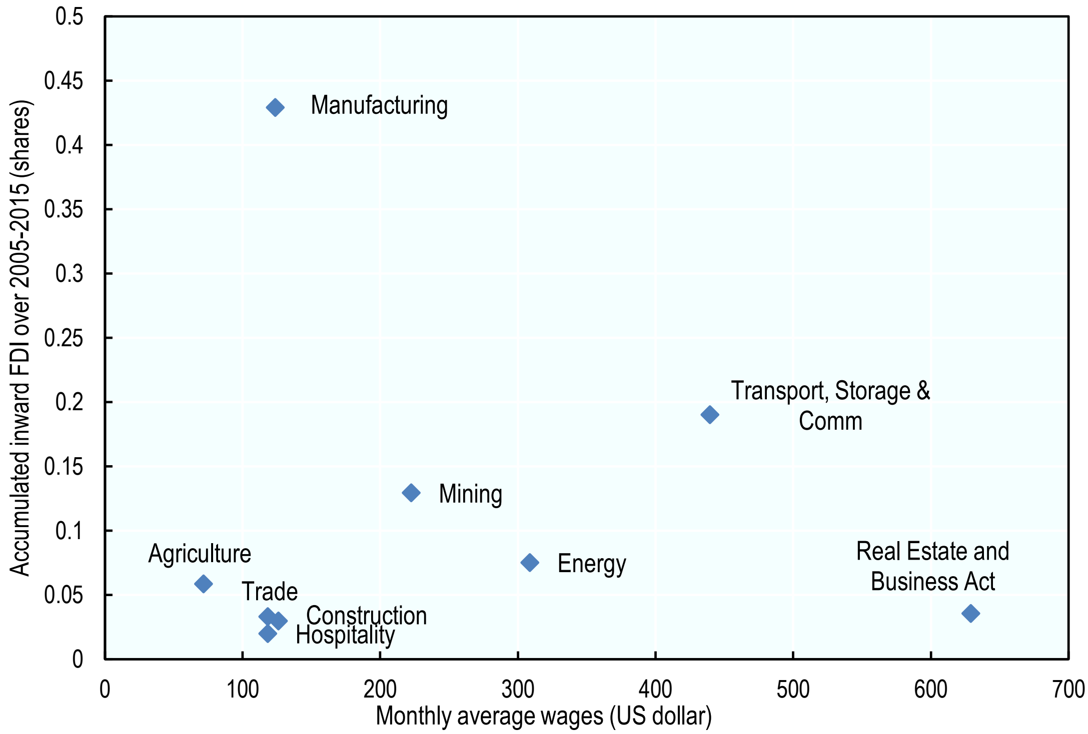
This section examines the relationship between FDI and three labour market outcomes in Indonesia and other comparator countries, namely wages, skills and selected aspects of gender equality. Due to data limitations, the analysis cannot disentangle direct and spillover effects of FDI, but rather provides an indication of how FDI correlates with the above outcomes. Specifically, it shows whether FDI supports the expansion of sectors with higher (or lower) wages. It also examines differences between foreign and domestic firms in relation to wages and skills. Finally, it investigates whether FDI is found more in sectors with higher (or lower) female employment and looks for systematic differences in gender equality practices between foreign and domestic firms.

Foreign firms operate in sectors with higher wages and pay their employees more

The data show that FDI is concentrated in sectors with relatively higher wages, with the notable exceptions of manufacturing and real estate and business activities (Figure 2.24). Manufacturing attracts a significant share of FDI but has on average lower wages than other sectors. Conversely, real estate and business activities receive less FDI but have relatively higher wages. Generally, the findings are in line with those for productivity; sectors that receive more FDI tend to be more productive and pay higher wages (Figure 2.16). This is not surprising given that productivity and wages tend to evolve together.

The results also show that in Indonesia foreign companies pay, on average, higher wages than domestic firms (Figure 2.25). The indicator is positive (and statistically significant) also for India, China and Myanmar. Wage differences between the two groups of firms mirror the productivity premia observed in those countries (Figure 2.18). A similar indicator is produced at the sectoral level for Indonesia. Other than plastics & rubber, foreign firms pay better wages than indigenous firms in all sectors (Figure 2.26).[14] Not surprisingly, sectors with a relatively higher foreign productivity premium, namely non-metallic minerals, food and chemicals, are also those with a higher foreign wage premium (Figure 2.19). This further supports the evidence of strong link between productivity and wages.

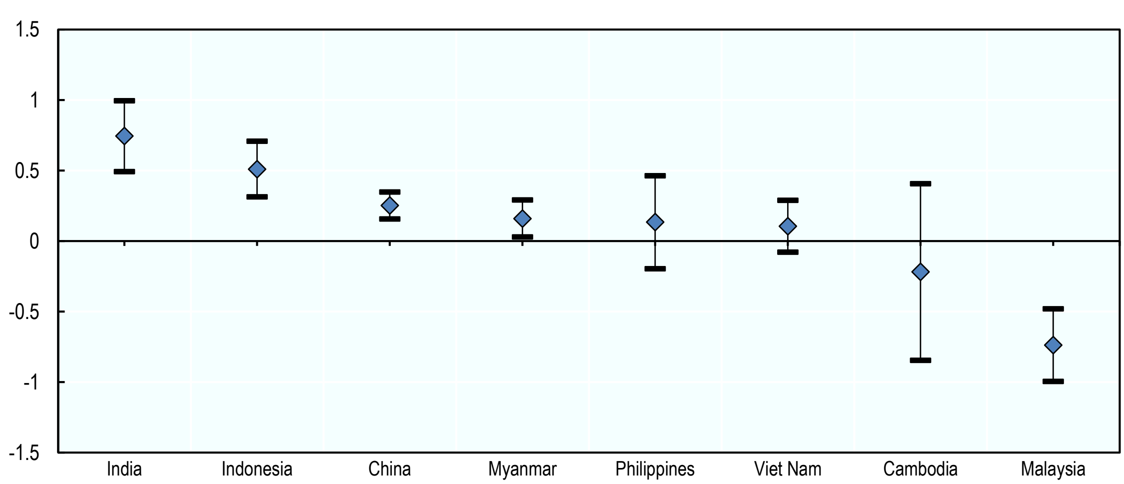
Figure 2.24. FDI goes to sectors with relatively higher wages



Note: Oil and gas, banking and non-bank financial services are excluded.
Source: OECD elaboration based on Indonesia Investment Coordinating Board (BKPM) and ILO

Figure 2.25. In Indonesia, foreign firms pay higher wages than domestic firms

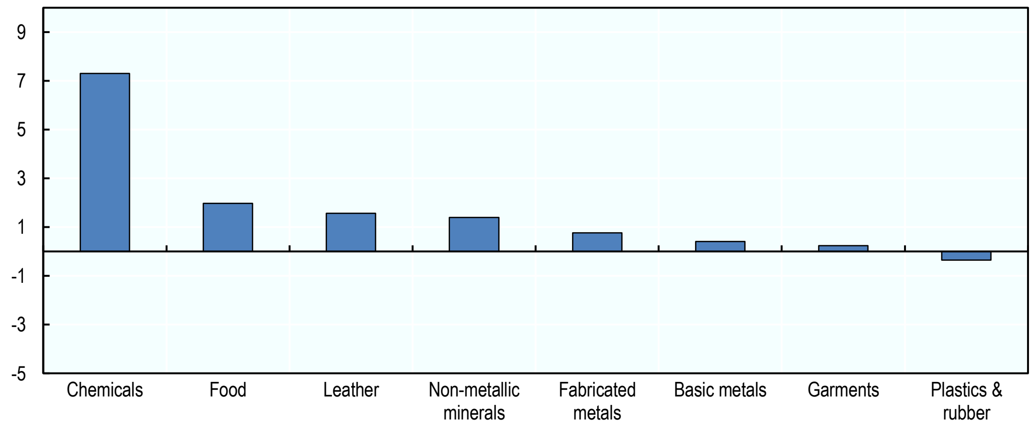
Do foreign firms pay higher wages than domestic firms? Yes>0, no<0



Note: The chart shows a Type 1 FDI Qualities indicator. See Annex A for a description of the methodology. Data for Indonesia refers to 2015 and covers the manufacturing sector.
Source: OECD elaboration based on the World Bank Enterprise Survey

Figure 2.26. The foreign wage premium is higher in chemicals, food, leather and non-metallic minerals

Do foreign firms pay higher wages than domestic firms? Yes>0, no<0



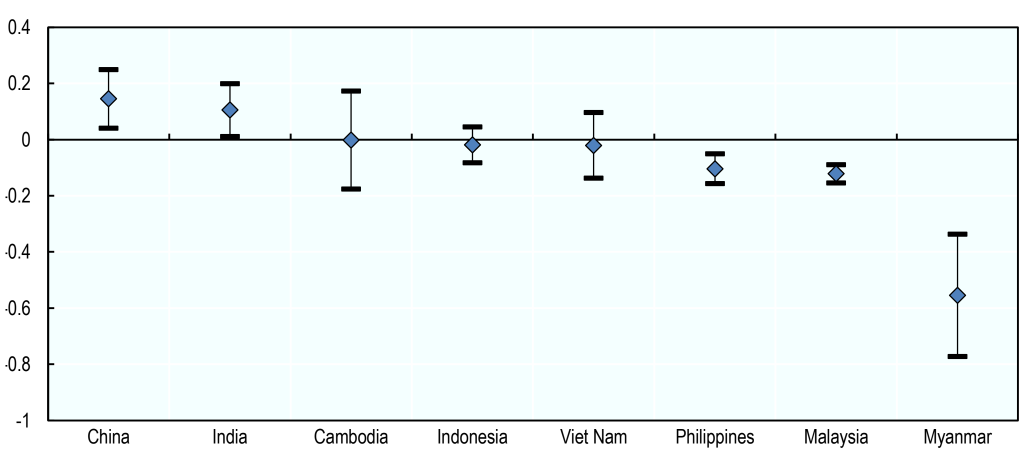
Note: The chart shows a Type 1 FDI Qualities indicator. See Annex A for a description of the methodology. Data for Indonesia refers to 2015 and covers the manufacturing sector.
Source*:* OECD elaboration based on the World Bank Enterprise Survey

Foreign and domestic firms do not differ systematically in their skill intensity

The analysis presented above shows that, on average, foreign firms tend to be more productive and pay higher wages. In the economic literature, this productivity-wage premium is explained by the fact that foreign firms tend to have access to better technologies, inputs and human capital (OECD, 2019). For the same reasons, foreign firms are also expected to employ larger shares of skilled workers relative to domestic firms.

Figure 2.27. In Indonesia, variations in skill intensity between foreign and domestic firms are not systematic

Do foreign firms employ higher shares of skilled workers? yes>0, no<0



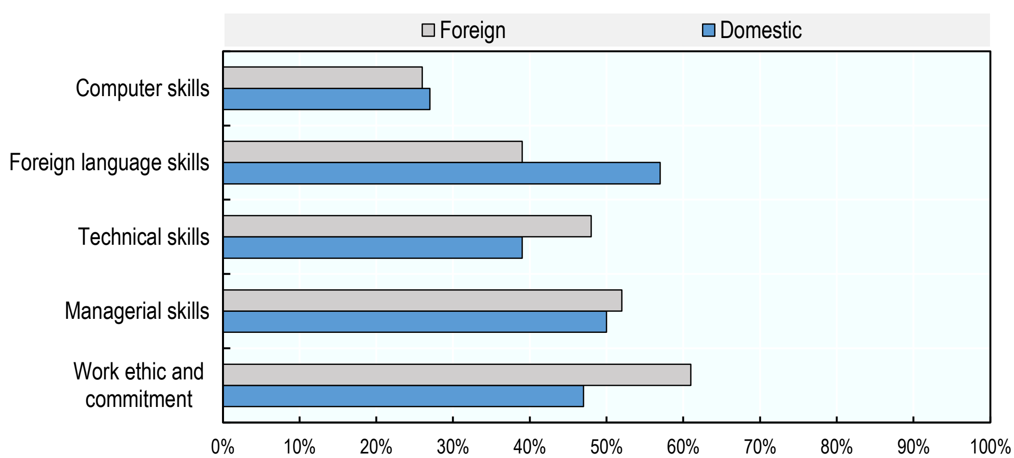
Note: The chart shows a Type 1 FDI qualities indicator. See Annex A for a description of the methodology. Data for Indonesia refers to 2015 and covers the manufacturing sector.
Source*:* OECD elaboration based on the World Bank Enterprise Survey

In Indonesia foreign firms have, on average, lower shares of skilled workers than domestic firms although the indicator is not statistically significant, meaning that variations in skill intensity between these two groups of firms are not systematic (Figure 2.27). These results confirm the empirical findings presented above: foreign and domestic firms of comparable size and in the same sector of activity tend to hire similar shares of skill workers (panel a, Figure 2.13).

Furthermore, domestic and foreign firms in Indonesia report similar difficulties in finding workers with the required skills. According to the answers provided by 120 domestic firms and 23 foreign firms in the World Bank Enterprise Survey of Indonesia (2015), the three most difficult-to-find skills in the local labour market are i) managerial skills, ii) foreign language skills, and iii) technical skills (Figure 2.28). While available data do not allow to examine how firms respond to hiring difficulties (e.g. by increasing pay) and how this can affect their performance, skill shortages are likely to raise costs and lower productivity, at least in the short run. Workforce skills gaps in core disciplines (e.g. engineering) and lack of workforce readiness are highlighted as key concerns in the latest Investor Perceptions Study for Indonesia (Arise Plus-Indonesia, 2020), which analyses the answers provided by 84 international corporate executives with a documented experience or interest in Indonesia. Based on the study, this skill deficit affects many sectors, from infrastructure and transport, to chemicals and energy, to tourism and agribusiness. These issues are even more challenging for investors operating in more remote parts of the country.

Figure 2.28. Foreign and domestic firms face similar difficulties in hiring skills

Percentage of firms with difficulty in finding employees with skills, by ownership and skill type



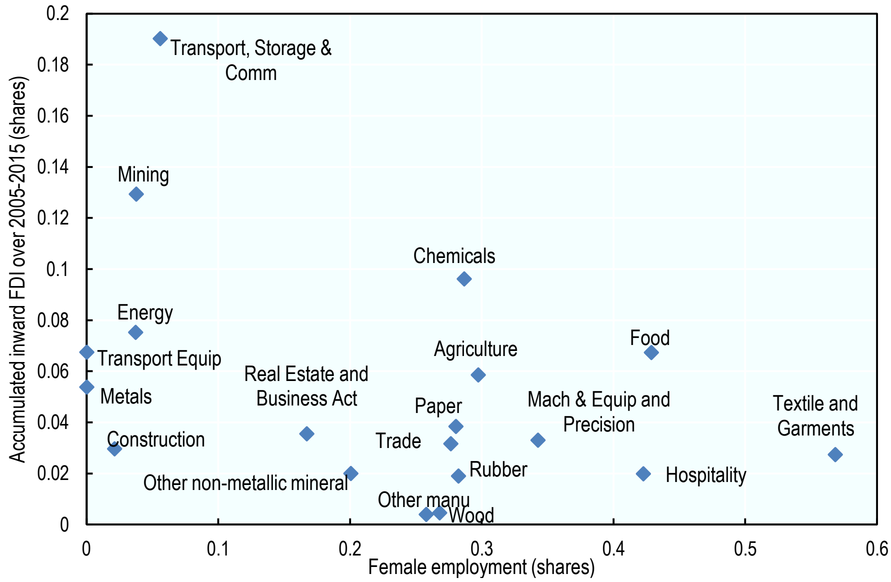
Note: Percentages are calculated using the total numbers of foreign and domestic firms. The sample includes 120 domestic firms and 23 foreign firms.
Source*:* OECD elaboration based on the World Bank Enterprise Survey

Foreign firms operate in male-dominated sectors but are more gender-inclusive

A key indicator of gender inequality in the labour market is the share of female (dependent) employment. Plotting this measure against FDI at the sectoral level shows a negative relationship for Indonesia (Figure 2.29).

This negative association is explained by the higher concentration of FDI in typically male-dominated sectors, notably transport, storage and communication, and energy. As expected, mining also plays a prominent role, as a sector with considerable foreign investment and fewer jobs for women. Conversely, sectors with a large presence of women, such as textiles and food, receive relatively less FDI. The results are in line with existing evidence: a negative relationship between FDI and the share of female employment is often observed, especially in countries at advanced stages of industrialisation (OECD, 2019).

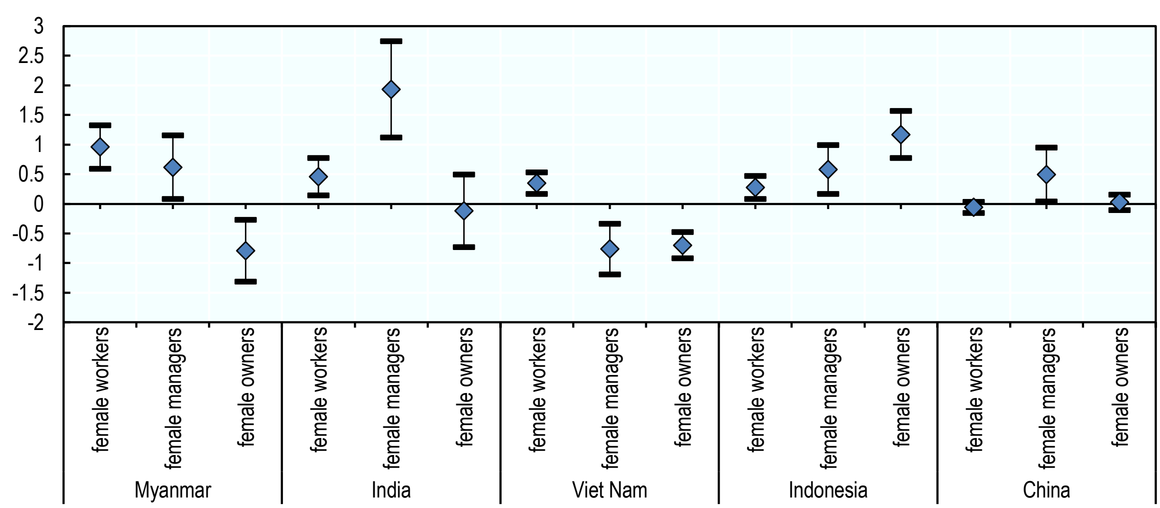
Figure 2.29. Foreign investors are concentrated in male-dominated sectors



Note: Oil and gas, banking and non-bank financial services are excluded.
Source*:* OECD elaboration based on Indonesia Investment Coordinating Board (BKPM) and ILO.

Figure 2.30. In Indonesia, foreign firms are more gender-inclusive than domestic firms

Are foreign firms more gender-inclusive than domestic firms? yes>0, no<0



Note*:* The chart shows a Type 1 FDI qualities indicator and the respective 95% confidence interval. See Annex A for a description of the methodology. Data for Indonesia refers to 2015. Female workers: share of female workers in total production workers; female managers: share of firms with female managers; female owners: share of firms with female owners.
Source*:* OECD elaboration based on the World Bank Enterprise Survey

To compare gender outcomes of foreign and domestic manufacturers in Indonesia and regional peers, three indicators are presented: the share of female workers; the share of firms with female top-managers; and the share of firms with a female owner (Figure 2.30). The results for Indonesia indicate that foreign firms are more gender inclusive than domestic firms: they employ larger shares of female workers and are more likely to be run and owned by women. The findings are more mixed for other comparator countries.

In particular, foreign firms are more likely to have female top-managers everywhere, but the results vary considerably across countries in relation to other gender outcomes.

FDI affects environmental targets in contrasting ways

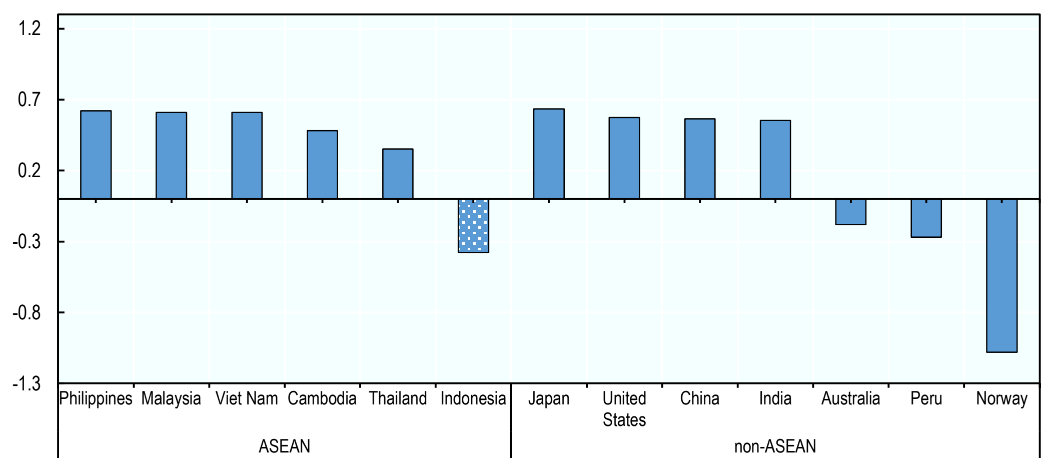
This section analyses the contribution of FDI to the greening of the economy in Indonesia and in comparator countries. It examines whether FDI is channelled to sectors that generate more (or less) CO_2 emissions. The section also shows whether foreign firms use more energy-saving technologies and are, therefore, more energy efficient than domestic firms. Finally, the section analyses the extent and evolution of FDI in renewables in Indonesia and other regional peers.

FDI goes to more polluting sectors, but foreign firms are more energy-efficient

An indicator examines whether greenfield FDI projects are prevalent in sectors that produce higher (or lower) CO_2 emissions per unit of output, relative to the overall economy (Figure 2.31).[15] It shows that in Indonesia FDI is concentrated in relatively more polluting sectors in terms of CO_2 emissions. Conversely, FDI is observed in cleaner sectors in regional peers. The results are not surprising as Indonesia is a resource-rich country and attracts a significant amount of FDI in extraction and energy transformation (e.g. coal, oil, natural gas), both highly polluting activities. In fact, similar results are found for other resource-rich countries like Norway, Peru and Australia.

Figure 2.31. In Indonesia, FDI is prevalent in sectors that are more polluting

Is greenfield FDI concentrated in cleaner activities? (yes if value > 0; no if value < 0)

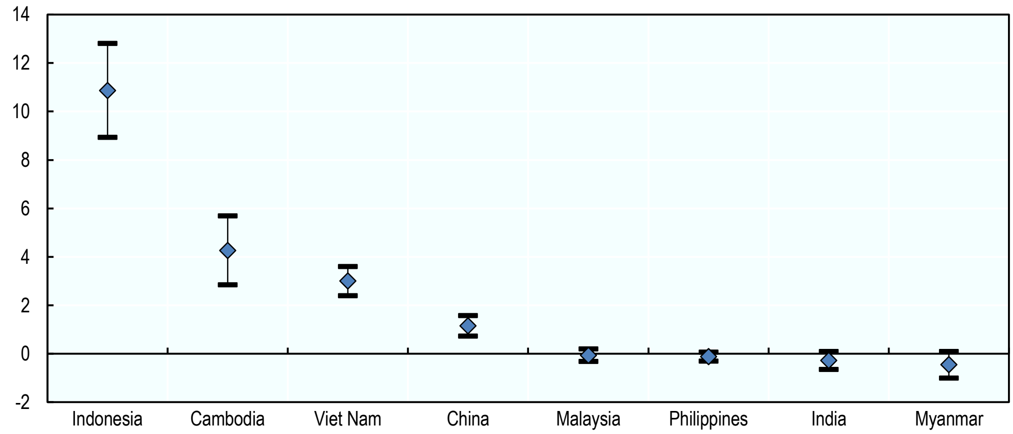


Note: The chart shows a Type 2 FDI qualities indicator. See Annex A for a description of the methodology.
Source: OECD based on Financial Times' fDi Markets database; OECD Input-Output Tables; International Energy Agency's World Energy Statistics; International Energy Agency's CO2 Emissions database

While the indicator above captures both the scale and the composition effects of FDI on the economy, another indicator shows whether foreign investors improve energy efficiency in the host country by bringing cleaner technologies (Figure 2.32). The following indicator compares sales over electricity and fuel costs across foreign and domestic firms in manufacturing. Since foreign and domestic firms face the same electricity and fuel prices, the indicator captures the quantity of output sold per unit of electricity and fuel consumed, which serves as a proxy for energy efficiency. For Indonesia, as well as for Cambodia, Viet Nam and China, the indicator is positive and statistically significant. This means that on average foreign firms are more energy–efficient than domestic firms.

Figure 2.32. In Indonesia, foreign firms are more energy efficient than domestic firms

Are foreign firms more energy efficient than their domestic peers? (yes if value > 0; no if value < 0)



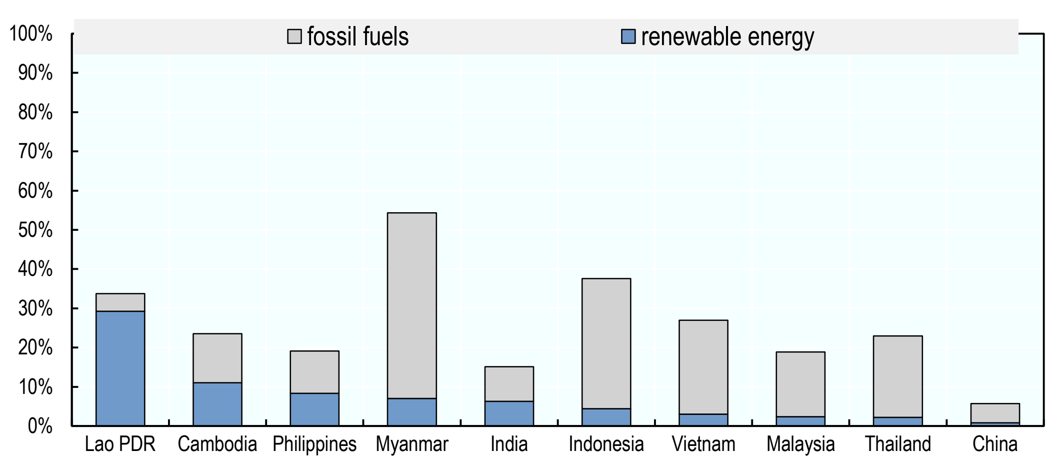
Note*:* The Figure shows a Type 1 FDI Qualities indicator and corresponding 95% confidence interval. See Annex A for a description of the methodology and data. Energy efficiency: sales over electricity and fuel cost.
Source*:* OECD based on World Bank Enterprise Surveys

FDI in renewables is low but growing

While energy efficiency is critical in mitigating climate change in the long run, the use of renewable energy is key for meeting growing energy demand and curbing emissions in the short term (OECD, 2019). Based on greenfield FDI statistics, in Indonesia as well as in most regional peers, investment in fossil fuels far exceeds investment in renewable energy (Figure 2.33). With few noticeable exceptions, in most countries FDI in renewable energy is still dwarfed by investment in fossil fuels by a factor of six or above.

Figure 2.33. Investment in fossil fuels dominates investment in renewables

Greenfield FDI in the energy sector by type (share of total Greenfield FDI)



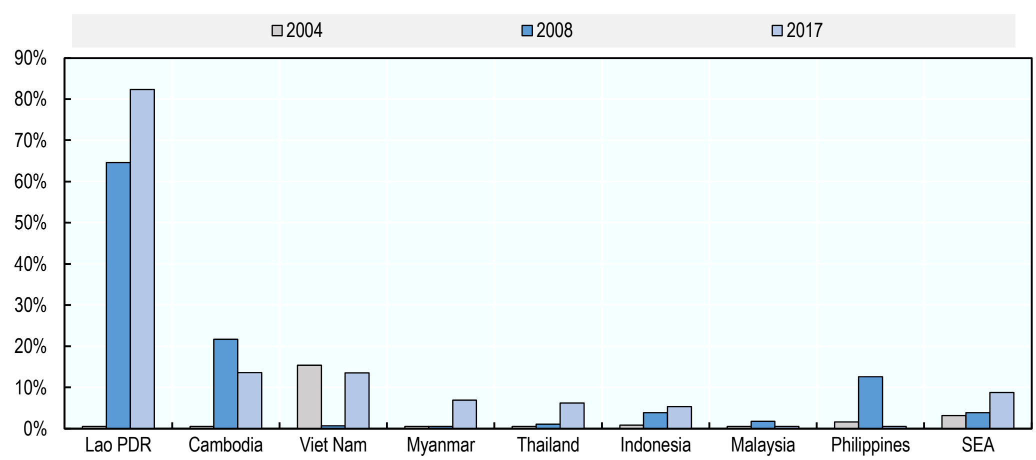
Note: Renewables include wind, solar, geothermal, tide/wave/ocean, small hydroelectric, and biomass; fossil fuels comprise coal, oil and natural gas and related extraction activities.
Source*: OECD based on Financial Times' fDi Markets database*

The results are in line with a recent OECD study (2019), which shows that the stocks of FDI in renewables tend to exceed FDI in fossil fuels in most OECD and many emerging countries, while the opposite is generally observed in less developed countries. According to the study, this is due to more advanced technological requirements associated with renewable energy and the lack of domestic capabilities for investing in renewable energy technology. Other factors may also play a role like the structure and degree of liberalisation of the energy market, the natural resource endowment and geographical position of a country, as well as other economic and political factors. The results for Indonesia for instance, are likely to be driven also by the fact that the country is rich in fossil fuels, and therefore attracts considerable investments in those sectors.

Examining FDI flows shows that this trend is changing rapidly in the region. In 2004, FDI flows in renewables going into the region (excluding China and India) were less than 3% of total FDI flows (Figure 2.34). By 2017, the share of FDI in renewables was close to 10%. At the national level, countries performed differently. In Indonesia FDI flows in renewables tripled, going from less than 1% in 2004 to 5% in 2017. A similar trend is observed also in Lao PDR, Cambodia, Myanmar, and Thailand. Box 2.6 provides a description of the OECD Clean Energy Finance and Investment Mobilisation Programme in Indonesia, which aims to help the government attract investments in renewables and energy efficiency.

Figure 2.34. The share of FDI flows in renewables is increasing rapidly

Greenfield FDI flows in renewables: 2004, 2008 and 2017 (share of total greenfield FDI flows)



Note: Renewables include wind, solar, geothermal, tide/wave/ocean, small hydroelectric, and biomass.
Source*:* OECD based on Financial Times' fDi Markets database

Box 2.6. OECD Clean Energy Finance and Investment Mobilisation Programme in Indonesia

Realising Indonesia's clean energy potential will require an unprecedented scale up in the level of investment for energy efficiency and renewable energy projects. Despite substantial potential across all end use sectors, energy efficiency in Indonesia remains largely untapped. At the same time, renewable electricity development remains at a very early stage of deployment as numerous barriers – including grid access, unattractive tariff structure in certain areas, risk of curtailment, lack of capacity among smaller project developers to prepare bankable feasibility studies, and access to land – have resulted in a relative scarcity of investment-ready projects.

In 2019, the OECD launched a multi-year engagement with the Government of Indonesia to help support the country's efforts to accelerate the development and scale up of investments in clean energy. The OECD Clean Energy Finance and Investment Mobilisation (CEFIM) Programme supports Indonesia and other emerging economies in strengthening clean energy policy frameworks to unlock finance and investments in renewables and energy efficiency.

The Programme builds off wide-ranging OECD experience in helping countries strengthen and align policy frameworks; build robust pipelines of bankable projects; and mobilise institutional investors for clean energy and sustainable infrastructure investments. To achieve its objectives, the CEFIM Programme intends to create an impactful collaboration across relevant domestic and international stakeholders with a view to collectively identifying and operationalising key policy solutions for accelerating clean energy investment in Indonesia.

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Annex 2.A. Methodology of calculation of indicators Type 1 and 2

This chapter uses two types of FDI Qualities indicators (see Box 2.3). Their methodology of construction is presented below.

Indicator Type 1

Type 1 indicator measures how foreign firms perform relative to domestic firms for a given outcome (e.g. productivity). It takes positive values if foreign firms have higher outcomes than domestic firms, on average, and vice versa. The indicator is constructed as the proportional difference between average outcomes of foreign firms and average outcome of domestic firms:

$$Type\ 1 = \ (\bar{Y}_F - \bar{Y}_D)/\ \bar{Y}_D$$

where $\bar{Y}_F$ is the average outcome of foreign firms and $\bar{Y}_D$ is the average outcome of domestic firms, and population averages are calculated using survey weights.

Indicator Type 2

Type 2 indicator shows whether FDI is concentrated in sectors with higher or lower sustainable development outcomes, while controlling for the economic size of each sector. This indicator type compares two sector-weighted averages. The first weighted average (the "FDI-weighted" outcome) is a function of sector-level GDP and FDI. The second weighted average (the "baseline" outcome) only uses sector-level GDP shares as weights. The indicator is constructed as the proportional difference between the FDI-weighted and baseline outcomes:

$$Type\ 2 = \frac{\sum_s \omega_s Y_s - \sum_s \delta_s Y_s}{\sum_s \delta_s Y_s},$$

$$\omega_s = \frac{1}{\sum_s \frac{FDI_s}{FDI_{TOT}} \frac{GDP_s}{GDP_{TOT}}} \left(\frac{FDI_s}{FDI_{TOT}} \frac{GDP_s}{GDP_{TOT}} \right),$$

$$\delta_s = \left(\frac{GDP_s}{GDP_{TOT}} \right)$$

where Y_s is the average outcome of sector s; ω_s is the weight corresponding to sector s constructed using the product of the GDP share and the FDI share of sector s; δ_s is the GDP share of sector s. The indicator takes positive values if the FDI-weighted outcome is higher than the baseline; and vice versa. The growth rate of Type 2 indicator can be further decomposed into two factors to assess how the relationship between FDI and a given outcome has changed over time. This decomposition disentangles the extent to which the indicator changes (1) as a result of changes in outcomes (e.g. labour productivity) in sectors that have received the bulk of FDI, or (2) as a result of shifts in FDI to sectors with different outcomes.

Mathematically, this implies totally differentiating Type 2 indicator (Y) with respect to FDI (FDI) and the outcome under analysis (OUT).

$$Y = F(FDI, OUT)$$

$$dY = F_{FDI} dFDI + F_{OUT} dOUT$$

where F_i corresponds to the partial derivative of Y with respect to variable $i = \{FDI, OUT\}$. The equation is then divided by Y and each change is converted into a growth rate:

$$\frac{dY}{Y} = \left(\frac{F_{FDI}FDI}{Y}\right)\frac{dFDI}{FDI} + \left(\frac{F_{OUT}OUT}{Y}\right)\frac{dOUT}{OUT} = \beta\frac{dFDI}{FDI} + \gamma\frac{dOUT}{OUT}$$

where β measures the change in the Type 2 indicator explained by FDI, and γ denotes the variation in the Type 2 indicator explained by the outcome variable.

Notes

[1] The terms 'affiliates of foreign firms', 'foreign affiliates' and 'foreign firms' are used interchangeably in this chapter.

[2] Chapter 7 examines FDI across regions and focuses on the sub-national dimension of investment policy in Indonesia.

[3] The strategy focuses on five pioneer manufacturing sectors, namely food and beverages, textile and apparel, automotive, electronics, and chemicals.

[4] The Paris Agreement requires each party to prepare, communicate and maintain successive nationally determined contributions (NDCs) that it intends to achieve.

[5] Biomass is excluded from the renewable energy target of 23%.

[6] The terms scale, composition and technique effects were first used by Grossman and Krueger (1991) in their investigation on the environmental impact of trade liberalisation within the context of NAFTA, and later applied to FDI (Gill, 2018; Pazienza, 2015; He, 2008, 2006).

[7] The high value observed in Q2 2020 is explained by one single announced FDI project in the chemical sector by a Chinese company.

[8] Greenfield investment involves the creation of a new asset under the control of the foreign firm, while M&A deals consist of a transfer of existing assets from local companies.

[9] The distribution of FDI across regions is analysed in Chapter 7, which focuses on investment policy in the context of regional development.

[10] Based on BKPM classification, a joint venture between two companies from different countries is considered as coming from the company, and therefore from the country, with the highest share.

[11] The identification of FDI direct effects and spillovers on domestic productivity requires large firm-level datasets, both of foreign and domestic firms, which have not been available for the purpose of this study.

[12] See for example, Arnold and Javorcik (2009), Guadalupe et al. (2012), Criscuolo and Martin (2009) and Bandick et al. (2014).

[13] Local content requirements are quantitative targets for local sourcing or procurement procedures that give preference to domestic suppliers in a given industry.

[14] The indicator does not disentangle the different drivers of the wage premium. As the indicator compares *average* wages, and not *individual* workers' wages, it is likely that most of the premium reflects foreign firms' intrinsic features, i.e. that they are larger, more productive and have higher technology intensity.

[15] The indicator only captures direct CO_2 emissions, while it does not capture emissions associated to electricity and heat use.

3 Re-thinking Indonesia's FDI regime

This chapter focuses on barriers to entry and operation of foreign investors in Indonesia. It explains why reducing barriers and facilitating operations for investors from abroad matter for Indonesia in a world of global value chains. The chapter analyses Indonesia's regulatory regime for foreign investors in comparison to its regional peers and worldwide experience, and identifies a number of policy options for consideration by the authorities for improving Indonesia's attractiveness to foreign direct investment.

Summary and main recommendations

Indonesia has a number of attributes that makes it a naturally coveted destination for foreign direct investment (FDI). Yet, it has never really taken off as a leading FDI destination (see next section and Chapter 2 on trends and impacts of FDI). Foreign investors have been somewhat timorous of Indonesia's complex business environment, not least because of remaining FDI restrictions and entry conditions. But also because of the still strong political appetite for 'economic and resource nationalism', the strong role of state-owned companies (SOEs) in the economy and the heavy bureaucracy and decision-making processes for obtaining needed approvals, licences and permits from authorities at all levels of government (see Chapter 6 on investment promotion and facilitation), which have also at times added to keeping some investors at bay (World Bank/IFC, 2019).

The recent Sino-US trade tensions, which led to the relocation of some export-oriented investments out of China, once again drew attention to Indonesia's challenges in attracting FDI, although more recently some factories have announced plans to relocate production to Indonesia (JETRO, 2020; Nomura, 2019; Jakarta Post, 2020a, 2020b). The situation prompted a strong reaction from President Joko Widodo, who called out members of his cabinet for the country's failure to capture a 'fair share' of such relocations (Jakarta Globe, 2019; Katadata, 2019).

Increasing foreign investments and improving the ease of doing business became a key priority for the current administration, which in early 2020 submitted to Parliament a draft Omnibus Law on Job Creation aimed at streamlining and repealing dozens of overlapping regulations considered to be hampering investments and job creation. Among other issues, the law seeks to lift restrictions and conditions placed on FDI, centralise and streamline business licensing and land acquisition procedures, including by adopting a risk-based approach to business licensing and making it a more transparent and fully online process (see Chapter 6 for a discussion on investment facilitation measures) and significantly reform Indonesia's labour market.

Coupled with the upcoming omnibus law on taxation, it is perceived by the government as critical for strengthening economic competitiveness and particularly for revitalising Indonesia's manufacturing sector, which has steadily shrunk more than 10 percentage points as a share of GDP over the last decade and a half. The law was enacted in October 2020 despite strong opposition by labour unions, regional administrations and civil society, who expressed concerns over the law's amendments to the 2003 Labour Law, the recentralisation of administrative power in the hands of the executive and the lack of public hearings among others. Implementing such an 'all-in-one' law reform package will be a challenge but there are compelling arguments for revising the current FDI regulatory regime once the pandemic is controlled. This chapter focuses on the implications of the Omnibus Law for foreign investment restrictions in Indonesia. Other, more contentious areas of the new law are considered elsewhere in the review (see, for example, chapter 5 on responsible business conduct).

Over time, Indonesia has significantly liberalised its foreign investment regime, but it remains one of the most restrictive countries to FDI as measured by the OECD *FDI Regulatory Restrictiveness Index*, with many primary and services sectors still partly off limits to foreign investors (*e.g.* agriculture, fisheries, oil & gas, power, construction, hospitality, distribution, transportation, telecommunications insurance and other financial services). Beyond extensive sector-specific foreign equity restrictions, it maintains a range of discriminatory policies that apply across the board, such as higher minimum capital requirements for foreign-invested companies, stringent conditions on the employment of foreigners in key management positions, limitations on branching and access to land by foreign legal entities and preferential treatment accorded to Indonesian-owned entities in public procurement. Indonesia also makes extensive use of local content requirements, which add to the hurdles of carrying out foreign investments in Indonesia.

In addition to diverting potential FDI away and depriving Indonesia of a relatively more stable source of capital and foreign exchange for financing its structural current account deficit compared to portfolio investments, these restrictions contribute to holding back potential economy-wide productivity gains (OECD, 2019a, 2015; Duggan et al., 2013; Rouzet and Spinelli, 2016). As shown below, Indonesian manufacturers are among the most affected worldwide by FDI restrictions in services sectors. This is ever more pressing given the level of ('premature') de-industrialisation, which may weigh heavily on Indonesia's goal of becoming a high-income economy in the medium-term (Rodrik, 2015). In the modern context of intensified regional and global value chains (GVCs), FDI policies can no longer treat services and manufacturing separately.

A comprehensive overhaul of Indonesia's FDI regime may not be easy to achieve, but only a bold and comprehensive reform package would allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness as an investment destination. Out of six hypothetical FDI reform scenarios simulated using the OECD *FDI Regulatory Restrictiveness Index,* only the elimination of all sector-specific foreign shareholding restrictions, all other restrictions held constant, could bring Indonesia significantly closer to OECD levels of openness. The impact of substantial FDI liberalisation can be sizeable (Mistura and Roulet, 2019). Indonesia's inward FDI stocks, for instance, could be 25% to 85% higher if it were to reduce the level of FDI restrictiveness to the 50th and 25th percentile levels of the *OECD FDI Regulatory Restrictiveness Index, ceteris paribus*. Stringent barriers to FDI also make other doing business impediments, and reforms therein, less relevant as these may not bring about the intended benefits.

While revisiting the FDI regime is certainly warranted, the Omnibus Law on Job Creation should also ensure that past achievements are preserved. The transparency of Indonesia's policy framework for investment improved with the adoption, pursuant to the 2007 Law on Investment, of a 'negative list' approach for listing sectors that remained closed or open with certain conditions to foreign or domestic investors. A shift to a 'positive list', as it has sometimes been reported by the media, would represent a setback to transparency and on-going and future efforts of maintaining an open business environment if technically implemented. The authorities, however, have confirmed during this review that the 'negative list' approach will continue to be used for the regulation of market access. Improvements could thus be considered on the institutional setting and procedures for its formulation. Greater transparency and technical support, as well as a more inclusive consultation and institutional setting could help to broaden the information-base supporting discussions and deliberations in this regard.

The announced global economic downturn scenario – the OECD (2020a) projects a 4.5% contraction of the global economy in 2020 – might perhaps work in favour of pushing reforms forward. The pace of Indonesia's FDI reforms have historically been largely shaped by crises. If it were not for the current unique situation, past perspectives about FDI liberalisation reforms would be comforting in suggesting a pick-up in FDI activity. But this may prove particularly difficult this time. It might be challenging even to hold on to existing FDI considering the expected negative impact of the pandemic on global FDI activity (see Chapter 2).[1] ASEAN as a region is likely to remain well positioned to compete for investments, which could also benefit Indonesia. But without reforms, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI in the immediate aftermath of the pandemic may be slim.

Main policy recommendations

- In view of Indonesia's extensive list of activities restricted to foreign investment: undertake a comprehensive regulatory impact assessment of existing restrictions on FDI, including assessments of potential substitutive non-discriminatory policies where relevant, and subject the assessment to ample stakeholder scrutiny to identify priority areas for reform and inform policymaking in the context of the omnibus reform on job creation and further implementing regulations.
- In advancing FDI reforms, consider prioritising further liberalisation of FDI in services sectors due to their economy-wide productivity implications. In the current context of GVCs and the intensified 'servicification' of manufacturing activities, restrictions on FDI in service sectors end up

discriminating against domestic manufacturing producers and consumers, who may have to pay relatively higher prices for quality-adjusted services inputs. Accompanying reforms to behind-the-border services regulations should go hand in hand with FDI liberalisation for these to fully bring about their potential benefits.

- Eliminate discriminatory requirements against foreign direct investors in horizontal regulations to support enhanced competitiveness and efficiency and ensure a level playing field for all investors in Indonesia. In this respect:
  - Align the general minimum capital requirement for foreign-invested companies with capital requirements for domestic investors. The currently discriminatory minimum capital policy is particularly stringent for investors in less-capital intensive activities. Worldwide, where minimum capital requirements still exist, they are rarely discriminatory – in 2012 only eight countries out of 98 assessed in the World Bank's Investing Across Borders imposed a discriminatory minimum capital requirement – and typically much lower than what is required from foreign investors in Indonesia (about 17 times lower for the average OECD economy). This is the case even across economies with a level of income per capita much greater than that of Indonesia.
  - Promote a more level playing field in public procurement for foreign direct investors by eliminating preferential treatment accorded to Indonesian-owned entities, notably in the procurement of services. According preferential treatment to resident enterprises in public procurement is relatively common, but discriminating against foreign-owned firms established in the procuring jurisdiction is rather exceptional. As for other discriminatory measures, these might hinder competition and contestability in the affected markets and may drive up costs of goods and services procured by the government.
  - Reconsider the use of local content requirements for developing local industries and supporting domestic investors. Stringent local content requirements in some sectors add to the hurdles of carrying out foreign investments in Indonesia. By establishing hard to achieve local requirements, it may restrain competition and potential short-term gains in targeted industries can act as a drain on the rest of the economy. In pursuing such objectives, horizontal policies addressing deficiencies of the business and regulatory environment, trade and investment barriers, innovation policy, and infrastructure development, can offer an alternative to local content policies and have less negative economy-wide effects on output, exports and jobs.
- Preserve and improve Indonesia's current 'negative list' approach to regulating market access and treatment accorded to foreign investment in the on-going Omnibus law reform. Such an approach provides greater clarity and security for investors than the alternative 'positive list' approach sometimes mentioned in the context of the on-going reform. Investors have at times expressed discontent with the pace of liberalisation in past years and questioned the capacity of the 'negative list' revision process to encourage liberalisation, but this would likely be more challenging under the alternative 'positive list' proposal. Improvements could be considered on the institutional setting and procedures for the regular revision of such a 'negative list'. In these respects:
  - Continue to allow foreign investment without discrimination unless designated as restricted in a separate 'negative list' indicating a complete list (without carve-outs and exceptions) of activities closed to private investment (foreign or domestic), activities closed only to foreign investors, and activities where foreign investment is permitted under discriminatory conditions. Such a list should be clear and concise, describing any imposed condition with clarity and specifying where appropriate the relevant underlying provisions in national laws and regulations. Explicit reference to an international standard industry classification (on top of Indonesia's standard industrial code (KBLI) as currently the case) for accurate documentation of closed or restricted activities is also recommended. As currently the case, it should continue to be placed in an executive-level order for ease of amendments over time. It should also be

immediately updated whenever any relevant underlying legislation is introduced or modified to make sure every new or modified restriction and condition is not enforceable until appropriately reflected in the 'negative list'.

- Strengthen the process for assessing and revising the 'negative list' on a regular basis including by consulting more widely and systematically with relevant stakeholders, relying more on technical assessments by independent qualified institutions and publicising relevant documents supporting deliberations. A broader involvement of relevant stakeholders, as well as more transparency and technical inputs to the formulation of the 'negative list' would help to broaden the information-base supporting discussions and deliberations and facilitate dialogue with interested stakeholders, ultimately contributing to improved policy-making.

Why do barriers to FDI matter for Indonesia?

Indonesia has long been a challenging destination for foreign investment. It has a number of attributes that makes it a naturally coveted destination for FDI: the largest consumer market of Southeast Asia in one of the fastest growing regions in the world, abundant natural resources and a large and relatively young workforce, among other advantages. Yet, it has never really taken off as a leading FDI destination, especially considering the increasing importance of the Southeast Asia region as a world investment destination (Table 3.1). For the world's 16th largest economy in 2018 and which is still 2.5 times more populous than the second largest ASEAN peer, it is surprising that it featured among the top 3 ASEAN recipients of FDI in absolute dollar terms in only two periods over the past three decades (1990-1995 and 2016-2018). In relative terms, Indonesia's performance has been weaker, but overall improving since the mid-2000s, similarly to its performance in absolute terms.

Table 3.1. Indonesia's comparative performance in attracting FDI, 1995-2018

(World rank in parenthesis)

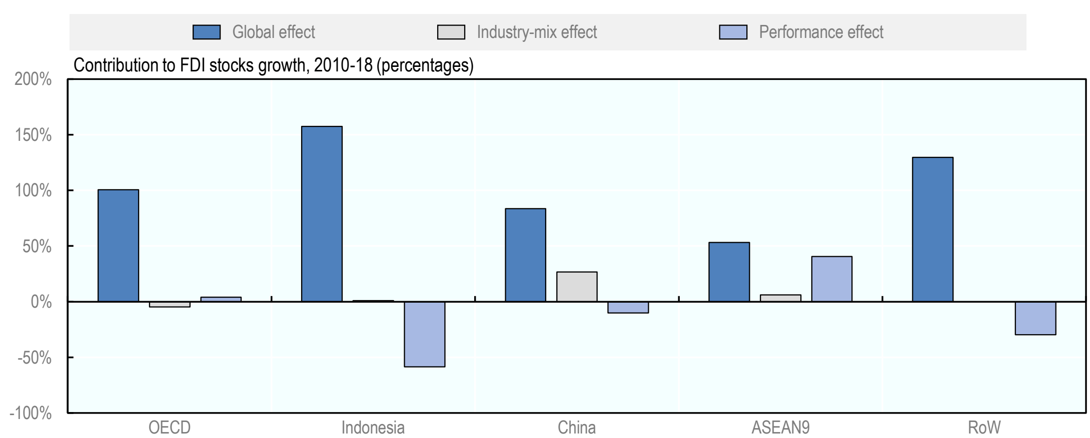
FDI inflows (% of world total)	1990-1995	1996-2000	2001-2005	2006-2010	2011-2015	2016-18
Brunei Darussalam	0.1 (90)	0.2 (63)	0.2 (61)	0.1 (125)	0.1 (116)	0.1 (122)
Cambodia	0.1 (98)	0.1 (86)	0.1 (120)	0.1 (98)	0.2 (73)	0.2 (58)
Indonesia	**1.1 (19)**	0.5 (38)	-0.2 (190)	0.4 (50)	0.6 (37)	**1.3 (19)**
Lao PDR	0.1 (114)	0.1 (116)	0.1 (167)	0.1 (135)	0.1 (121)	0.1 (80)
Malaysia	2.4 (13)	0.9 (21)	0.5 (40)	0.5 (45)	0.8 (27)	0.7 (32)
Myanmar	0.1 (66)	0.1 (64)	0.1 (81)	0.2 (80)	0.1 (93)	0.3 (49)
Philippines	0.5 (37)	0.3 (47)	0.2 (70)	0.2 (69)	0.3 (54)	0.5 (35)
Singapore	2.8 (9)	2 (13)	2.3 (13)	2.4 (13)	3.8 (7)	5 (5)
Thailand	1 (23)	0.7 (28)	0.8 (27)	0.7 (33)	0.5 (40)	0.5 (36)
Viet Nam	0.5 (40)	0.4 (44)	0.3 (58)	0.5 (41)	0.6 (35)	1 (22)
FDI inflows (% of GDP)	**1990-1995**	**1996-2000**	**2001-2005**	**2006-2010**	**2011-2015**	**2016-18**
Brunei Darussalam	2.4 (57)	11.9 (13)	15 (12)	2.8 (124)	3.5 (85)	2.1 (110)
Cambodia	2.7 (52)	6.4 (36)	3.5 (79)	9.5 (38)	12.2 (19)	12.6 (12)
Indonesia	1.3 (90)	0.1 (177)	1.1 (144)	1.5 (157)	2.2 (114)	1.6 (126)
Lao PDR	2.5 (56)	4.4 (56)	0.9 (162)	4.7 (82)	4.7 (62)	7.7 (27)
Malaysia	7.7 (12)	5.3 (47)	2.6 (107)	3.2 (113)	3.5 (83)	3.1 (79)
Myanmar	2.9 (45)	6.9 (32)	5.5 (46)	4.8 (80)	2 (119)	5.4 (42)
Philippines	1.7 (70)	2 (114)	1.1 (146)	1.5 (160)	1.3 (157)	2.4 (100)
Singapore	9.6 (8)	14.4 (9)	15.2 (11)	17.9 (11)	19.4 (10)	23.2 (8)
Thailand	1.5 (76)	3.6 (73)	3.6 (77)	3.3 (109)	1.8 (127)	1.4 (132)
Viet Nam	7.5 (14)	6.7 (34)	3.7 (73)	7.3 (50)	5.5 (53)	6.3 (37)
FDI inflows per capita (USD million)	**1990-1995**	**1996-2000**	**2001-2005**	**2006-2010**	**2011-2015**	**2016-18**

FDI inflows (% of world total)	1990-1995	1996-2000	2001-2005	2006-2010	2011-2015	2016-18
Brunei Darussalam	410.8 (14)	2026.3 (11)	3046.2 (8)	983.7 (37)	1524.8 (19)	626.9 (36)
Cambodia	7.5 (128)	18.9 (124)	13.8 (142)	66.1 (125)	123.6 (110)	174.1 (86)
Indonesia	12.4 (106)	4.7 (155)	14.2 (139)	33.6 (145)	76 (129)	58.5 (121)
Lao PDR	8.4 (122)	14.9 (129)	3.4 (175)	39.9 (139)	87.4 (125)	190.2 (84)
Malaysia	259.2 (24)	219.7 (50)	119.7 (77)	238.9 (86)	367.8 (61)	304.4 (64)
Myanmar	4.4 (135)	11.4 (138)	11.5 (145)	32.2 (146)	23.1 (163)	68 (115)
Philippines	16.7 (97)	21.4 (121)	11.4 (147)	23.5 (157)	33.3 (148)	70.2 (114)
Singapore	1930.8 (3)	3562.4 (4)	3701.3 (6)	6924.2 (6)	10783.5 (6)	13269.1 (4)
Thailand	32.4 (80)	75.3 (77)	85.1 (91)	136.2 (109)	107 (113)	90.7 (106)
Viet Nam	15 (102)	23.1 (117)	18.7 (134)	79.5 (118)	99.9 (118)	147.2 (90)

Note: Highlighted cells indicate where Indonesia features among the top 3 performers in ASEAN.
Source: UNCTAD FDI Statistics.

Much of the growth in inward FDI observed recently, notably since 2010, can be explained by the widespread growth of FDI worldwide (Figure 3.1). Indonesia's competitiveness factor in attracting FDI, measured as the difference between the actual change in FDI stock and the expected change in FDI stock had the FDI stock of each of its industry grown at the world industry FDI growth rate, was actually negative over the 2010-2018 period, denoting a loss of competitiveness in world FDI markets. Essentially, had Indonesia's competitiveness been sustained over the period and other factors held constant, its share in world FDI markets would have remained constant over time. But global FDI in industries holding a prominent share of Indonesia's FDI stocks has grown faster than in Indonesia. This is the case of manufacturing and services, for example.

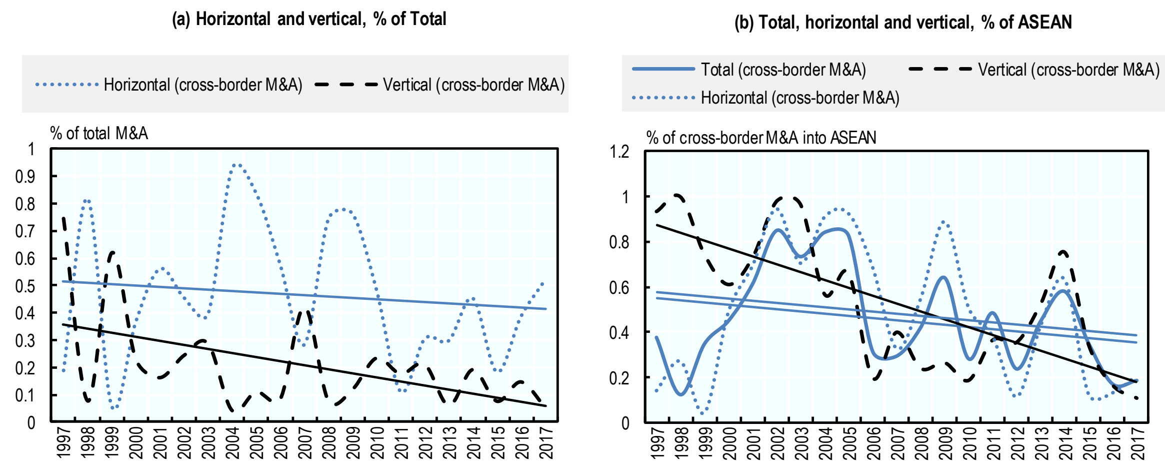
Figure 3.1. A Shift-Share Decomposition of Indonesia's FDI inward stock growth, 2010-18



Note: see Annex 3.A. Technical Notes.
Source: author's elaboration, based on various data sources (see Annex 3.A. Technical Notes).

Location-based investments in extractive industries and agricultural activities, and to a lesser extent, domestically-oriented investments, such as in construction activities, have fared better, but these have not allowed Indonesia to compensate for its loss of market shares in worldwide FDI. Particularly, and in contrast to the upward trend observed in the other ASEAN Member States collectively, Indonesia seems to be failing to attract the more efficiency-seeking type of investments. This is partly exemplified by the downward trend observed in vertical cross-border mergers and acquisitions of Indonesian firms as a share of all cross-border deals targeting Indonesia (Figure 3.2, panel a) and ASEAN firms (Figure 3.2, panel b). While investment projects might often serve multiple purposes, investments where efficiency-seeking motives prevail tend to be more export-oriented and typically outperform domestically-oriented FDI in a number of key development outcomes, such as labour productivity and wages, innovation capacity and invested capital (World Bank, 2019), although sometimes these may not translate into greater linkages and spillovers to the domestic economy.

Figure 3.2. Trends in horizontal and vertical FDI in Indonesia: 1997-2017



Note: see Annex 3.A. Technical Notes.
Source: author's elaboration, based on Dealogic Merger & Acquisitions data.

Hosting efficiency-seeking FDI is also a signal of the quality of the business environment as these investors are also more footloose. They are typically more sensitive to investment climate conditions because they seek to explore plant-level economies of scale, such as factor costs savings, besides vertical integration and other location-based opportunities associated with market access and geographical distribution, institutional arrangements and economic policies allowing the firm to rationalise its operational structure. Realising these potential gains, however, depends on the extent of costs arising from the fragmentation of the value chain, such as international trade costs and technical efficiency losses. The more efficient is the co-ordination and the business environment (e.g. in terms of obtaining licenses and permits, trading across borders, paying taxes, enforcing contracts etc.), the higher are the relative returns, and the higher is a location's competitiveness and attractiveness to investors.[2]

Foreign investors have long been somewhat cautious about Indonesia's complex business environment, not least because of remaining FDI restrictions and entry conditions discussed in the next section, such as foreign shareholding limitations and local content requirements, which might impinge on their ability to operate efficiently. But they are also concerned about the prevailing heavy bureaucracy and decision-making processes for obtaining needed approvals, licences and permits from authorities at all levels of government (see Chapter 4, Chapter 6 and Chapter 7) which have, together with the strong role of SOEs in the economy and the still strong political appetite for 'economic and resource nationalism' (see Chapter 1), added to keeping some investors at bay at times.

The recent Sino-US trade tensions, which led to the relocation of some export-oriented investments out of China, once again drew attention to Indonesia's challenges in attracting FDI. Anecdotal evidence and analysts seem to suggest that relocating investors have largely overlooked Indonesia in preference for some of its regional peers, such as Viet Nam, Thailand and Malaysia (JETRO, 2020, Nomura, 2019), although more recently several factories have announced plans to relocate production to Indonesia (Jakarta Post, 2020a, 2020b). The situation prompted a strong reaction from President Joko Widodo, who called out members of his cabinet for the country's failure to capture a 'fair share' of such relocations (Jakarta Globe, 2019; Katadata, 2019).[3]

Box 3.1. Global value chains and FDI

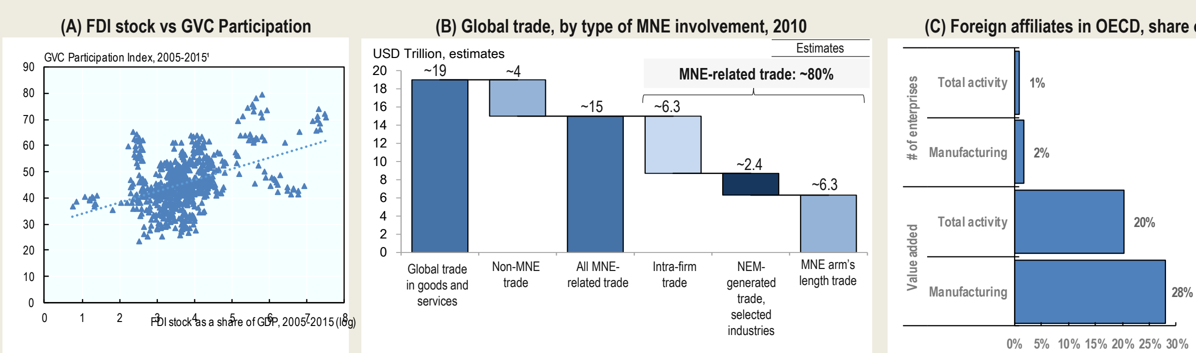
FDI restrictions might be further contributing to limited GVC development in Indonesia

GVCs have become an important driver of productivity and economic growth across countries, both in developed and developing countries (OECD, 2015b; World Bank, 2019; Kowalski et al., 2015). The increased international fragmentation of production processes associated with GVCs can be observed in the significant growth in intermediate goods and services trade in the past decades. Recently, more than 70% of world service imports were estimated to be intermediate services, and more than 50% of world manufactured imports were intermediate goods (OECD, 2013). Now more than ever firm competitiveness, and consequently that of countries, depends as much on the capacity to access cheaper, more differentiated world-class quality inputs as on the capacity to export – in other words, countries import in order to export successfully.

Multinational enterprises (MNEs) play a central role in GVCs, with a large share of cross-border trade taking place within affiliated networks (Figure 3.3). UNCTAD (2013) estimates that MNEs account for about 80% of global trade in goods and services, about 42% of which is intra-firm trade (Figure 3.3, Panel B). Cadestin et al. (2019) estimates a smaller participation but nonetheless important: roughly one half of international trade. FDI is therefore an important channel through which countries integrate and benefit from GVCs (Figure 3.3, Panel A). MNEs and their foreign affiliates are typically only a small fraction of the enterprise population but play a much greater role in terms of outcomes, partly because they are typically engaged in more capital- and scale-intensive industries (Figure 3.3, Panel C; OECD, 2013 and 2019). They usually account for a large share of exports and value added, and while part of the value added created may be repatriated, the rest stays in the host country in the form of labour compensation, taxes and reinvestments.

Depending on how strongly they are integrated into domestic economies, MNEs also represent a source of access to international markets and new technologies for their domestic suppliers and buyers, including SMEs, besides contributing to knowledge spillovers for domestic value chains. Every USD 1 of extra sales by foreign affiliates generates, on average, another USD 0.62 for the domestic economy in which they are located (Cadestin et al., 2019).

Figure 3.3. The importance of FDI in global value chains

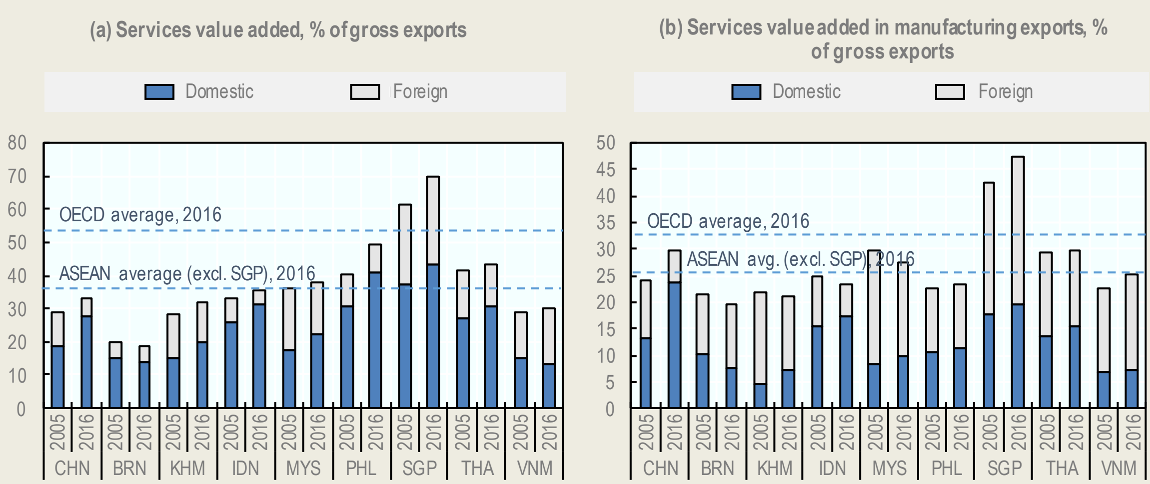


Note: ¹GVC participation index refers to the share of foreign inputs (backward participation) and domestically produced inputs used in third countries' exports (forward participation) in a country's gross exports. See Koopman et al. (2010) for more information.
Source: OECD (2014); UNCTAD statistics; UNCTAD (2013) and OECD AMNE Statistics (data for 2014).

The performance of service sectors plays an important role in this context. Services are a significant channel for value added generation in the context of GVCs. Worldwide, while the share of services in gross exports is relatively small, service sector activities contribute almost half of the value added inputs to exports (De Backer and Miroudot, 2013). In ASEAN, despite recent improvements, services value added embodied in exports, whether supplied locally or imported, remain subdued (38% excluding Singapore) compared to the OECD average (54%). In Indonesia, the share of services valued added in gross exports stood at 36% in 2016 (Figure 3.4, Panel A).

In addition, services play an increasingly important role in value added generation in manufacturing activities, either as inputs for production of manufacturing goods or corporate services activities within firms, as well as bundled together with goods sold (Miroudot and Cadestin, 2017). This "servicification" of manufacturing activities is clearly evidenced when one looks at the decomposition of value added embodied in manufacturing exports (Figure 3.4 Panel B). In OECD economies for instance, services inputs account for about 33% of the value added embedded in manufacturing exports, and adding the in-house provision of services in manufacturing firms, the share of services in manufacturing exports increases to 50% (Miroudot and Cadestin, 2017). In ASEAN (excluding Singapore) and Indonesia, the share of services value added embedded in manufacturing exports (excluding in-house services) stands at 26% and 23%, respectively. In OECD economies, about 90% of the embedded services value added is domestically generated. In Indonesia: about 75% is domestically produced by Indonesian or foreign-owned companies established in Indonesia; the rest is imported. This is remarkably high in comparison to other AMS and can be principally explained by Indonesia's exports being largely driven by natural-resource based industries, such as food products and chemicals and minerals, which make use of Indonesia's raw materials and domestic distribution and transport services throughout the chain.

Figure 3.4. Services value added share of exports and of manufacturing exports



Note: Domestic refers to the share of value added produced in the country either by locally-owned services providers or foreign affiliates in the country. Foreign refers to the share of imported value added from service providers located abroad. Service industries include construction, wholesale and retail, hotels and restaurants, transport and communications, finance, real estate and business services as well as public services, *i.e.* ISIC Rev.4 Divisions 41 to 98.
Source: OECD TiVA database.

Without a more thriving business environment for foreign investors, Indonesia might miss out on potential development opportunities associated with global value chains (Box 3.1). GVCs have become an important driver of productivity and economic growth across countries, both in developed and developing countries (OECD, 2015b; World Bank, 2019; Kowalski et al., 2015); and services sectors, which still largely restrict FDI in Indonesia, play an important role in this context as they account for a significant share of value added in the context of GVCs. The extent to which countries can provide the necessary conditions for global production networks to operate efficiently at each stage of the production chain, including in relation to access to world-class services inputs, is, therefore, a key determinant of their success in linking to and upgrading within GVCs.

FDI restrictions in service sectors in this context might deter GVC integration and development by hampering the development of competitive services and downstream manufacturing activities. Statutory restrictions on FDI (e.g. foreign equity limitations and discriminatory screening and approval mechanisms) are found not only to have a significant negative effect on a country's ability to attract FDI (Mistura and Roulet, 2019; Fournier, 2015; Nicoletti et al., 2003), there is also evidence that consumers and manufacturing sectors are also negatively affected by FDI restrictions in services sectors. Restrictive services regulations typically enable service providers to charge higher mark-ups in a majority of service sectors, affecting downstream activities and end-consumers (Rouzet and Spinelli, 2016).

This has economy-wide productivity implications given the increased importance of services as inputs for downstream manufacturing industries (Box 3.2). Previous OECD (2019a) work, for instance, demonstrates that ASEAN manufacturing firms in industries relying extensively on services, such as in machinery and transport equipment industries, would greatly benefit from further services FDI liberalisation. Such productivity benefits are greater for SMEs and for domestic market oriented and domestically-owned firmsthan for large, export-oriented and foreign-owned firms. Service sector reforms could also translate into significant economic gains in the long run. The IMF (2018) estimates that Indonesia's potential long-term real GDP gain from reducing trade and FDI restrictions to the global average would amount to roughly 10% in the medium-to-long term. Nearly 6 percentage points is attributable to FDI liberalisation in the estimation.

Box 3.2. Services reforms raise manufacturing productivity

Recent empirical literature has identified a clear association between services reforms and productivity growth in the economy as a whole; as well as specifically in manufacturing (Low, 2016). A study of 15 OECD countries illustrates that anti-competitive upstream regulations in services and other non-manufacturing sectors curbed multi-factor productivity growth in downstream sectors between 1985 and 2007 (Bourlès et al., 2010). A recent study of Lao PDR confirms that services liberalisation benefits economic development across economic sectors, not just in services (Isono and Ishido, 2016).

Focusing on manufacturing, Duggan et al. (2013) employ the OECD FDI Index to assess the effects of FDI restrictions in services on the manufacturing productivity of Indonesian firms and find that service sector FDI liberalisation accounted for 8% of the observed increase in Indonesian manufacturers' total factor productivity (TFP) from 1997 to 2009. Shepotylo and Vakhitov (2015) analyse the impact of services liberalisation on manufacturing productivity in Ukraine over 2001-07 and find that a one standard deviation in liberalisation in services is associated with a 9% increase in the TFP of manufacturing firms. The authors also find that the effect of services liberalisation is stronger for domestic and small firms. Arnold et al. (2012) find that India's policy reforms in banking, telecommunications, insurance and transport services all had significant and positive effects on the productivity of Indian manufacturing firms from 1993 to 2005. Both foreign and domestic firms benefited from services reforms, but the effects were stronger for foreign-owned firms. A one standard deviation increase in services liberalisation resulted in a productivity increase of approximately 12% and 13% for domestic and foreign manufacturing firms, respectively. Relatedly, Berulava (2011) finds that liberalisation in telecommunications, electric power, transport, water distribution and banking stimulated the expansion of export activities of manufacturers in 29 transition economies from 2002 to 2009.

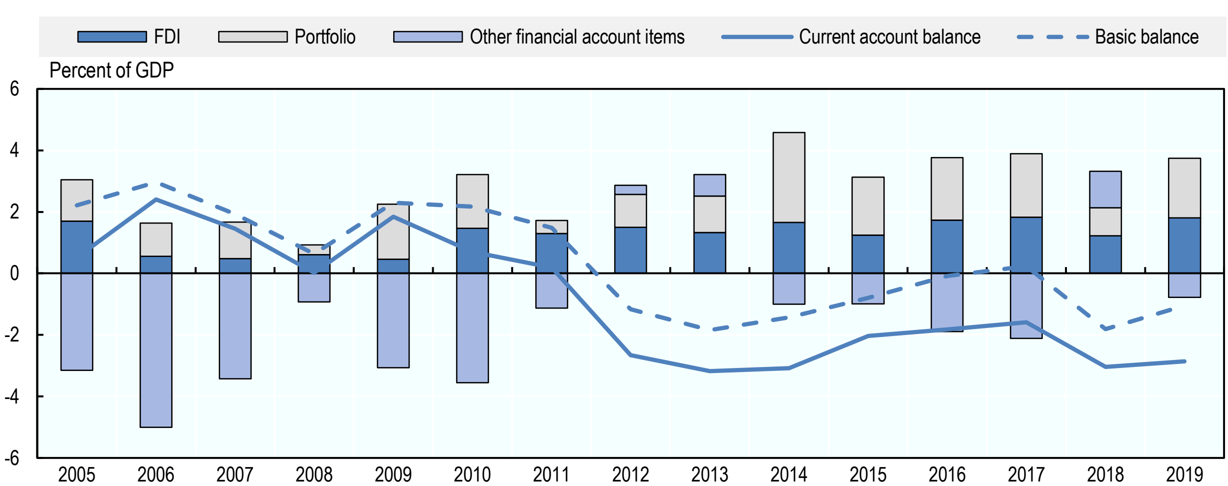
These findings are qualified by a recent study that argues that the effect of restrictions in upstream services is conditional on institutional quality (Beverelli et al., 2015). Using sector-level data in a panel dataset of 58 countries spanning all stages of economic development, the study finds that countries with better economic governance benefit more from open services policies. That is, higher quality institutions attract more productive service providers and support higher levels of services performance, which then affect downstream manufacturing sectors.

A number of studies also show a positive association between FDI in services and manufacturing productivity. Arnold et al. (2011) illustrate that increased foreign participation in services improved manufacturing productivity in the Czech Republic from 1998 to 2003. A one standard deviation in foreign presence in services is associated with an approximately 8% increase in the productivity of Czech manufacturing firms relying on services inputs. Fernandes and Paunov (2012) conduct a similar study on the effects of FDI in services sectors on the productivity of Chilean manufacturing firms between 1995 and 2004. A one standard deviation increase in service FDI would increase Chilean firms' TFP by 3%, and forward linkages from FDI in services explain 7% of the observed increase in the TFP of Chile's manufacturing firms during the period. Forlani (2012) finds that increased competition in network services in France improves the productivity of manufacturing firms.

Source: reproduced from OECD (2019a).

By limiting Indonesia's ability to attract more FDI, restrictions also have implications for the financing of Indonesia's current account deficit observed recently (Figure 3.5). Since 2012, the current account has had an average negative balance equivalent to 2.5% of GDP, mostly due to a deterioration of Indonesia's goods trade balance.[4] The basic balance has also turned negative since then as FDI has not been enough to cover the current account deficit, meaning that Indonesia has become more dependent on more volatile portfolio investments for the financing of its current account deficit. In this respect, the sharp reversal of portfolio investments in emerging economies following the COVID-19 outbreak, combined with an expected slowdown on FDI worldwide (OECD, 2020a; 2020b; 2020c), might become a further challenge for Indonesia, although financing pressures might be attenuated by a small reduction in the current account deficit according to World Bank (2020a) projections.

Figure 3.5. Indonesia's current account financing structure (% of GDP)



Note: Basic balance refers to the sum of the current account balance and net FDI.
Source: International Monetary Fund, Balance of Payments and World Economic Outlook (October 2019) Databases.

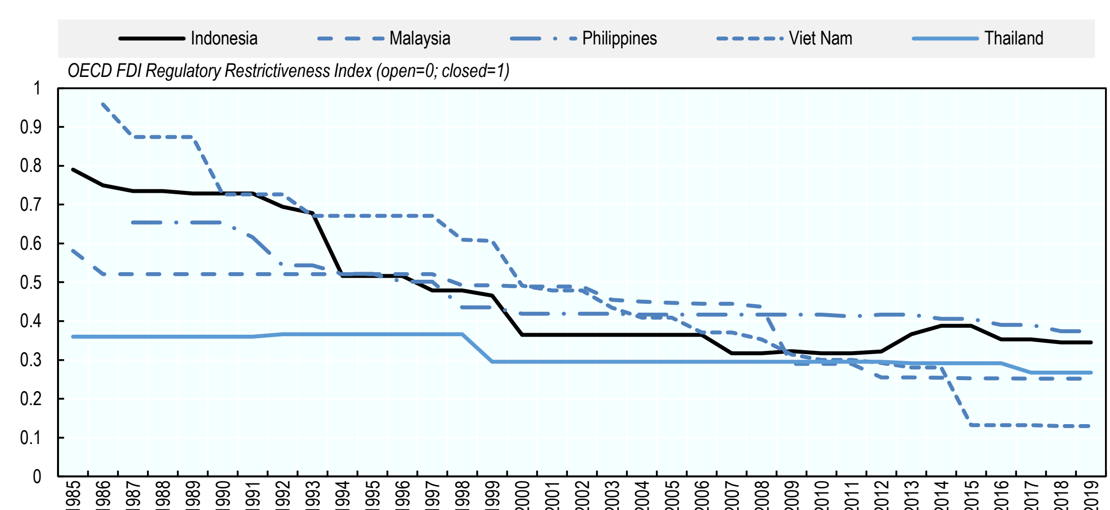
Overall, even if restrictions may not deter some investments altogether, they might affect the nature of the FDI coming to Indonesia. Joint-venture requirements, for instance, raise the issue of finding suitable local partners with adequate capacity and skills and of guarding against undue technology appropriation by partners and competitors. This, at times, may end-up reducing the potential surplus of a project by inducing the inefficient use of local resources or by simply limiting their potential spillovers vis-à-vis the case where no conditions are imposed. Foreign investors may opt for deploying older technologies and production techniques as compared to the international industry frontier when faced with foreign equity restrictions or joint-venture requirements (Moran, Graham and Blomström, 2005).

All the potential implications of FDI restrictions discussed above reinforce the importance of weighing their benefits against the costs on a regular basis and in light of the country context and circumstances. The right of governments to favour some investors over others in order to achieve social, economic or environmental goals is widely accepted, but any policy that discriminates against one group of investors involves a cost. Discriminatory measures against foreign investors can thus only serve the broader public interest to the extent that their potential costs in terms of forgone FDI and potential efficiency gains are compensated by broader social and economic benefits. For this reason, they should be constantly re-evaluated to determine whether their original motivation remains valid and their scope remains proportional to their public intent so to ensure that any potential costs are not greater than needed (OECD, 2015a).

Despite significant liberalisation in the past, Indonesia's foreign investment regime remains quite restrictive

Seen from a broad perspective, Indonesia has significantly liberalised restrictions on international investment over time, albeit at a slower pace and with some occasional relapses more recently (Figure 3.6). Yet, Indonesia still remains quite restrictive to FDI according to the OECD FDI Regulatory Restrictiveness Index (Figure 3.7; Box 3.3). Governments all over the world discriminate among investors in one way or another, sometimes deliberately, sometimes unwittingly. But the extent of FDI regulatory restrictiveness observed in Indonesia is by far greater than in most other emerging and developing countries and is even higher than in some of its direct ASEAN peers, such as Thailand, Malaysia and Viet Nam.

Figure 3.6. OECD FDI Regulatory Restrictiveness Index: a historical perspective, 1985-2019

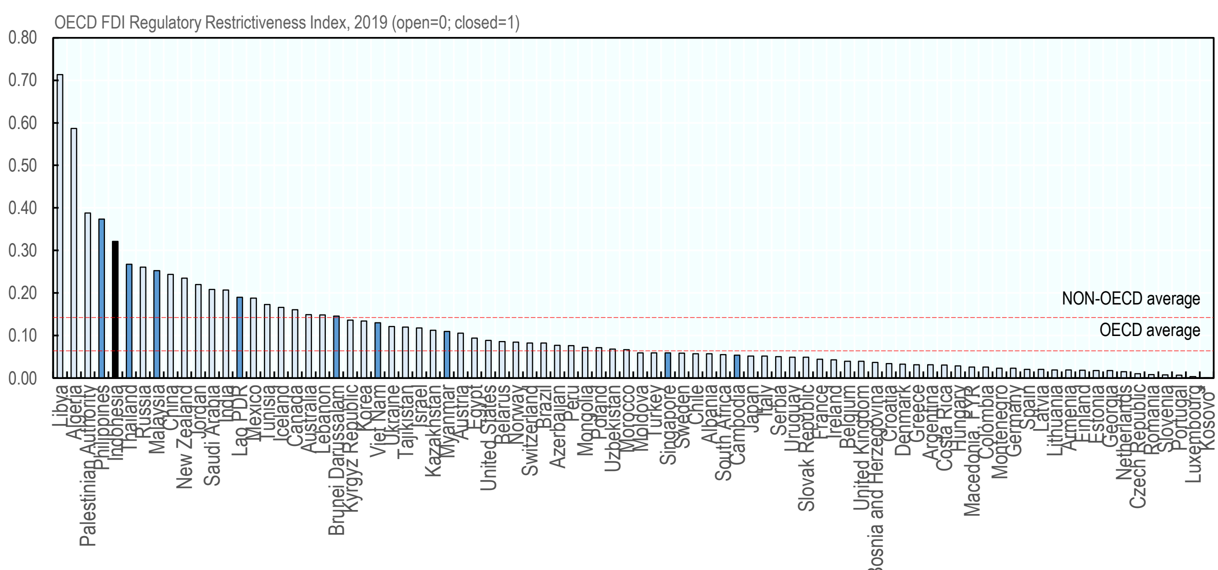


Note: The OECD *FDI Regulatory Restrictiveness Index* covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other important aspects of an investment climate (e.g. the implementation of regulations and state monopolies, preferential treatment for export-oriented investors and SEZ regimes among other) are not considered. Data reflect regulatory restrictions as of end-December. Please refer to Kalinova et al. (2010) for further information on the methodology.
Source: Author's elaboration based on the OECD FDI Regulatory Restrictiveness Index methodology, http://www.oecd.org/investment/fdiindex.htm.

The current investment negative list (DNI) of May 2016 has only modestly helped to bring Indonesia's FDI regime closer to international and regional levels of openness, although it has played a key role in restating Indonesia's willingness to attract foreign investment. The list sets out the business fields closed to investment and those open with conditions, including in relation to foreign ownership limitations, location requirements, special licensing requirements, businesses reserved for 100% domestic (Indonesian) ownership and in which higher foreign ownership thresholds apply for ASEAN investors. It came at a critical moment as the previous negative list issued in 2014 revealed a more ambivalent sentiment towards foreign investment by the government.

Despite some liberalisation, the 2014 list overall reversed some past achievements by making foreign investment in some key sectors, such as mining, more restrictive. Meanwhile key regional peers and competitors continued to open their economies to foreign investors, leaving Indonesia relatively less attractive as an investment destination. The 2016 list was, thus, an important breakthrough as it signalled again a more positive attitude towards foreign investment, notably by lifting foreign ownership caps on 45 business lines (*e.g.* toll roads, tourism-related activities and e-commerce) and easing foreign equity restrictions in some other key service sectors (*e.g.* warehousing, distribution and transport).

Figure 3.7. OECD FDI Regulatory Restrictiveness Index, 2019



Note: See note to Figure 3.6 above.
Source: OECD *FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

However, the list still places limits on foreign-equity participation and prohibits foreign investment altogether either in a wide range of activities spanning agriculture, fisheries, mining and quarrying, manufacturing, power generation, construction, distribution, banking, insurance and other financial services, hotels and restaurants, media, telecommunications and transport sectors. Many activities are reserved exclusively for domestically-owned micro, small and medium enterprises (MSMEs) as well.

Box 3.3. Calculating the OECD *FDI Regulatory Restrictiveness Index*

Covering roughly 80 countries, the OECD *FDI Regulatory Restrictiveness Index* seeks to gauge the restrictiveness of a country's FDI rules. It is not a standalone measure of a country's investment climate, as it does not cover many other aspects of the investment regulatory framework which may impinge on the FDI climate, nor does it capture the actual implementation of formal restrictions. Nonetheless, FDI rules are a critical determinant of a country's attractiveness to foreign investors and the Index, used in combination with other indicators measuring various aspects of the FDI climate, contributes to assessing countries' international investment policies and to explaining the varied performance across countries in attracting FDI.

The *FDI Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial and professional services). Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a simple average of individual sectoral scores. For a detailed description of the scoring methodology, please refer to the technical working paper by Kalinova et al. (2010).

For each sector, the scoring is based on the following elements:

- the level of foreign equity ownership permitted,
- the screening/approval procedures applied to inward foreign direct investment;
- restrictions on key foreign personnel; and
- other restrictions, e.g. on land ownership, corporate organisation (branching).

The measures taken into account by the *Index* are limited to statutory restrictions on FDI typically reflected in official OECD instruments on investment or identified in OECD *Investment Policy Reviews* and yearly monitoring reports. The *FDI Index* does not assess actual enforcement and implementation procedures. The discriminatory nature of measures, *i.e.* when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored. Preferential treatment for special-economic zones and export-oriented investors is also not factored into the *FDI Index* score, nor is the more favourable treatment of one group of investors as a result of preferential treatment under international agreements.

The government's expressed intention to massively revise Indonesia's FDI regime in the context of the Omnibus law reform on job creation is, therefore, a timely and welcome step for increasing Indonesia's appeal to international investors. The last significant FDI liberalisation dates back already to the early-1990s and early-2000s, driven, as historically the case in Indonesia, by the difficult economic contexts that marked those eras (Box 3.4). These allowed Indonesia to catch up somewhat in terms of openness to FDI with some of its regional peers during the 2000s, but its relative competitiveness has been eroding since then as others continued to progress with reforms more intensively.

Box 3.4. Historical perspective of FDI reforms in Indonesia

Indonesia's FDI reforms have traditionally been influenced by crisis and external pressures, rather than from political conviction and support for more open investment policies. In the late-1990s and early 2000s, FDI liberalisation, particularly in the banking sector and for acquisitions of local firms, was contemplated in the context of economic recovery from the Asian Financial Crisis, but seen from a longer term perspective the crisis merely served to speed up a process which was already under way. In the mid-1990s, it was the increased competition from China for FDI , together with a significant decline in Japanese FDI in Indonesia, that exerted considerable pressure on the Indonesian government to step up FDI liberalisation efforts that had started nearly a decade earlier, when the need for foreign exchange and capital mounted with declining oil revenues and the appreciation of the yen (a large portion of Indonesia's external debt was denominated in yen) (OECD, 1999; Conklin and Lecraw, 1997).

Unlike some of its regional peers, such as Malaysia and Thailand, it was not until the mid-1980s that Indonesia came to appreciate the potential role of FDI for its economic development and started to adopt a consistently more open policy stance on foreign investment. Previously, an early attempt to create a more favourable environment to FDI had occurred in the late 1960s with the promulgation of the first Foreign Investment Law (1967), following from the deep economic crisis that gulfed Indonesia during that decade. But this was quickly reversed in the 1970s and early 1980s when the government, facilitated by increased oil income, turned again to more inward-looking policies and placed increasingly severe conditions on inward investment.

Then, in the 1980s, when economic conditions deteriorated again, the government began to contemplate more thoroughly the potential role of FDI for Indonesia's economic development and to adopt more friendly policies towards foreign investment. Starting in 1986, limits on foreign ownership for export-oriented investments were first relaxed and investment licensing procedures were made easier in order to attract foreign capital. Various other policy packages opening up the Indonesia economy to FDI were adopted in the following years, culminating in 1994 with the most significant liberalisation package ever implemented.[5] This marked a major change in the government's FDI policy orientation (OECD, 1999; Conklin and Lecraw, 1997).

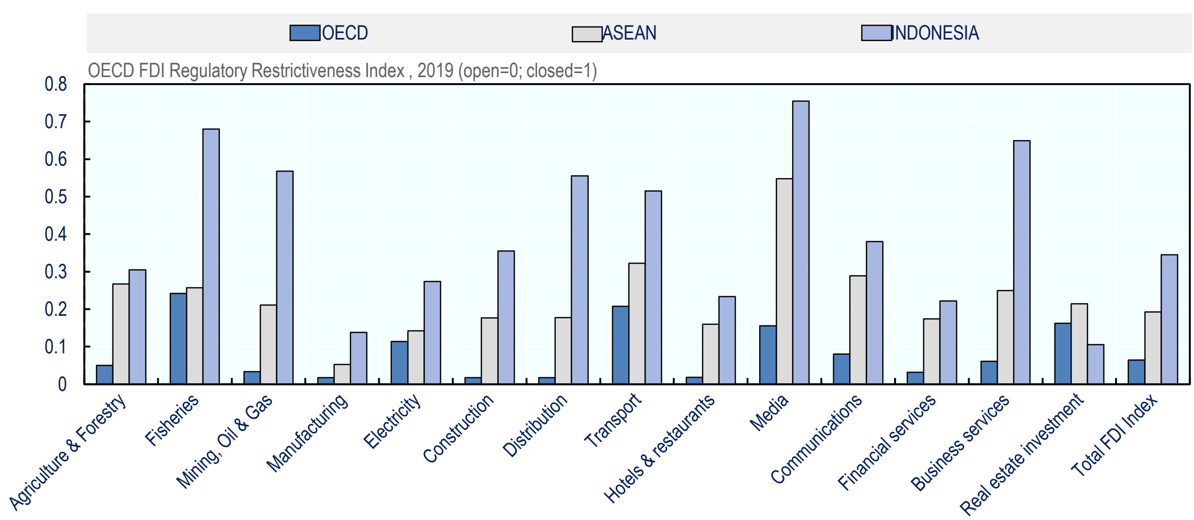
This time again, although not emerging from the current global crisis, Indonesia's FDI reform will likely be influenced by the challenging global economic context. Time will tell what sort of impact the pandemic will have on industries and firms' FDI strategies and behaviour going forward. Some expect FDI to become scarcer as more and more firms and government policies will turn to re-shoring or near-shoring strategies as a solution for possible value chain disruptions in the future. Others see in further off-shoring and FDI an increased opportunity for diversification and supply chain resilience, by avoiding putting 'all the eggs into one basket'. There is some evidence supporting the latter from past supply chain disruptions arising from natural disasters (Miroudot, 2020). Whichever the case, the global economic slowdown will put considerable strain on firms' abilities to pursue FDI projects in the near term.

Probably more than ever, FDI reforms will have to be compelling for boosting, or even preserving, Indonesia's attractiveness to FDI in such times. The OECD (2020a) projects a 4.5% contraction of the global economy in 2020 and estimates (2020c) global FDI flows will fall by more than 30% in 2020 even under the most optimistic scenario for the success of the public health and economic support policy measures taken by governments to address the COVID-19 pandemic and the resulting recession (see Chapter 2). In the past, FDI generally responded positively to Indonesia's liberalisation efforts (OECD, 2010). But this may prove particularly difficult this time considering the scale and magnitude of the current crisis. Even holding on to existing FDI might prove a challenge. Without reforms, however, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI quickly for the recovery following the pandemic could be slight.

Discriminatory measures against foreign investors harm domestic consumers, as well as firms in downstream industries

Manufacturing has been widely liberalised, but many primary and service sectors remain partly off limits to foreign investors, holding back potential economy-wide productivity gains (Figure 3.8). Restrictions in place often exceed considerably the ASEAN average. In the primary sector, the relatively high level of restriction is mostly due to the outright prohibition on foreign investment in commercial capture fishing activities in Indonesian territorial waters and the open sea, and the various equity limitations on foreign investment in oil & gas activities and in mining, where foreign investors additionally face divestment obligations and more or less stringent ownership limitations depending on whether processing or purification activities, or both, are carried out.

Figure 3.8. OECD FDI Regulatory Restrictiveness Index, by sector: Indonesia vs. ASEAN vs. OECD, 2019



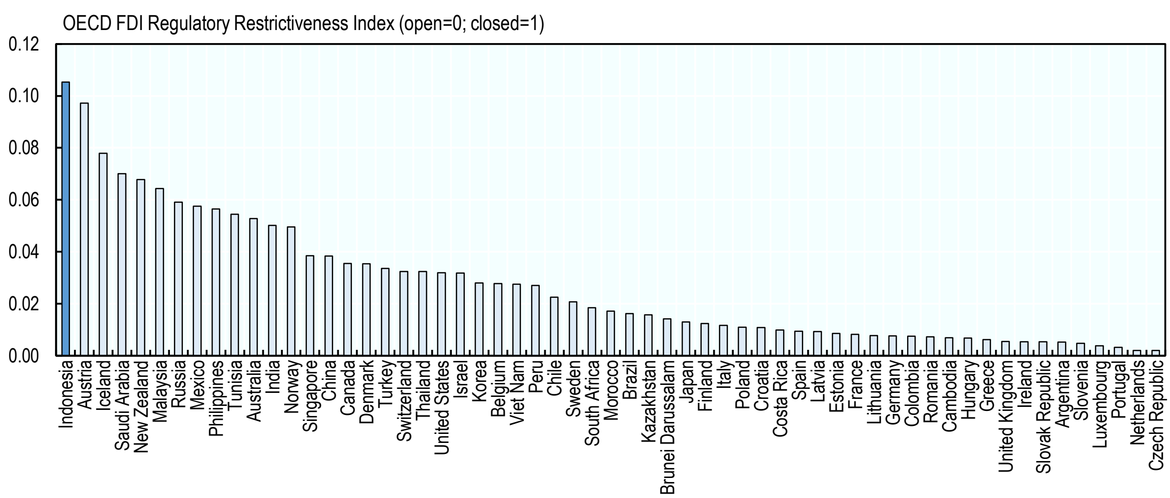
Note: See note to Figure 3.6 above.
Source: *OECD FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

Services liberalisation has typically lagged behind that of manufacturing almost everywhere, including in OECD countries, finding strong resistance in domestic interest groups. But by shielding domestic service providers from foreign competition, Indonesia has implicitly been favouring local service providers over domestic consumers and manufacturing firms relying increasingly on services inputs for their activities. As discussed in the section above, FDI restrictions, even partial ones, impose additional costs on FDI entry and make the services sector overall less efficient by limiting competition and contestability, which translates into higher input prices for downstream activities and end-consumers.

Manufacturing industries in Indonesia are among the most affected worldwide by FDI restrictions in services sectors (Figure 3.9). This is because local manufacturers rely quite extensively on inputs from domestic services sectors relatively more insulated from foreign competition than elsewhere. Maintaining such a high level of restrictiveness in services sectors imposes a sizeable cost on manufacturing sectors. In line with the evidence available for other countries, Duggan et al. (2013) estimate that about 8% of the observed increase in Indonesian manufacturers' total factor productivity over 1997-2009 can be explained by the relaxation of FDI restrictions in services throughout the period.

This is ever more pressing given the level of ('premature') de-industrialisation, which has steadily shrunk more than 10 percentage points as a share of GDP over the last decade and a half and which may weigh heavily on Indonesia's ambition to become a high-income economy in the medium-term (Rodrik, 2015). The decline in competitiveness is particularly visible in exports markets, which have seen total exports of goods and services halve to 20% of GDP since 2000, largely due to a reduction in manufacturing exports (World Bank, 2018).

Figure 3.9. Services FDI restrictiveness impinging on manufacturing activity, 2019

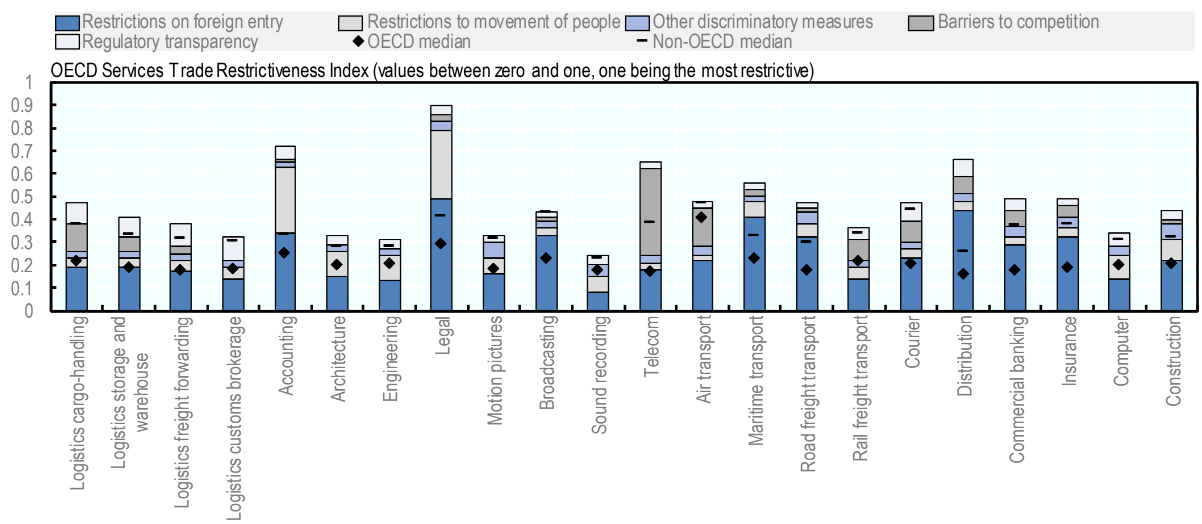


Notes: see Technical Notes.
Source: author's elaboration based on the OECD FDI Regulatory Restrictiveness Index, the OECD Input-Output Tables 8 Edition.

Barriers to entry are only one part of the story in services sectors. The development of efficient services depends as much as on policies that eliminate discrimination and barriers to entry and allow for greater competition and contestability pressures, as on policies that promote an efficient regulatory environment behind the borders for all firms in the sector. A more granular analysis of the domestic regulatory regime in services is beyond the scope of this review, as services sectors are quite diverse and would require a more industry-specific approach. But it is worth noting that Indonesia maintains a fairly stringent regulatory regime in services sectors overall, including beyond market access barriers (Figure 3.10). In almost all 22 services sectors assessed by the OECD Services Trade Restrictiveness Index, Indonesia appears as more restrictive than the average of OECD and non-OECD economies covered. And while restrictions on foreign entry are particularly dominant, the level of restrictiveness observed in other behind-the-border policy dimensions important for services development, such as measures related to the movement of people, barriers to competition, regulatory transparency and other discriminatory measures that affect the ease of doing business, is also considerable.

Furthermore, with services being increasingly traded online, a trend that is likely to accentuate in the post covid-19 context, regulatory barriers in sectors like telecoms risk derailing the potential gains from digitalisation going forward. As portrayed in the new OECD Digital Services Trade Restrictiveness Index, regulatory barriers to digitally enabled services have been trending upwards in many countries in the past years and, while this is not the case for Indonesia, it maintains one of the most restrictive frameworks for digital services trade among the countries covered in the index (Ferencz, 2019). Such barriers may hold back innovation and create obstacles for possible spillover effects to other services, like business or audio-visual services. Information, communication and technology backbone infrastructure is also a core input to modern logistics management and GVCs (e.g. the ability to track and trace shipments is critical for just-in-time production), much like other infrastructure such as transport and warehousing. As such, accompanying reforms to behind-the-border services regulations should go hand in hand with FDI liberalisation for these to fully bring about their potential benefits.

Figure 3.10. OECD Services Trade Restrictiveness Index, by sector and policy area, 2019

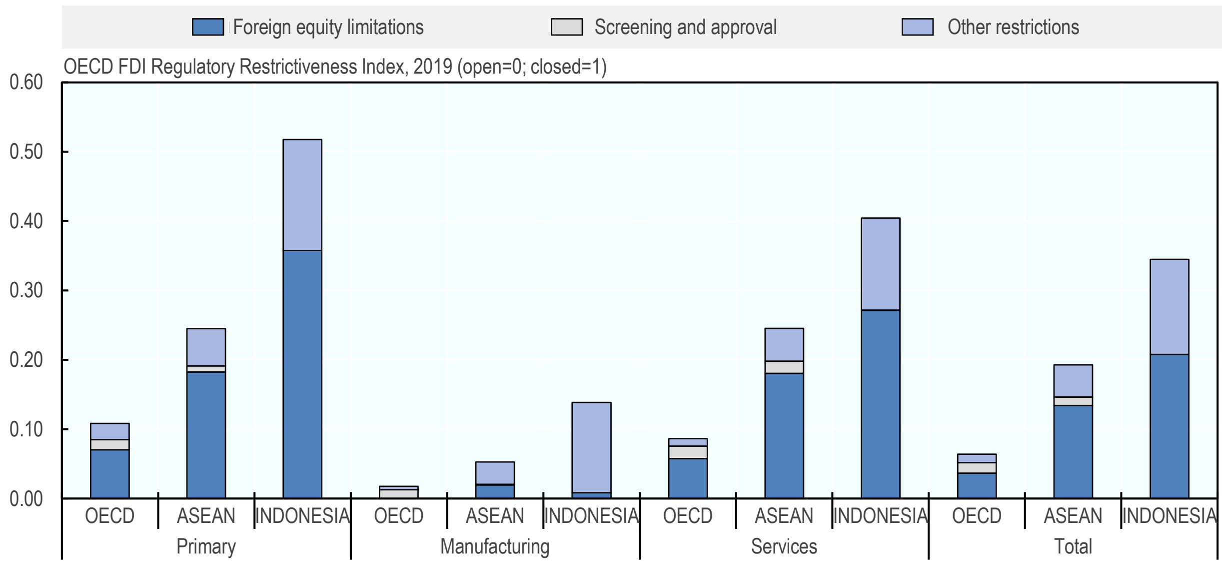


Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 37 OECD Members, Brazil, China, Costa Rica, India, Indonesia, Malaysia, Russia, South Africa and Thailand. The STRI database records measures on a Most Favoured Nation basis. Preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people).
Source: OECD Services Trade Restrictiveness Index, http://oe.cd/stri.

Foreign equity restrictions are the most prevalent type of barrier to FDI, but other operational measures are unusually pervasive in Indonesia

As for most countries, foreign equity restrictions are the most prevalent type of barrier to FDI in Indonesia (Figure 3.11), reflecting both a relatively extensive incidence of such measures across sectors and their stringency in terms of the level of foreign participation permitted.[6] This is particularly the case in primary sectors and in services where foreign shareholding limitations are far more prevalent than elsewhere. In manufacturing, foreign equity restrictions are limited and lower overall than in the average ASEAN economy. Indonesia also does not impose horizontal or sector-specific discriminatory investment screening and approvals for the admission of foreign investors, as is sometimes the case in ASEAN and a few OECD economies.[7]

Figure 3.11. OECD FDI Regulatory Restrictiveness Index, by type of restriction, 2019



Note: See note to Figure 3.6 above. Other restrictions groups together restrictions on key foreign personnel and other operational measures.
Source: OECD *FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

Another salient feature of Indonesia's FDI regime is its discriminatory policy on minimum capital requirements for foreign-invested companies (PT PMA, Perusahaan Terbatas Penanaman Modal Asing). Except for investments in banking and oil & gas, Indonesia does not permit the establishment of local branches by foreign investors. All investments must be conducted through a locally incorporated company in the forms of a limited-liability company (PT) with foreign shareholding (PMA). Unless otherwise provided by specific legislation, an Indonesian-owned PT company shall have a minimum authorised capital of IDR 50 million, at least 25% of which must be issued and paid-up in full in accordance with Indonesia's Company Law 40/2007. A PT PMA, in turn, must invest at least IDR 10 billion, excluding land and buildings, of which IDR 2.5 billion (25%) must be issued and paid-up in full by the shareholders in order to start the business, according to BKPM's Regulation 1/2020 regarding guidelines and procedures for investment licensing and facilities.

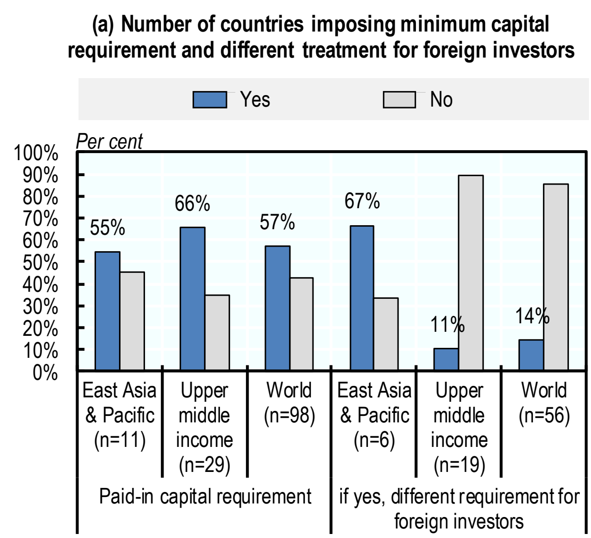
This is 200 times the minimum amount of paid-up capital required from domestic investors, and applies on top of any applicable foreign equity limitation, further restricting foreign participation to even larger undertakings in these sectors. It also precludes foreign participation in business fields reserved for MSMEs as the maximum legal threshold for being considered a medium-sized enterprise under the Law No. 20 of 2008 on MSMEs is IDR 10 billion, also excluding land and buildings used by the business, or having up to IDR 50 billion in revenues annually.

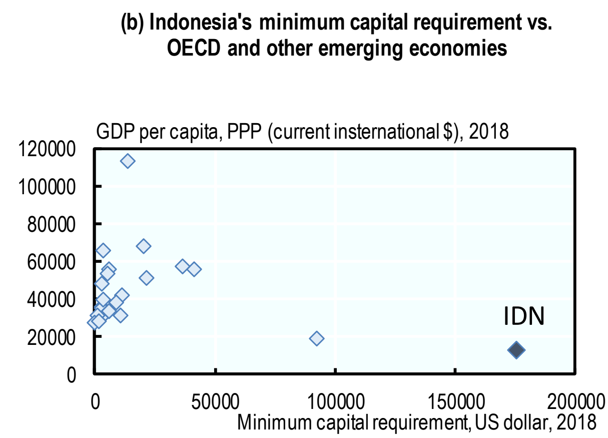
The use of discriminatory minimum capital requirements is somewhat more prevalent in East Asia but far less so in other parts of the world. According to the World Bank's Investing across Borders database (last available year is 2012), only eight countries (out of the 98) discriminated then between foreign and domestic investors in this regard, four of which are in the East Asia and Pacific region (Figure 3.12, panel a). The use of minimum capital requirements for general business activities[8], whether or not discriminatory, has declined considerably over the past decade. According to the World Bank (2014), 39 economies eliminated capital requirements in the preceding seven years, and many others never had them in the first place. Despite this, non-discriminatory minimum capital requirements remain a reality in many countries.

Out of 190 economies included in the World Bank's Doing Business 2020, 56 economies still required a minimum amount of capital to be paid-in by investors to register a business (World Bank, 2020b).

Where minimum capital requirements still exist, the amount required is typically much lower than what is required for foreign investors in Indonesia. This is the case even across economies with a level of income per capita much greater than that of Indonesia (Figure 3.12, panel b). The minimum paid-up capital requirement of not less than Rp 2.5 billion for a foreigner to be allowed to establish operations makes Indonesia an outlier in this respect.

Figure 3.12. Indonesia's minimum capital requirement policy in international comparison





Note: Data in Figure 3.12, panel b refer to minimum capital requirement for limited liability companies and was converted at the 2018 yearly average exchange rate. In addition to Indonesia, the figure covers another 25 OECD and large emerging economies applying minimum capital requirements for the establishment of limited liability companies as reported in the OECD *Services Trade Restrictiveness* database.
Source: World Bank's Investing Across Borders database (Panel a); OECD *Services Trade Restrictiveness* database, IMF International Financial Statistics and World Bank's World Development Indicators (Panel b).

Another restriction contributing to Indonesia's relatively higher scores across sectors as observed in Figure 3.11 is the relatively stringent system for employing foreigners in key management positions. It is worth noting that the measures captured in the OECD *FDI Regulatory Restrictiveness Index* do not encompass general foreign employment quotas and other restrictions not specifically affecting foreign investors' capacity to place foreigners in top executive-level positions. Measures taken into account in this respect also do not need to be discriminatory, *i.e.* they might apply equally to foreign and domestically-owned companies, but they are considered to be more burdensome to foreign investors and, thus, treated as a restriction under the *FDI Index*.

In spite of being relatively unimportant in the *FDI Index*, such restrictions are relatively more prominent in Indonesia's overall score because of the economy-wide scope of application of Indonesia's measures. While it is not uncommon for countries to impose general limitations on foreign employment that apply across sectors, these typically do not affect foreign investors' capacity to nominate foreigners to top executive level positions. The general legal framework in Indonesia requires a company to obtain prior government approval for engaging a foreign employee to whichever position, including that of a Director or Commissioner, unless the nominated person is also a shareholder of the company. In this case, the company is exempted from having to submit for approval an expatriate placement (known as RPTKA, Rencana Penempatan Tenaga Kerja Asing) plan for such purposes.[(9)(10)] Additionally, foreigners are not allowed to hold certain top executive positions, including that of Human Resources Director and 'Chief

Executive Officer’, which despite the term does not refer to the President-Director, but to the Head of the Office in the field of personnel and administration. While measures like these are unlikely to be a ‘deal-breaker’, they add to the overall cumbersomeness of business-related bureaucracy observed in Indonesia to date.

Public procurement legislation also discriminates against foreign investors. Indonesia accords preferential treatment to majority-owned Indonesian services suppliers in public procurement and the rule on public procurement of goods favours those companies partnering with Indonesian MSMEs, applying work, health & environmental safety standards and possessing management quality certificates in addition to meeting domestic component threshold levels in terms of goods and services inputs.[11] According preferential treatment to resident enterprises in public procurement is widely observed across countries, but discriminating against foreign-owned established firms in this respect is rather exceptional. As for other nationality-based discriminatory measures, these might hinder competition and contestability in the affected markets and may drive up costs of goods and services procured by the government.

Stringent local content requirements in some sectors add to the hurdles of carrying foreign investments in Indonesia

Data from the Global Trade Alert database suggest that Indonesia is the 7th country in the world with the highest number of local sourcing requirements imposed since November 2008 and in force as of end-2018. These apply on top of foreign equity restrictions discussed above and span various product groups (Table 3.2) in quite prohibitive manner in some cases. A brief description of selected measures in force can be found in Annex Table 3.B.1.[12] While local content requirements tend not to discriminate against foreign-owned firms established in the country, and in which case they are not considered a FDI restriction under the *OECD FDI Regulatory Restrictiveness Index*, they may still discourage FDI by establishing hard to achieve local requirements that restrain competition from imports, which might contribute to higher production costs and ultimately higher prices to downstream industries and consumers. Potential short-term gains in the targeted industry can, therefore, act as a drain on the rest of the economy. The costs in terms of forgone investments might also not necessarily be compensated by improved local development outcomes if any, such as increased employment, investment and technology transfer.

The literature on the potential effects of local content requirements is extensive, and while there may be situations where these policies could potentially increase domestic welfare depending on market characteristics (e.g. potential learning and technological spillovers, economies of scale etc.), the overall evidence suggest that they tend to lead to suboptimal allocation of resources (Stone et al., 2015; OECD, 2019b; Deringer et al., 2018). There is some evidence indicating that this may be the case in Indonesia. Local content policies seem to be negatively affecting not only foreign investments in Indonesia but also domestic investments (World Bank, 2017). Besides indicating that investors face difficulties in meeting some of the requirements, it suggests that such measures have had a limited crowd-in effect and have potentially failed to spur further technology spillover to domestic parties. Negara (2016) also finds that local content policies in Indonesia may adversely affect industrial performance and thus competitiveness.

In pursuing such objectives, horizontal policies addressing deficiencies of the business and regulatory environment, trade and investment barriers, innovation policy, and infrastructure development, can offer an alternative to local content policies and have less negative economy-wide effects on output, exporting industries and jobs (OECD, 2019b).

Table 3.2. Product groups affected by local sourcing requirements in Indonesia

UN Central Product Classification v2.1: 3-digit product groups
Computing machinery and parts and accessories thereof
Parts for the goods of classes 4721 to 4733 [TV, radio and telephone equipment] and 4822 [radar and radio apparatus]
Motor vehicles, trailers and semi-trailers; parts and accessories thereof
Other transport equipment and parts thereof
Agricultural or forestry machinery and parts thereof
Machinery for mining, quarrying and construction, and parts thereof
Television and radio transmitters; television, video and digital cameras; telephone sets
Pharmaceutical products
Specialised store retail trade services
Accommodation services for visitors
Other accommodation services for visitors and others
Weapons and ammunition and parts thereof
Food serving services
Beverage serving services
Internet telecommunications services
Medical and surgical equipment and orthopaedic appliances
Non-specialised store retail trade services

Note: The list of sectors reflect local sourcing requirements introduced since November 2018 and still in force as of end-2018. Product classes 4721 to 4733 belong the following product groups: 472 - Television and radio transmitters; television, video and digital cameras; telephone sets; 473 - Radio broadcast and television receivers; apparatus for sound and video recording and reproducing; microphones, loudspeakers, amplifiers, etc. Product class 4822 refers to: Radar apparatus, radio navigational aid apparatus and radio remote control apparatus.
Source: Global Trade Alert, https://www.globaltradealert.org/.

The Omnibus Law on Job Creation: market access issues for consideration

Indonesia has been active in improving the business environment for both foreign and domestic investors since the early 1990s. Since then, numerous economic reform packages have sought to make the private sector the engine of growth and sustainable development. Economic and FDI liberalisation played an important role in the early days. In the 2000s, efforts focused predominantly on legislative changes improving the overall regulatory and institutional environment across all economic areas. In the field of investment, the 2007 Investment Law was an important landmark. It unified the previously distinct foreign and domestic investment laws and increased the transparency of Indonesia's policy framework for investment, including by clarifying which sectors were closed or partly open to foreign and domestic investors (OECD, 2010).

Since the current administration first took office, there has been a further push for business climate improvements, particularly in terms of reducing red tape. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms to ease the process of starting and operating a firm. For this, successive measures intending to improve transparency, streamline licences and facilitate the process to start a company were implemented.

At the beginning of 2020, the government submitted to Parliament two draft omnibus laws on taxation and on job creation, which could become key new milestones in the business environment reform process. The Omnibus Law on Job Creation brings back to the centre of investment climate reforms the issue of economic and FDI liberalisation, including key measures to lift restrictions and conditions placed on FDI, while continuing to press ahead with reforms to centralise and streamline business licensing and land acquisition procedures and significantly reform Indonesia's labour market.

Despite strong opposition by labour unions, regional administrations and civil society, who expressed concerns over the bill's proposed amendments to the 2003 Labour Law, the recentralisation of administrative power in the hands of the executive, the lack of public hearings and on environmental protection regulations, the Omnibus Law on Job Creation was eventually enacted in October 2020. Implementing such an 'all-in-one' law reform package will be a challenge but there are compelling arguments for revising the current FDI regulatory regime once the pandemic is controlled. While this section focuses on the implications of the Omnibus Law for foreign investment restrictions in Indonesia, other, more contentious areas of the new law are considered elsewhere in the review.

Beyond the more fundamental reasons, tapping into a larger pool of FDI than previously the case might be ever more critical for the economic recovery following the pandemic, which is projected to significantly weaken Indonesia's real GDP growth from the above 5% observed in recent years to -3.3% in 2020 as projected by the OECD (2020a). Typically larger and more geographically diversified and productive, foreign-owned firms are overall more resilient to crisis (Alfaro and Chen, 2012; Desai et al., 2008). Therefore, they could potentially be an asset to reignite recovery earlier or faster. In addition, at a time of record-high portfolio capital outflows from emerging markets (OECD, 2020b), FDI could help to ease any possible financing pressure on Indonesia's current account deficit, which is projected to widen once again on the back of sluggish tourism exports and commodity markets (World Bank, 2020a).

The announced global economic downturn scenario – the OECD (2020a) projects a 4.5% contraction of the global economy in 2020 – might perhaps work in favour of pushing reforms forward. The pace of Indonesia's FDI reforms have historically been largely shaped by crises, rather than being driven by strong political leadership with support from domestic constituents for more open investment policies.[13] This time is different as the Omnibus Law on Job Creation does not seem to be originally stemming from a severe economic crisis or external factor. Yet, as the current global downturn spreads and overwhelms Indonesia's economy, the reform process might end up being largely influenced by the crisis situation, as on past reform occasions.

If it was not for the current unique situation, past perspectives about FDI liberalisation reforms would be comforting in suggesting a pick-up in FDI activity. In the past, FDI generally responded positively to enhanced market opportunities and conditions resulting from Indonesia's liberalisation efforts (OECD, 2010). But this may prove particularly difficult this time. It might actually be challenging even to hold on to existing FDI. The impact of the pandemic on FDI flows globally, and particularly for emerging economies, is projected to be severe, with global FDI flows projected to fall by more than 30% in 2020 even under the most optimistic scenario (see Chapter 2).[14] ASEAN as a region is likely to remain well positioned to compete for investments looking for further diversification following the pandemic, which could also benefit Indonesia. Without reforms, however, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI in the immediate aftermath of the pandemic may be slim.

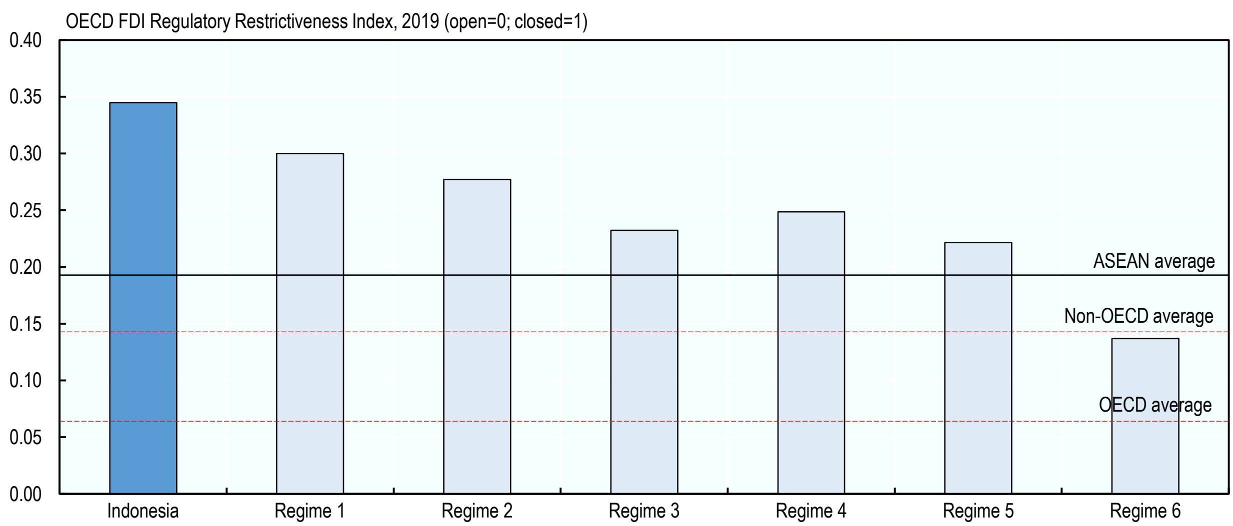
Ambitious reforms are needed to bring Indonesia closer to ASEAN levels of FDI openness

A comprehensive overhaul of Indonesia's FDI regime may not be easy to achieve, but only such a bold and comprehensive reform package would allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness as an investment destination. Stringent barriers to FDI also make other doing business impediments, and reforms less effective. Figure 3.13 below synthesises the results of how Indonesia's FDI regime would compare to peers if some hypothetical reforms scenarios were to be achieved with the on-going Omnibus Law on Job Creation. Six different reform regimes are contemplated in the exercise, which draws on the OECD *FDI Regulatory Restrictiveness Index*:

- *Regime 1* – abolishment of the discriminatory treatment against foreign investors in terms of minimum capital requirements for doing business in Indonesia

- *Regime 2* – easing of foreign shareholding restrictions by (1) allowing foreign investors to hold minority stakes in business activities closed to foreign investment; and (2) allowing foreign investors to hold majority-ownership stakes in business activities where they are only allowed to hold minority stakes
- *Regime 3* – the combination of *regimes 1* and *2* above
- *Regime 4* – easing of foreign shareholding restrictions by reducing equity restrictions to the ASEAN average level in those sectors where Indonesia is more restrictive, all else held constant
- *Regime 5* – easing of foreign shareholding restrictions by reducing equity restrictions to the non-OECD average level in those sectors where Indonesia is more restrictive, all else held constant.
- *Regime 6* – eliminating all foreign shareholding restrictions, all else held constant

Figure 3.13. Omnibus Law on Job Creation: reform simulations on Indonesia's FDI regime



Note: See note to Figure 3.6 above.
Source: author's elaboration based on the *OECD FDI Regulatory Restrictiveness Index*, http://www.oecd.org/investment/fdiindex.htm.

As can be seen in Figure 3.13 above, only some substantial reforms to sector-specific foreign shareholding policies and/or horizontal policies, as exemplified in the hypothetical reform scenarios, would bring Indonesia closer to average international levels of openness. Of all simulated scenarios, only the full removal of foreign shareholding limitations (regime 6) in line with a more optimistic reading of the Omnibus Law on Job Creation would lead to a FDI regime that is more open than in the average non-OECD economy included in the *OECD FDI Regulatory Restrictiveness Index*.[15]

This requires the Omnibus Law on Job Creation to break with Indonesia's rather timid track record in reforming its FDI regime in recent years. As demonstrated earlier, despite other improvements to the business environment, there has been only limited progress in terms of FDI liberalisation since the 2000s. Economic and resource nationalism still resonate in public opinion and political forces favouring the protection of certain segments of the local economy from foreign competition have been effective in countering those supporting more in-depth FDI reforms.

Overall, Indonesia has yet to demonstrate a clear intention to place FDI at the centre of Indonesia's economic, social and environmental development ambitions. At the outset, the Omnibus Law on Job Creation has the ambition to do just that, but the extent of success will depend greatly on how much it will be able to achieve in the end. The challenge is not small.

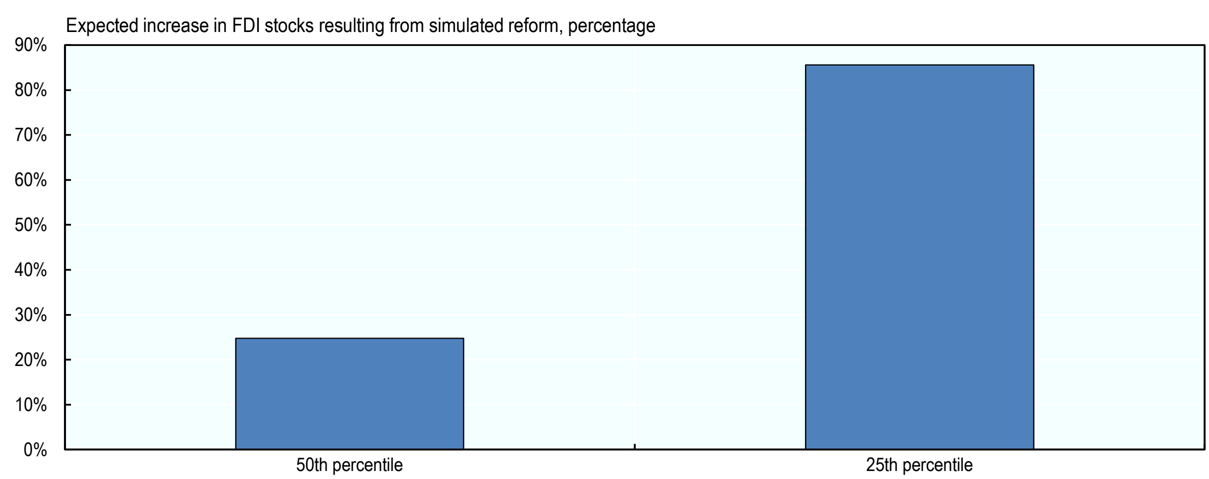
The impact of substantial FDI reforms can be sizeable

The right of governments to favour some investors over others in order to achieve social, economic or environmental goals is widely accepted, but any policy that discriminates against one group of investors involves a cost. Discriminatory measures can thus only serve the broader public interest to the extent that their potential costs are compensated by broader social and economic benefits. For this reason, they need to be constantly re-evaluated to determine whether their original motivation remains valid, supported by an evaluation of the costs and benefits, including an assessment of the proportionality of the measure to ensure they are not greater than needed to address specific concerns (OECD, 2015a).

As already alluded to in the beginning of this chapter, a number of potential costs have been associated with discriminatory policies against FDI in the empirical literature, most notably in terms of forgone investments and potential efficiency gains. In terms of investments, recent OECD research estimated that the introduction of FDI reforms leading to a 10% reduction in the level of FDI restrictiveness, as measured by the OECD *FDI Regulatory Restrictiveness Index*, could increase bilateral FDI inward stocks by around 2.1% on average across countries (Mistura and Roulet, 2019). While it is evident that when foreign investment is prohibited an economy will receive no such investment, the evidence suggests that even partial restrictions, such as foreign equity limitations and discriminatory screening and approval mechanisms, can have a significant impact on FDI (Mistura and Roulet, 2019; Fournier, 2015; Nicoletti et al., 2003).

For Indonesia, an illustrative simulation exercise using the average partial direct elasticity obtained in Mistura and Roulet (2019) suggests that if Indonesia were to reduce restrictions to the 50th and 25th percentile levels of the *FDI Index*, inward FDI stocks could be 25% to 85% higher, respectively (Figure 3.14).

Figure 3.14. Simulated Effects of FDI Liberalisation: reducing Indonesia's restrictions to the 50th and 25th percentile levels of OECD FDI Regulatory Restrictiveness Index



Note: The simulation is based on the average partial direct elasticity of FDI to regulatory restrictions estimated through an augmented gravity model of bilateral inward FDI positions using a poisson pseudo-maximum likelihood estimator. Typical gravity variables and a series of other policy and non-policy factors are included (distance, contiguity, the existence of a common language, colonial ties, market size, real GDP growth rates, real exchange rates, similarity in size and factor resource endowments, trade openness, natural resource endowments, institutional maturity, FDI restrictions, participation in free trade areas, corporate tax), as well as host and home country and time-fixed effects. The regressions cover bilateral FDI relationships between 60 countries over the 1997-2012 period.
Source*:* author's elaboration based on Mistura and Roulet's (2019) baseline estimation.

The effect is found to be larger for FDI in services sectors, reflecting greater incidence of restrictions in these sectors. But even FDI into manufacturing sectors, which are mostly open to FDI, is also negatively affected by restrictions in services activities (Mistura and Roulet, 2019). As discussed earlier, this can have economy-wide productivity implications given the increasing importance of services inputs for other economic sectors as well as end-consumers.

Keeping the 'achievements' of the 2007 Investment Law

While revisiting the FDI regime is certainly warranted, the Omnibus Law on Job Creation should ensure that past achievements are preserved. Economic policy certainty in Indonesia improved substantially in the field of investment with the passing of the Investment Law in 2007 (OECD, 2010). This landmark law covered both domestic and foreign investment and stipulated national treatment for foreign investment, charting a future of a more level playing field for all investors (see Chapter 4 on investment protection and dispute resolution).

It also increased the transparency of Indonesia's policy framework for investment, in particular by adopting a 'negative list' approach for clarifying which sectors were closed or open with certain conditions to foreign or domestic investors. To date, there have been four Presidential Regulations specifying the list of business activities facing investment restrictions, most recently Presidential Regulation 44/2016. These lists have overall added to transparency, including by adopting a standard industrial classification system for the listing of activities, e.g. Standard Classification of Indonesian Business Fields (KBLI) or International Standard for Industrial Classifications (ISIC). These are all key achievements that deserve being preserved in the ongoing reform introduced by the Omnibus Law on Job Creation.

As of August 2020, there was still uncertainty as to whether the previous 'negative list' approach would continue to be used for regulating market access conditions for foreign investors following the current Omnibus reform. According to consultations with the Office of Cabinet Secretary, the government intends to re-conceptualise the negative investment list into a 'positive' Investment Priority List (DPI), through the revision of Presidential Regulation Number 44 Year 2016 with business fields covering: (1) closed business fields; (2) business fields reserved to government activity; and (3) open business fields, including: priority business fields; business fields in which investors are required to partner with medium, small and micro enterprises (MSMEs); business fields in which investment is allowed subject to requirements; business fields reserved for MSMEs, and other open business fields.

It was not clear, however, in what ways such a 'positive' DPI would depart from a 'negative list' in technical terms if it was to follow the above-mentioned structure. A shift to a 'positive list' would technically imply that only those sectors and/or activities contemplated in the list would be open to investment under the stipulated conditions, all else would be potentially off-limits to investors. Foreign investors have at times expressed discontent with the current pace of liberalisation and questioned the capacity of the 'negative list' revisions process to encourage liberalisation. But one can easily understand the challenge in implementing an open business environment under this setting as it would require listing all the activities open for investment, which requires a massive undertaking not to leave aside any activity unintentionally and to avoid uncertainty associated with broad scope definitions. The 'negative list' approach is more efficient and predictable in this respect, as all activities are deemed opened without conditions, except for those few identified and listed in the regulation.

The authorities, however, have confirmed during this review that the 'negative list' approach will continue to be used for the regulation of market access. Improvements could thus be considered on the institutional setting and procedures for the formulation of such list going forward. The Co-ordinating Ministry of Maritime Affairs and Investment is since 2019 the responsible authority for monitoring, evaluating, and settling problems arising out of the implementation of investment activities in the business fields listed.[16] Presidential Regulation 76/2007 on the criteria and requirements for formulation of closed and conditionally opened business lines in the investment sectors provides some guidance on the procedures for formulating such lists. They are to be evaluated and improved periodically in accordance with developments of economy and national interests on the basis of studies, findings and recommendations of investors. Ministers or leaders of institutions concerned are to recommend closed and conditionally opened business lines along with supporting reasons to the Co-ordinating Minister of Maritime Affairs and Investment. Recommendations draw on the criteria and considerations stipulated in the presidential regulation for placing conditions or determining certain activities closed to foreign or domestic investors. The Co-ordinating Ministry of Maritime Affairs and Investment shall then set up a team to judge, formulate, evaluate and finalise these lists.

The process of assessing and formulating the lists of sectors to be opened up or restricted could likely benefit from greater transparency and technical support. The current procedure is silent on rules for the composition of the team in charge of assessing and formulating the policies. Considering the potential implications of restrictions for other sectors beyond their sectors of application, an inter-agency composition would likely be warranted, as would the involvement of representatives from foreign and domestic chambers of commerce, trade unions, civil society and consumers. A more balanced representation could help to broaden the information-base supporting discussions and deliberations.

Recommendations by concerned ministries could also be complemented by more technical assessments of the implications of proposed measures by qualified independent institutions, such as academia and research institutes, private sector consultants and international organisations, or at least by a qualified technical unit within the government. It is not clear the extent to which in practice technical assessments are prepared to support deliberations by the responsible ministry, but if there have been any, these have not been publicly disclosed. To date, there has also been limited public stakeholder consultations on related matters. More transparency on the formulation of the 'negative list' would facilitate dialogue with interested stakeholders and help to contribute to improved policy-making.

Presidential Instruction No. 7 of 2017[17] and the Cabinet Secretary Regulation No. 1 of 2018[18] provide guidance to ministries and government agencies for formulating policies that are strategic, have a broad impact on the community, and are of a national scale. The adoption of such guidance in the formulation of FDI policies would already be a step towards implementing a proper regulatory impact assessment of existing restrictions on FDI, including assessments of potential substitutive non-discriminatory policies where relevant. They contemplate issues such as the need to conduct public consultations, risk mitigation, and other matters such as considering alternatives other than establishing regulations. According to the authorities, the implementation of policy formulation based on the Presidential Instruction and the Cabinet Secretary Regulation still faces obstacles: some perceive it to excessively extend the policy formulation cycle and there is still room to simplify the policy formulation procedures. Nevertheless, the guidance is an important initial step for improving the policy making process in Indonesia and its implementation in the context of FDI reforms is certainly warranted.

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Annex 3.A. Technical Notes

Shift-share decomposition of Indonesia's FDI inward stock growth, 2010-18

The above decomposition is based on the traditional shift-share analysis (see WTO (2009) for description) as follows: $\Delta I_j = rI_j' + \sum_i (ri - r) I_j' + \sum_i (ri_j - ri) I_j'$, where for each country or grouping *j*, Δ*Ij* is the difference in inward FDI stocks between 2010 and 2018; *Ij'* is the inward FDI stock in 2010; *r* is the growth rate of world inward FDI stock in the 2010-18 period; *ri* is the growth rate of world inward FDI stock of industry *i* in the same period and *rij* is the growth rate of country or grouping *j*'s inward FDI stock of industry *i* in the period.

Due to the limited availability of disaggregated and comparable data on FDI stocks per sector across countries or groupings, the analysis was limited to the following industries: agriculture, forestry and fishing; mining and quarrying; manufacturing; construction; and others (residual). Sectoral FDI stocks were estimated as per the following:

- China: FDI stocks per industry were estimated using the total International Investment Position reported by the State Administration of Foreign Exchange, adjusted by the share of FDI inflows per sector over 2005-10 (for 2010) and 2005-18 (for 2018) as reported by the National Statistics Bureau;
- OECD: FDI stocks per industry are based on total FDI positions in OECD economies reported in the OECD's FDI statistics database, adjusted by the share of FDI positions per sector based on available data;
- Indonesia: industry FDI estimates are based on total IIP data by Central Bank of Indonesia, adjusted by the share of cumulated inflows per sector over 2004-2010 (for 2010) and 1990-2018 (for 2018) as reported by the Central Bank of Indonesia. Similar trends, albeit of greater magnitudes, are obtained using cumulated inflows per sector over 1990-2010 (for 2010) and 1990-2018 (for 2018) as reported by BKPM [not reported];
- ASEAN9 (excluding Indonesia): estimates are based on total FDI stocks in ASEAN9 as reported in UNCTAD's FDI statistics database, adjusted by the share of cumulated inflows per sector over 2005-10 (for 2010) and 2012-18 (for 2018) as reported in the ASEAN's Secretariat FDI Statistics database;
- World: estimates are based on the total world FDI position reported by the OECD, adjusted by the share of FDI positions per sector in OECD, Indonesia, China and ASEAN9 altogether;
- Rest of the World: estimated as the residual of World estimates minus OECD, Indonesia, China and ASEAN9.

Trends in horizontal and vertical FDI in Indonesia: 1997-2017

The estimation of horizontal and vertical FDI follows Alfaro's (2007) methodology with some adjustments:

- Horizontal FDI: a cross-border M&A transaction is classified as horizontal FDI whenever both the target's and the acquirer's Primary SIC Code are the same. Depending on the industry's variety of sub-activities, 2 or 3-digit level groupings were used.
- Vertical FDI: a cross-border M&A transaction is classified as vertical FDI whenever the target's and the acquirer's Primary SIC Code (4-digit) are identified as vertically associated as per Alfaro's (2007) methodology with some adjustments. Using the United States BEA Industry-by-Industry

Total Requirements Table (2012, the latest), a vertical industry relationship (upstream and downstream respectively) is identified whenever the acquirer or the target industry share of the total direct and indirect industrial output associated with the production of one dollar of output of the reference industry (acquirer or target firm's industry) is equal to or higher than 1,6%.Alfaro (2007) relies on a static 0.05 threshold level.

  - The relative threshold level used is slightly more encompassing than Alfaro's static level: it captures roughly the same number of one-way (upstream or downstream) relationships per industry (maximum observed is 14 against 13 using Alfaro's threshold level), but expands the total number of vertical industries pairs identified from 1638 to 2286. For the estimation, BEA industry codes were corresponded to target and acquirer 4-digit Primary SIC Codes using correspondence matrixes available at BEA's website. The use of the US Input-Output structure instead of each countries' respective I-O tables is because of the unparalleled level of disaggregation of BEA's data, and the likelihood of US industry relationships being relatively more encompassing given the size and sophistication of the US economy.

- Other/diversification FDI: deals not qualifying as horizontal nor vertical FDI (respectively, 50% and 18% of total deal value in Indonesia in 1997-2017) are denoted 'other/diversification FDI' (not reported for presentational purposes).
- The dataset used in the exercise comprise 32 846 completed cross-border M&A deals from 1997 to 2017, which resulted in the ownership by the ultimate acquirer company of at least 10% of the shares of the acquired company after the transaction, as reported in the Dealogic's Merger & Acquisitions database.

Services FDI restrictiveness impinging on manufacturing activity

The exposure of manufacturing sectors to service sector FDI restrictions is estimated by calculating the weighted average the *OECD FDI Regulatory Restrictiveness Index* in nine services sectors (construction, transport, telecommunications, electricity, wholesale and retail distribution, financial and business services), where the weights are given by the sectors' respective shares in the total input costs of manufacturing sectors. It is constructed as: $rest_{s,c} = \sum_{j}^{J}(w_{s,c,j} * Index_{j,c})$, where *rest* is the weighted-average FDI restrictiveness index faced by manufacturing sector *s* in country *c*; *w* is the share of domestic service sector *j* in total inputs of manufacturing sector *s* in country *c* based on the 2015 OECD Input-Output Tables data (latest available); and *Index* is the *OECD FDI Regulatory Restrictiveness Index* of service sector *j* in country *c.*

Annex 3.B. Selected sample of local content requirements in Indonesia

Annex Table 3.B.1. Selected sample of local content requirements in Indonesia

Date announced	Scope	Description	Legal authority	Date of entry into force
2019-08-08	2019 presidential regulation to promote local EV industry	Minimum local content requirement for being eligible to access fiscal and non-fiscal incentives for the production of electric vehicles in Indonesia: at least 35% for vehicles with four or more wheels and of at least 40% for vehicles with two or three wheels. The local content level will be raised until it reaches 80% in 2030 and 2026, respectively.	Presidential Regulation 55/2019 promoting the local electric vehicle industry	12-08-2019
2018-08-15	Local bio-component requirement in diesel	PR 66/2018 introduces a requirement for locally-sold diesel to contain a minimum bio-component of 20% (so-called "B20 biodiesel mix"). As stated in the preamble of the regulation, it is meant to foster the growth of the local palm oil industry.	Presidential Regulation 66/2018 introducing a local bio-component requirement for diesel sales	01-09-2018
2017-02-27	Action plan to push local pharmaceutical and medical equipment industries	The regulation includes the provision that the pharmaceutical and medical equipment industries shall prioritise the use of local raw materials. The regulation also stipulates that the provision of pharmaceutical goods and medical equipment by the government or by private entities for the needs of the community shall prioritise those goods that use local raw materials. There are no clear rules on what percentage the local content requirements shall be set. However, there are some indications in the appendix of the regulation: for instance, during the research and development stage, the content shall be at least 25%. In the production process, the content shall be at least 35%. Furthermore, the regulation mentions reducing the current import market share from 94% to 45% by 2035.	Ministry of Health Regulation 17/2017 introducing an action plan to push the local pharmaceutical and medical equipment industries	28-02-2017
2017-02-07	Restricted investment opportunities for Internet Protocol Television	IPTV providers shall provide Internet Protocol Set-Top-Boxes with a minimum local content requirement of 20%, with the amount rising to 50% within 5 years of starting operations in Indonesia. Furthermore, the IPTV operator shall provide at least 10% of domestic content during its broadcasting services, 30% during its multimedia services, and "the number of domestic Independent Content Providers contributing to the implementation of IPTV services shall be at least 10% (ten per cent) of the number of Content providers in the Content Library of the Organizer and gradually increase to 50% (fifty Percent) within 5 (five) years."	Ministry of Communications and Information Technology Regulation No. 6/2017 on Internet Protocol Television	07-02-2017
2016-07-27	Updated localisation requirements for smartphones & tablets	Ministry of Communication and Information announced a regulation requiring 4G telecommunication devices (on smartphones and tablets) to fulfill a local content requirement of 30%. Meanwhile, "base stations", e.g. wireless modems using 4G LTE networks will be required to have a local content requirement of 40%. The local	Ministry of Industry Regulation 65/2016 introducing further schemes related to the localisation requirement	01-01-2017

Date announced	Scope	Description	Legal authority	Date of entry into force
		content requirement holds for both hardware and software, such as phone applications. The producer has the option to localise the software rather than the hardware components of the devices. For instance under one scheme, creating a number of popular applications and games could reduce the hardware localisation required to 10% and the design and firmware localisation to 20%. The regulation also offers the reduction of the localisation restrictions depending on the size of foreign investment. In the case of investments worth at least 1 trillion IDR (ca. USD 77 million), the localisation requirement would be scrapped altogether.		
2015-09-30	Local content promotion scheme via import tariffs on goods, machinery, and materials used in construction	In order to support the Indonesian construction industry, the government expanded import tariff exemptions to the contruction industry. The exemptions do not cover any services and require each company to use at least 30% locally sourced machinery and materials.	Ministry of Finance Regulation 188/PMK.010/2015 expanding the import tariff exemptions to the construction industry	30-09-2015
2015-03-23	Extended localisation requirements for the automotive industry	The regulation introduces further localisation requirement in the automotive industry. Whereas previously car manufacturers were required to perform four stages of the assembly in Indonesia, the new provisions require de facto the entire assembly process to take place locally.	Ministry of Industry Regulation 34/M-IND/PER/3/2015 on the automobile industry.	23-09-2016
2013-12-12	Local content requirements for traditional markets, modern stores & shopping centers	Shopping centers are required to offer a "counter image" in designated floors strictly reserved for domestic products. Traditional markets, shopping centers and modern stores are required to supply 80% of their products with domestic ones. Exemptions are granted to the following retail categories: (1) Requiring uniformity of production and sourcing from a global supply chain; (2) Having a brand that is world famous (premium products) and have yet to have a production base in Indonesia; or (3) Products from certain countries being sold to meet the needs of their citizens living in Indonesia.' Exempted stores are expected to gradually increase the sales of similar goods that are domestically produced and report its implementation to the Minister through the Director General of Domestic Trade'.	Ministry of Trade Regulation 70/M-DAG/PER/12/2013 concerning traditional markets, shopping centers and modern stores.	12-06-2014/17-09-2016
2013-02-11	Local content requirement in food & beverage franchises	Among other restrictions such as a maximum of 250 franchise stores, the regulation included a minimum 80%-local content requirement on raw materials and business equipment used by the franchisor as well as the franchisee. According to art. 7(2), the Ministry of Trade may give exemptions to this LCR 'after considering the recommendation from the Assessment Team'.	Ministry of Trade Regulation 07/M-DAG/2/2013 concerning the franchise business in the food & beverage industry.	11-02-2013
2009-01-19	Localisation restrictions in the telecommunications sector	The regulation requires tools and equipment used for wireless broadband service which uses radio frequency band of 2.3 GHz and 3.3 GHz to meet the Domestic Component Level of at least 30% for the subscriber station and 40% for the base station. This localisation requirement was to be raised to 50% within five years.	Ministry of Communication and Information Regulation 07/PER/M.KOMINFO/01/2009 introducing localisation restrictions in the telecommunications sector	19-01-2009

Source*:* Global Trade Alert, https://www.globaltradealert.org/.

Notes

[1] This scenario does not consider any fundamental changes in firms' behaviour regarding FDI strategies going forward. In the long-run, some expect worldwide FDI to become scarcer as they expect firms and government policies to turn to re-shoring or near-shoring strategies as a solution for value chain disruptions in the future. On the other hand, increased diversification and off-shoring might turn out to be an even more reliable source of supply chain resilience, as it avoids putting 'all the eggs into one basket'.

[2] Investment climate conditions also play a role in horizontal FDI decisions, albeit likely to a relatively lesser extent. Horizontal FDI (seeking to serve the host market) is typically associated with firm-level economies of scale and, therefore, production can be more easily duplicated in the host market because the benefits of market access and the increasing returns on scale at the firm-level assets are higher than the forgone economies of scale at the plant level. Investment climate conditions play a role particularly in relation to horizontal FDI that seeks to serve regional markets. In these cases, similarly to efficiency-seeking FDI, investors are inclined to look for the most efficient locations for serving the regional market, taking advantage of a combination of factors allowing the rationalisation of their operations, including factor endowments, cultural and institutional arrangements, market structures, and economic policies that certain locations offer.

[3] In response, according to the authorities, the government has plans to form a special inter-ministerial task force to handle investment reallocation, in accordance with Presidential Instruction (Inpres) No. 7 of 2019 concerning Acceleration of Ease of Doing Business. BKPM has already started to give priority to the investment reallocation plan of 40 foreign companies (with future potential projections of 300 companies) in China originating from the United States (US) and Japan. As reported by the authorities, the task force's work would include (1) detecting companies that will be relocating in the near term; (2) checking the facilities provided by competing jurisdictions, and (3) entering into and making decisions in negotiations.

[4] The more recent deterioration of Indonesia's is mostly due to lower commodity exports and higher infrastructure-related imports (IMF, 2019). In addition, the services and income account have long been in deficit notably due to recurrent deficits in the transport and insurance sectors, respectively associated with increasing payments to foreign transport companies used in import-export activities and foreign reinsurance activities, and due to increasing FDI-related income deficits, which is partly offset by reinvested earnings.

[5] Among other things, FDI up to 100% was allowed in permitted sectors without previous conditions (e.g. minimum 5% Indonesian shareholding at the time of investment and divestment to minority foreign-shareholding within 20 years; export-oriented and/or labour-intensive, located in Batam Economic Zone or

in Eastern Indonesia, above USD50 million), allowed partial foreign shareholding in various previously closed sectors, such as telecoms, transport, media and electricity (Conklin and Lecraw, 1997).

[6] Foreign shareholding restrictions are considered a more important barrier to FDI in the OECD *FDI Regulatory Restrictiveness Index* than are other restrictions covered by the indicator, such as foreign investment approval mechanisms, restrictions on the employment of key foreign personnel and other operational restrictions. As such, they are given a higher weight in the *Index* methodology, which partly explains why foreign equity restrictions tend to dominate in terms of barriers to FDI in Indonesia and elsewhere (see Kalinova *et al*., 2010 for further information on the methodology). However, the extent to which this is the case in the aggregate is largely driven by their scope of application, both across and within sectors. In the former case, this is determined by how prevalent foreign equity restrictions are in the 22 sectors covered in the *Index;* in the latter, by how stringent these restrictions are. The *Index* methodology distinguishes three thresholds in this respect: if foreign investors are fully prohibited from investing in the sector, if they are allowed to hold only a minority participation in companies operating in the sector, or if they are only restricted from establishing a wholly-owned operation.

[7] Foreign investment screening and approvals and other policies exclusively based on national security grounds are not considered taken into account in the *OECD FDI Regulatory Restrictiveness Index*.

[8] "What is a minimum capital requirement? It is the share capital that must be deposited by shareholders before starting business operations. For the Doing Business starting a business indicator the paid-in minimum capital is usually the amount that an entrepreneur needs to deposit in a commercial bank or with a notary when, or shortly after, incorporating a business, even if the deposited amount can be withdrawn soon after a company is created" (World Bank, 2014).

[9] As per the Presidential Regulation 20/2018 on Foreign Workers Utilization and Regulation 10/2018 from the Ministry of the Minister of Manpower on Foreign Workers Utilisation Procedures.

[10] According to BKPM's Regulation 5/2019 amending BKPM's Regulation 6/2018 concerning Guidelines and Procedures for Licensing and Investment Facilities, Directors and Commissioners with terms of ownership in a company equivalent to at least Rp 1 billion or the equivalent in US dollar may also benefit from immigration facilities in the field of investment. These includes BKPM's recommendation for being granted a limited stay visa, for transferring a stay permit status to be a limited stay permit, for transforming a limited stay permit to a permanent stay permit.

[11] In order to be considered as a Domestic Service Company, the majority of shares have to belong to an Indonesian citizen and two thirds of the board members have to be locals. If no domestic service suppliers are participating in the procurement, national service suppliers (with at least 10% of shares belonging to Indonesians) will be taken into consideration. When these are unavailable, foreign services suppliers are allowed in the procurement process. Domestic Service Companies are allowed to co-operate with foreign service companies in the form of a consortium or joint venture or subcontract part of the work to foreign service companies, but such a consortium must be led by the Domestic Service Company in the case of on-shore construction services and at least 50% of the implementation work by contract value needs to be carried out the domestic service company. In the case of off-shore construction services, the Domestic Service Company is obliged to perform at least 30% of the work in value terms. For more information, see Ministry of Industry No. 02/M-IND/PER/1/2014 concerning guidelines for improving the use of domestic products in the procurement of government goods and services.

[12] Stakeholders consulted during the review reported some additional local content requirements to those featuring in Annex 3.B based on the Global Trade Alert database, notably in: (A) distribution services, where foreign investors in wholesale distribution of food, beverages, and tobacco, and textile, clothing and

footwear with minimum space above 5,000 meter square are subject to an obligation to cooperate with at least 100 Indonesian SMEs suppliers and/or retailers yearly, along with training and development. Wholesalers in the form of modern stores are also required to offer a minimum of 80% of domestic goods in terms of the total quantity and types of good offered (as reported in the Annex 3.B); (B) Construction and related engineering services: in addition to meeting foreign equity limitations and project size threshold, foreign investors are subject to an obligation to perform domestically at least 50% of the value of construction work and at least 30% (thirty percent) of the construction value is conducted by a partner domestic Construction Services Business Enterprise (BUJK). There are also additional obligations to transfer of knowledge and/or technology and to use domestic products, technology and/or materials; (c) Architectural Services, Engineering Services, Integrated Engineering Services, Urban Planning Services: foreign investors are required to have all the technical planning work done domestically and have at least 50% of the value of the construction planning work undertaken by a domestic partner. Similarly to construction services, there are also obligations to transfer of knowledge and/or technology and to use domestic products, technology and/or materials.

[13] An early attempt to create a more favourable environment to FDI came in the late 1960s, following the deep economic crisis that engulfed Indonesia during the decade, with the promulgation of the 1967 Foreign Investment Law. But unlike some of its regional peers, such as Malaysia and Thailand, Indonesia only came to appreciate the potential role of FDI for its economic development at a later stage. It was not until the mid-1980s, when the need for foreign exchange and capital mounted with declining oil revenues and the appreciation of the yen (a large portion of Indonesia's external debt was denominated in yen), that Indonesia began to adopt a more open policy stance on foreign investment (OECD, 1999; Lecraw, 1997). The policies implemented starting in 1986 marked then an important shift from the preceding inward-looking policy orientation of the 1970s, which had placed increasingly severe conditions on inward investment. Limits on foreign ownership for export-oriented investments were first relaxed and investment licensing procedures were made easier in order to attract foreign capital. This wave of FDI liberalisation intensified in the early 1990s and then again as a consequence of the Asian Financial Crisis in 1997.

[14] See end note 2.

[15] Article 84(2) proposes to amend article 12 of the 2007 Law on Investment, which would read as follows as per the text submitted to Parliament: "*Article 12 (1) All business fields are open to investment activities, except those declared closed for investment or activities that can only be carried out by the Central Government. (2) Business fields closed to investment as referred to in paragraph (1) include: […] [list of 6 activities provided]. (3) Further provisions regarding the investment requirements as referred to in paragraph (1) and paragraph (2) shall be regulated in a Presidential Regulation*." The precedent text provided for an exception "for business sectors or business types that are declared to be closed and open with requirements", which were established and revised by successive Presidential Regulations. The latest of such regulation was Presidential Regulation No. 44 of 2016. As it stands, the Omnibus draft language already incorporates in the law the list of business fields closed for investment, both foreign and domestic, and no longer provides for business sectors or business types that are open with requirements, and as such can be interpreted as not allowing anymore for a discriminatory treatment towards foreign investors in relation to market access conditions. Additionally, Article 84(3) also proposes to remove the previous obligation for the government to establish business sectors that are reserved for micro, small and medium enterprises and cooperatives, as well as business sectors that are open to large businesses on condition that they cooperate with micro, small and medium enterprises, and cooperatives (Article 13(1) of the 2007 Law on Investment).

[16] Pursuant to the Presidential Regulations No. 92 of 2019, the roles and function of co-ordinating, synchronization and controlling investment affairs have been shifted from the Co-ordinating Ministry of

Economic Affairs (CMEA) to the Co-ordinating Ministry of Maritime Affairs and Investment. The latter also assumed the responsibility for overseeing BKPM in 2019.

[17] Presidential Instruction No. 7 of 2017 concerning Taking, Supervising, and Controlling Policy Implementation at the State Ministry and Government Institution Levels.

[18] Cabinet Secretary Regulation No. 1 of 2018 concerning Guidelines for the Preparation, Implementation and Follow-up of the Results of the Cabinet Session.

4 Investment protection and dispute resolution

This chapter examines the legal frameworks for investment protection and dispute resolution that apply to investors in Indonesia. It focuses on several core investment policy issues – the non-discrimination principle, protections for investors' property rights and mechanisms for resolving investment disputes – under Indonesian law and Indonesia's investment treaties. It also addresses the government's recent policy approaches to data protection and cybersecurity, tackling corruption and public sector reforms. It takes stock of recent achievements, identifies key remaining challenges and proposes recommendations to address them. In terms of investment treaty policy, this chapter provides an overview of Indonesia's investment treaties, analyses the main substantive protections and investor-state dispute settlement provisions in these treaties and identifies considerations for possible policy reforms.

Summary and main recommendations

Rules that create restrictions on establishing and operating a business in Indonesia, discussed in Chapter 3, are an important part of the broader legal framework affecting investors. Protections for property rights, contractual rights and other legal guarantees, as well as efficient enforcement and dispute resolution mechanisms, are equally important elements.

Indonesian law provides a number of core protections to investors relating to non-discrimination, expropriation and free transfer of funds. Most of them are found in Law 25/2007 concerning Investment (the Investment Law) and have not changed significantly in recent years. These protections are generally in line with similar provisions found in other regional investment laws and provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are also seen to be robust. Some incremental improvements may be possible to bring these provisions closer in line with international good practices, including further specification of the provisions on expropriation.

Clarifications may also improve the existing legal frameworks to protect investors' intellectual property and land tenure rights, which are comprehensive in many respects. The government has not made significant updates to land laws in Indonesia in several decades. While foreigners are now able to own land, these rights are relatively limited and interactions between formal land laws and customary land rights remain complex and subject to interpretation. Initiatives to accelerate land registration and the use of electronic databases for land administration have yielded promising initial results but sustained momentum is needed for these changes to be durable in the long term. Investors also report some issues with the legal framework for intellectual property rights, notably with respect to restrictive patentability criteria, but in the main these laws are well-developed, have been periodically improved through amendments and comply with international standards in five core areas: trademarks, patents, industrial designs, copyrights and trade secrets. Some problems nonetheless persist in practice. Online piracy and counterfeiting are widespread, and efforts to implement and enforce laws is poor or inconsistent in several areas. The government is pursuing a range of different initiatives that seek to address these well-known shortcomings.

In terms of dispute resolution, the Indonesian courts have a reasonable record concerning the rule of law and contract enforcement when compared to similar economies. Despite important reforms to establish an independent judiciary and improve court services, however, some stakeholders still cite concerns with the lack of transparent and fair treatment in the Indonesian court system. The effectiveness of the courts is hampered by some long-standing negative perceptions. For these reasons, many firms prefer to use alternative dispute resolution rather than litigation to settle their disputes. Law 30/1999 on Arbitration and Alternative Dispute Resolution provides a solid framework to support arbitration in Indonesia and works reasonably well in practice. The government is not considering any major reform proposals in this area but it may wish to investigate amending some provisions of the law to improve legal certainty.

Other areas attracting attention from the top levels of government are data protection and cybersecurity, the fight against corruption and public sector reforms. The government has taken significant strides towards making cybersecurity a national policy priority. It established a national cybersecurity agency in 2017 and stepped up its international engagement on these issues, but there is still no overarching regulatory framework in Indonesia for cybersecurity or data protection. Fighting corruption in all levels of society has also been a top priority for many years. The Corruption Eradication Commission (KPK) has played a major role in building public awareness and trust through impressive results. A wide range of public sector reforms introduced in recent years to improve transparency, reduce bureaucracy, and encourage public engagement in the policy cycle will also contribute to strengthening public integrity. Enduring concerns regarding corruption are deep-rooted, however, and may only be overcome in the long term, which the government recognises and seeks to address.

The government has also substantially revised its investment treaty policies in recent years. Indonesia's investment treaties grant protections to certain foreign investors in addition to and independently from protections available under domestic law to all investors. Domestic investors are generally not covered by these treaties. Indonesia is a party to 37 investment treaties in force today. Like investment treaties signed by many other countries, these treaties typically protect investments made by treaty-covered investors against expropriation and discrimination. Provisions requiring "fair and equitable treatment" (FET) are also common, providing a floor below which government behaviour should not fall. While there are some significant recent exceptions, investment treaties often enforce these provisions through access to investor-state dispute settlement (ISDS) mechanisms that allow covered investors access to impartial international arbitration that awards monetary damages in an effort to depoliticise such disputes.

Investment protection provided under investment treaties can play an important role in fostering a healthy regulatory climate for investment. Expropriation or discrimination by governments does occur. Investors need some assurance that any dispute with the government will be dealt with fairly and swiftly, particularly in countries where investors have concerns about the reliability and independence of domestic courts. Government acceptance of legitimate constraints on policies can provide investors with greater certainty and predictability, lowering unwarranted risk and the cost of capital. Investment treaties are also frequently promoted as a method of attracting FDI which is an important goal for many governments. Despite many studies, however, it has been difficult to establish strong evidence of impact in this regard (Pohl, 2018). Some studies suggest that treaties or instruments that reduce barriers and restrictions to foreign investments have more impact on FDI flows than bilateral investment treaties (BITs) focused only on post-establishment protection (Mistura et al., 2019). These assumptions continue to be investigated by a growing strand of empirical literature on the purposes of investment treaties and how well they are being achieved.

The government's comprehensive review of its investment treaties in 2014-16 led to the termination of at least 23 of its older investment treaties. But like many other countries, Indonesia still has a significant number of older investment treaties in force with vague investment protections that may create unintended consequences. Many countries, including Indonesia, have substantially revised their investment treaty policies in recent years in response to these concerns as well as increased public questioning about the appropriate balance between investment protection and sovereign rights to regulate in the public interest and the costs and outcomes of ISDS. The government is well aware of these ongoing challenges. It is taking a leading role in multilateral discussions on ISDS reform in UNCITRAL's Working Group III and updating its model investment treaty in light of recent treaty practices. Experiences with the COVID-19 pandemic may further shape how the government views key treaty provisions or interpretations and how it assesses the appropriate balance in investment treaties.

Notwithstanding the potential benefits of having signed international investment agreements, they should not be considered as a substitute for long-term improvements in the domestic business environment. Any active approach to international treaty making should be accompanied by measures to improve the capacity, efficiency and independence of the domestic court system, the quality of a country's legal framework, and the strength of national institutions responsible for implementing and enforcing such legislation.

Main policy recommendations for the domestic legal framework

- Amend Article 7 of the Investment Law to provide further specification on investor rights to protection from unlawful expropriation and the government's right to regulate. Issues for possible clarification include whether investors are protected from indirect expropriation, exceptions to protect the government's right to regulate in the public interest, and the valuation methodology for determining market value of expropriated property. This is not necessarily urgent but the government may wish to identify an appropriate opportunity to propose incremental improvements to this and other aspects of the Investment Law.

- Consider updating and modernising existing land laws. Land policy is one of the few areas affecting investors where the government has not enacted significant new legislation in recent decades. The existing system for land tenure is based primarily on legislation enacted in 1960. New laws could clarify existing categories of land tenure rights and reduce conflicts between customary and formal laws. Efficient land administration services go hand-in-hand with clear legal rights. The government should also allocate sufficient funds, institutional capacity and political backing to consolidate on early successes for ongoing initiatives to achieve universal land registration, improve the quality of land data and expand digital solutions and online accessibility for land administration.
- Continue to prioritise efforts to improve the regime for intellectual property (IP) rights, especially enforcement measures. Investors continue to report concerns with widespread online piracy and counterfeiting, long-standing market access issues for IP intensive sectors, high numbers of bad faith registrations of foreign trademarks by local companies and restrictive patentability criteria that make effective patent protection particularly challenging. The government is well aware of these concerns and designs initiatives to address them. Improvements in implementation and IP enforcement measures will help to build overall investor confidence in this area.
- Rethink existing approaches to reforming the court system. The government and the Supreme Court have taken significant strides towards ensuring judicial independence, creating specialised courts and judges, establishing a system for legal aid and expanding e-court services. Bold thinking may be required to dismantle certain negative perceptions regarding the effectiveness of the courts and revitalise the core institutions. The government may wish to consider commissioning a thorough review of the existing civil procedure rules, redesigning the system for judicial appointments to ensure integrity and encouraging the Supreme Court to propose, in consultation with civil society organisations and other stakeholders, more wide-ranging initiatives to promote transparency and greater public scrutiny of court functions.
- Evaluate potential amendments to Law 30/1999 on Arbitration and Alternative Dispute Resolution. It may be prudent for the government to take stock of court decisions and user experiences under the law over the past two decades to assess the merits of potential amendments to improve legal certainty, user experiences and the attractiveness of arbitration in Indonesia. Areas for possible legislative clarification include the scope of the law vis-à-vis international arbitrations conducted in Indonesia, whether contract disputes involving claims based on tort or fraud are arbitrable and the public policy ground for refusing enforcement of an arbitral award under Article 66 of the law.
- Maintain data protection and cybersecurity as a national policy priority. Comprehensive laws that draw on international good practices need to be enacted and effectively implemented in these areas. As with all legislation, the government should consult widely on the existing drafts of these laws and encourage input from business and civil society organisations. The government should also account for considerable, additional work once laws are in place to raise awareness among the private sector and other users, and nurture effective mechanisms to deal with security and data breaches.
- Sustain momentum for building a culture of integrity in the public sector and throughout all levels of society. Among other initiatives, the KPK has made significant inroads into concerns regarding corruption through some impressive results, which have transformed it into an important symbol of the government's commitment to fighting corruption. The government should continue to allocate sufficient resources to the KPK and other anti-corruption institutions and vigorously defend their independence.

Main policy recommendations for investment treaty policy

- Continue to reassess and update priorities with respect to investment treaty policy. An important issue for period reassessment is how the government evaluates the appropriate balance between investor protections and the government's right to regulate, and how to achieve that balance in practice. Indonesia's model BIT, which the government is currently updating, should reflect the government's current assessment of the appropriate balance and inform negotiations for new investment treaties. It is more difficult for governments to update their existing treaties to reflect current priorities. Depending on whether the parties wish to clarify original intent or revise a provision, it may be possible to clarify language through joint interpretations agreed with treaty partners. If revisions, rather than clarifications of original intent are desired, then treaty amendments may be required. Replacement of older investment treaties by consent – which appears to be the approach Indonesia has taken in respect of its newest BIT with Singapore – may also be appropriate in some cases.

- Continue to participate actively in inter-governmental discussions on investment treaty reforms at the OECD and at UNCITRAL. Many governments, including major capital exporters, have substantially revised their policies in recent years to protect policy space or to ensure that their investment treaties create desirable incentives. Consideration of reforms and policy discussions on frequently-invoked provisions such as FET are of particular importance in current investment treaty policy. Emerging issues such as the possible role for trade and investment treaties in fostering responsible business conduct as well as ongoing discussions about treaties and sustainable development also merit close attention and consideration.
- Conduct a gap analysis between Indonesia's domestic laws and its obligations under investment treaties with respect to investment protections. There are differences between the Investment Law and Indonesia's investment treaties in some areas. Identifying these differences and assessing their potential impact may allow policymakers to ensure that Indonesia's investment treaties are consistent with domestic priorities.
- Continue to develop ISDS dispute prevention and case management tools. Whatever approach the government adopts towards international investment agreements, complementary measures can help to ensure that treaties are consistent with domestic priorities and reduce the risk of disputes leading to international arbitration. The government should continue to participate actively in the work of UNCITRAL's Working Group III, the OECD and other multilateral fora on these topics. It may also wish to consider ways to promote awareness-raising and inter-ministerial co-operation regarding the government's investment treaty policy and the significance of investment treaty obligations for the day-to-day functions of line agencies. Developing written guidance manuals or handbooks for line agencies on these topics could encourage continuity of institutional knowledge as personnel changes occur over time.

Investor protections under the Investment Law

Indonesian law provides a number of core protections to investors in relation to expropriation, non-discrimination and free transfer of funds that have not changed significantly since the first OECD *Investment Policy Review* (2010). Most of these protections appear in Law 25/2007 concerning Investment (the Investment Law) which has since been supplemented by regulations issued at various levels of government including BKPM. These protections are generally in line with similar provisions found in other regional investment laws and provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are also seen to be robust. The government proposed a number of amendments relating to investment liberalisation as part of the new Omnibus Law on Job Creation but none of these proposals affect the existing provisions on investment protection.

Like many other countries, Indonesia has enshrined in its domestic law a principle of non-discriminatory treatment as between foreign and domestic investors. The Investment Law establishes ten key principles that underpin the government's objectives for the investment climate (Article 3) including legal certainty through the rule of law, transparency and non-discriminatory treatment as between foreign and domestic investors. In designing investment policies, the government is "to provide the same treatment to any domestic and foreign investors, by continuously considering the national interest" (Article 4(2)). Article 6 provides an express guarantee of "equitable treatment to all investors of any countries that carry out investment activities in Indonesia in accordance with provisions of laws and regulations." These provisions establish Indonesia's commitment to a level playing field for all investors and contribute to positive signals regarding an open investment policy, without prejudice to the possibility for the government to preserve its right to implement certain policies that are exempted from this broad equality guarantee.

Despite formal guarantees of non-discrimination, some stakeholders have reported concerns of *de facto* discrimination against foreign investors linked to economic protectionism (EuroCham, 2019b; US Department of State, 2019). These stakeholders indicate that economic nationalism and an oft-stated desire for self-sufficiency by the government continues to manifest itself through negotiations, policies, regulations and laws in ways that companies consider as eroding investor value. These include local content requirements, requirements to divest equity shares to Indonesian stakeholders and requirements to establish manufacturing or processing facilities in Indonesia. Political forces favouring the protection of certain segments of the local economy from foreign competition have been effective in countering those supporting more in-depth FDI reforms (discussed further in Chapter 3). Some foreign companies operating natural resources projects in Indonesia report growing sentiments that domestic interests should not have to pay prevailing market prices for domestic resources, which some fear may lead to adverse impacts for foreign investors established in this sector (US Department of State, 2019).

Another important legal protection for investors is the government's guarantee of freedom from unlawful nationalisation or expropriation in Article 7 of the Investment Law. This provision requires the government to provide compensation to investors if it expropriates their property. Compensation should reflect the market value of the property. Disagreements regarding the valuation of expropriated property may be settled through arbitration, if the parties agree, or through domestic courts. While these provisions encapsulate the core building blocks for investor protection from expropriation, they are relatively simplistic alongside the expropriation regimes that Indonesia provides to some foreign investors under its investment treaties and expropriation regimes under investment laws in other countries. For example, Indonesia's new trade and investment treaty with Australia, which entered into force in July 2020, contains a detailed set of provisions on expropriation including an annex on the interpretation of those provisions. This creates scope for amendments to Article 7 to provide further specification. Issues for possible clarification include:

- whether investors are protected from indirect expropriation in the form of government measures that have an effect equivalent to direct expropriation without formal transfer of title or outright seizure and, if so, how indirect expropriation is defined and whether there are any exceptions (e.g. for non-discriminatory regulatory actions designed to achieve legitimate public welfare objectives);
- general exceptions such as the government's right to nationalise or expropriate property for public interest purposes in certain situations;
- the valuation methodology for determining market value, including the valuation date, and whether any specific factors should be taken into account when determining this value such as the investor's conduct, the reason for the expropriation or the profits made by the investor during the lifetime of investment;
- whether compensation for expropriation includes interest and, if so, how that interest should be calculated; and
- the distinction between compensable and non-compensable expropriations, if appropriate, to establish a minimum level of policy space for the government to implement public policy objectives without being constrained by obligations to compensate affected investors.

Aside from expropriation and non-discrimination, the Investment Law also guarantees that investors may freely transfer and repatriate in foreign currency funds associated with their investment activities including profits, interest, dividends and proceeds from the sale of their assets (Article 8). Repatriation is subject to reporting requirements and obligations to pay taxes, royalties and other government income associated with investment activities. The government and local courts may defer repatriation rights if there are pending claims against the investor (Article 9). Regulations issued by the central bank in recent years impose special reporting requirements on non-bank companies in Indonesia that borrow offshore in foreign currency and mandate the use of rupiah for domestic transactions in Indonesia with only a few limited exceptions, notably international commercial transactions.[1]

A range of investor obligations accompany the protections offered in the Investment Law. Investors must give precedence to Indonesian nationals wherever possible when addressing their labour needs even if foreign nationals are required for special expertise or management positions (Article 8). Investors must provide training for their local workforce and allow technology transfers to take place between foreign and Indonesian employees, the merits of which are discussed in Chapters 2 and 3 above. Investors are required to follow good practices on corporate governance and corporate social responsibility, fulfil certain reporting requirements, respect local cultural and business traditions and comply with domestic laws and regulations that apply to their activities (Article 15). The Investment Law also identifies a range of more general investor responsibilities regarding contributions to environmental sustainability, fair competition and workers' rights (Article 16). It envisages further environmental recovery obligations in sectoral laws applicable to non-renewable mining and extractive industries (Article 17). Similar obligations appear in investment laws in other ASEAN countries (see e.g., Myanmar's Investment Law No. 40/2016, Articles 65-72). Although these efforts may have been limited by implementation challenges and some opposing views about their efficiency, they are a marker of Indonesia's commitment to responsible business conduct and provide a good basis for continued efforts by the government in this area (see Chapter 5 on responsible business conduct).

Significant strides towards a reliable land administration system but more could be done to clarify ambiguities in land tenure rules

Secure rights for land tenure and an efficient, reliable system for land administration are indispensable for investors in many countries, including Indonesia. This requires a clear legal framework for acquiring, registering and disposing of land rights, as well as proactive land use plans at all levels of government.

Land tenure rules

The first *OECD Investment Policy Review* (2010) noted that land policy was one of the few areas of the investment climate where new legislation had not been drafted over the past decade, although a number of regulations had been enacted. This situation has not changed significantly since the first *Review*. While a new land law had been under preparation in 2010, the government has not enacted any significant new laws relating to land tenure and other land rights since the first *Review*. Renewed support from the highest levels of government may be needed to consolidate and clarify the system of land rights for investors that is still based primarily on a law enacted in 1960.

The two main laws dealing with land ownership in Indonesia are the Constitution and Law 5/1960 concerning the Basic Provisions concerning the Fundamentals of Agrarian Affairs (the BAL). The Constitution recognises that the state has the right to bestow rights to land. The BAL divides all land into either state land or certified land owned exclusively by natural persons with Indonesian citizenship. It envisages several types of land rights, including rights for ownership, use, construction, management and cultivation. The most extensive right to land in Indonesia is the *Hak Milik* (right of ownership) which is only available to Indonesian citizens, state companies, religious bodies recognised by the National Land Agency (the BPN) and social organisations recognised by the BPN. With the exception of forestry and mining, the BPN is responsible for all matters relating to Agrarian Law.

It was not possible for foreigners to own land in Indonesia until Government Regulation 41/1996 came into effect in 1996. This regulation introduced new rights for foreign nationals domiciled in Indonesia to own individual apartments or condominiums as strata title units. It also allowed foreign nationals to hold permits for secondary rights to use or develop land where the state holds the primary ownership right. The relevant permits include *Hak Guna Bangunan* (building rights for up to 50 years) and *Hak Pakai* (right of use for up to 70 years). These secondary rights can only be granted in relation to state-owned land. Foreigners wishing to acquire rights over privately-owned land must first negotiate with the land owner to relinquish its ownership rights to the state. Government Regulation 103/2015 updated these rules in 2015. The new regulation introduces a precondition for foreigners to hold a residential visa, removes a previous limit on the number of land rights that could be held simultaneously by foreigners and clarified the rights of Indonesian nationals married to foreigners. Article 144 of the Omnibus Law on Job Creation passed by parliament in October 2020 confirms these rights for foreigners. Ordinary long-term lease arrangements of up to 95 years are also possible for foreigners under Indonesian law. Nominee ownership structures, whereby an Indonesian national owns land on behalf of a foreign national, are illegal.

While the legal regime for land ownership is gradually becoming more transparent and liberal, some concerns remain. Many of these concerns stem from the complex system of land rights in the BAL, which sought to merge land rights granted during the Dutch colonial era, customary rights under Indonesia law (*adat*) and a new system for statutory land rights into a single legal regime that still applies today. The government's commitment in Article 22 of the Investment Law to simplifying certain land acquisition procedures for investors has done little in practice to improve the situation. The complexity of the BAL continues to create problems for consistent interpretation. While *adat,* or Indonesian customary law, is declared a primary source of land law, it is simultaneously subjected to all restrictions of formal land law (Article 5 of the BAL). In practice, the implementation of the BAL regime has not always managed to resolve ambiguities in the interaction between customary *adat*, which varies widely across the archipelago, and new statutory rights. Some stakeholders have consistently urged the government to propose new land legislation to clarify existing categories of land tenure rights and reduce conflicts between customary and formal laws (USAID, 2013, 2019). Others have noted that administrative controls to protect public interests, including proper public announcement of land rights, community participation, protection of occupiers' interests, and thorough examination of evidence to protect these rights are often bypassed in practice.

Land titling and administration

In order to provide for secure land tenure rights, land administration should be accessible, reliable and transparent. If properly undertaken, land rights registration can enhance land tenure security by recording individual and collective land tenure rights, thereby facilitating the transfer of land tenure rights and allowing investors to seek legal redress in cases of violation of their tenure rights.

As described in the first *OECD Investment Policy Review* (2010), a fragmented and incomplete land administration system has long hindered the management and governance of land and natural resources in Indonesia. The government has nevertheless taken significant strides towards improving the system for land registration. Since 1997, land holders have been required to register their land. Government Regulation 24/1997 concerning Land Registration identified ways to accelerate land registration, improve legal certainty and conduct programmes to raise public awareness about land laws and land registration. The government also established in 2006 a new Deputy for Land Dispute Resolution Affairs to improve the speedy resolution of land disputes.

Only around 35% of land in Indonesia has been registered to date, most of it in urban areas. Current estimates indicate that there are around 126 million available parcels of land in Indonesia, of which approximately 42 million were registered between 1960 and 2016. BPN statistics available on its website and updated regularly indicate as of May 2020 that this equates to nearly 40 million hectares of land that have been registered and almost 68 million land rights certificates issued. The number of land titles issued each year is also rising, which is a promising sign. Between 2010 and 2016, BPN registered between one and two million new titles annually, while this number has jumped to over eight million titles per year since 2018.

Problems still persist, however, in terms of the time and number of procedures needed to register property. Indonesia ranks 106 out of 190 countries in terms of registering property according to the 2020 edition of the *Doing Business* indicators, which suggests that there is still room for sustained, longer-term improvement. These indicators are based on firms operating in the Jakarta and Surabaya regions and hence may not be fully representative of the rest of the country. Other than the average time needed to register a land deed (28 days in Jakarta and 40 days in Surabaya), these regions rank below the average for countries in East Asia & Pacific regarding the number of procedures, the cost of registering and the quality of the land administration. Indonesia also ranks 76th out of 141 countries in terms of quality of land administration in the World Economic Forum's 2019 Global Competitiveness Report.

Other concerns relate to the time, resources and data still needed to register all available land parcels in Indonesia. The BPN is able to register around one million new (i.e. previously unregistered) parcels of land each year. A study published in 2019 by the Ministry of Agrarian Affairs and Spatial Planning estimates that it would take another 85 years to record all unregistered land parcels at this rate (Wibowo, 2019). Data quality is another issue. Among the 42 million parcels that have been registered to date, the same study estimates that only 20 million of these parcels have been verified by a chartered surveyor and correctly plotted. These issues contribute to a lack of access to reliable land records and spatial data at the local government level where many resource planning and land registration functions are carried out under the current model for decentralised land administration. This can, in turn, inhibit infrastructure investments and create a lack of clarity and transparency in decision-making, spatial planning and resource allocation (World Bank, 2018b).

Stakeholders have also identified concerns with respect to the prevalence of land disputes between communities and large-scale land users, particularly on environmental matters (see Chapter 5 on responsible business conduct); a lack of clarity in relevant laws and regulations to support land authorities at the provincial level, particularly in relation to settling land conflicts (see Chapter 7 on investment policy and regional development); rising land prices and the effects of increased speculation for land acquisitions, including in relation to proposals to relocate the country's capital to East Kalimantan; disempowerment of local landowners facing threats of displacement due to unclear land tenure arrangements and the ongoing gaps in registered land rights in some regions; and the disproportionate impacts for women as compared to men of land use conversion, industrial expansion and deforestation (World Bank, 2018b).

The government is aware of these various concerns and seeks to address them. Many initiatives in the past decade have prioritised efforts to register all available parcels of land. The 2011 Geospatial Information Law and the One Map Project (OMP) aim to establish a unified base set of geospatial data (i.e., topography, land use, and tenure) and the National Spatial Data Infrastructure to inform decision-making by land authorities (see Chapter 7 on investment policy and regional development for more information on the OMP). Efforts to accelerate the registration of unregistered land have been redoubled under the Regulation of the Minister of Agrarian and Spatial Planning and the Head of the National Land Agency 12/2017 concerning the Complete Systematic Land Registration Acceleration. This programme enjoys support from the highest levels of government. Under Presidential Instruction 2/2018, President Jokowi instructed relevant ministries to take all steps to achieve universal land registration by 2025. Promising results since 2018, whereby 8-10 million new parcels of land have been registered annually, indicate that the achievement of this goal is increasingly likely if the current momentum is sustained. Another positive development relates to funding. The government secured USD 200 million in funding between 2018 and 2023 from the World Bank to help to realise this project (World Bank, 2018b). All steps that can be taken to improve the quality of data collected in the national Electronic Land Administration System (eLand) during this project should be encouraged. In particular, the government should encourage BPN to explore digital solutions and online accessibility options that would increase transparency for land information, including through the development of web-based applications to record and publish land information online and improve the efficiency of data collection.

The Omnibus Law on Job Creation, passed by parliament in October 2020, seeks to simplify some land administration procedures and redefine the central government's role in land policy. Chapter VIII of the law amends several existing laws to ease the requirements for public procurement of small land parcels, clarify procedures for compensation in cases of public land procurement and strengthen protections for land designated as sustainable agricultural land. The law also envisages a more prominent role for the central government in land policy. It establishes a Land Bank Agency under central government supervision to manage and distribute state-owned land and carry out a broad range of functions relating to land planning, acquisition, procurement, management, use and distribution (Article 125). The law introduces strict rules to discourage idle possession of land whereby land left unused or uncultivated for a period of at least two years can automatically revert to the Land Bank Agency (Article 180). The law also vests the central government with new powers to set spatial planning policy and determine environmental approvals under existing laws (Articles 13-20), as well as easing requirements for environmental approvals for some investment projects. It remains to be seen how these various legislative changes will impact investors on the ground. The BPN should make every effort to ensure that these proposed changes, once implemented in the future, lead to sustainable, long-term improvements for investors in their dealings with land administration authorities.

Further progress is needed to improve the protection and enforcement of intellectual property rights

An effective regime for registering, protecting and enforcing intellectual property (IP) rights is a crucial concern for many investors. Strong IP rights provide investors with an incentive to invest in research and development (R&D) for innovative products and processes. These rights also instil confidence in investors sharing new technologies, for instance through joint ventures and licensing agreements. Successful innovations may be suffused within and across economies in this way, and contribute to elevating productivity and growth. At the same time, IP rights entitle their holders to the exclusive right to market their innovation for a certain period. The protection granted to intellectual property therefore needs to strike a balance between the need to foster innovation and society's interest in having certain products, such as pharmaceutical products, priced affordably.

Indonesia has a relatively extensive legal framework for IP rights protection that generally complies with international standards in at least five main areas: trademarks, patents, industrial designs, copyrights and trade secrets. Laws in three of these areas have been amended since the first *OECD Investment Policy Review* (2010): Law 19/2014 Concerning Copyright (2014 revision); Law 13/2016 Concerning Patents (2018 and 2020 revisions); and Law 20/2016 Concerning Trademarks and Geographical Indications (2018 and 2020 revisions).

At the international level, Indonesia joined the World Intellectual Property Organization (WIPO) in 1979 and the World Trade Organisation (WTO) in 1995. Indonesia is an active participant in the WTO Council for Trade-Related Aspects of Intellectual Rights (TRIPS Council). It has also signed several key WIPO-administered IP treaties.[2]

Despite a relatively well-developed legal framework for IP rights protection in Indonesia, issues remain with the effectiveness of enforcement measures and the poor or inconsistent implementation of existing laws. Investors and other stakeholders routinely cite IP rights infringement issues as a principal problem in many ASEAN countries, including Indonesia (European Commission, 2020; EuroCham, 2019a; US Department of State, 2019; USTR, 2020b; IPR SME Helpdesk, 2016). These stakeholders report specific concerns with widespread online piracy and counterfeiting, long-standing market access issues for IP-intensive sectors, high numbers of bad faith registrations of foreign trademarks by local companies and restrictive patentability criteria that make effective patent protection particularly challenging for investors. USTR has urged the government to "develop and fully fund a robust and coordinated IP enforcement effort that includes deterrent-level penalties for IP infringement in physical markets and online" (USTR, 2020b). Many of these issues were identified as ongoing concerns and challenges for the government in the first OECD *Investment Policy Review* (2010).

These concerns are partly reflected in Indonesia's international rankings in this area. Indonesia ranks 51st out of 141 countries in terms of IP Protection in the World Economic Forum's 2019 Global Competitiveness Report; 85th out of 129 economies in the Global Innovation Index 2019 prepared by WIPO, INSEAD and Cornell University; and 46th out of 53 countries analysed in the 2020 US Chamber International IP Index, which benchmarks the IP framework in these economies on the basis of 45 different indicators. Indonesia remains a "Priority 2" country in the European Commission's annual IP rights report on third countries based on limited progress made by the government in addressing systemic IP rights protection and enforcement issues identified in the report (European Commission, 2020). It is also listed on USTR's "Priority Watch List" in its 2020 Special 301 Report (USTR, 2020b). This annual report identifies countries that the USTR considers to deny adequate and effective protection for intellectual property rights or deny fair and equitable market access for investors relying on intellectual property protection. USTR recently reiterated its concerns to the Indonesian government as part of an ongoing country review process for trade preferences that the US grants to Indonesia (USTR, 2020a).

The government is pursuing a range of different initiatives that seek to address these well-known shortcomings. European and US stakeholders have noted positive developments related to Indonesia's efforts to address online piracy, such as the Infringing Website List (European Commission, 2020; USTR, 2020b). This initiative seeks to encourage advertising brokers and networks to avoid placing advertisements on websites that infringe copyrights on a commercial scale. The government has also issued administrative orders to block over 480 copyright-infringing websites in recent years while the Ministry of Finance has issued regulations clarifying its *ex officio* authority for border enforcement against pirated and counterfeit goods. The Directorate General for Intellectual Property reports steady increases in its numbers of investigators and other staff, which saw its capacity to conduct infringement investigations double from 16 in 2017 to 36 in 2018. Stakeholders have welcomed Indonesia's accession to the Madrid Protocol for the Registration of Trademarks in 2017 and the government's implementing regulation issued in 2018, which bring Indonesia's trademarks regime closer to international standards.

The new Omnibus Law on Job Creation, which was passed by parliament in October 2020, is the government's latest effort to improve laws in certain areas. The Law amends Law 20/2016 Concerning Trademarks and Geographical Indications to introduce stricter criteria for trademark registration aimed at stamping out bad faith registrations of foreign trademarks by local companies (Article 108). It also amends Law 13/2016 Concerning Patents to limit the scope of patents subject to compulsory licencing requirements and significantly reduce wait times for decisions on simple patent applications (Article 107). It remains to be seen whether the implementation of these amendments is successful in addressing stakeholder concerns, especially regarding compulsory licensing following Ministerial Regulation 39/2018 on Procedures of Imposition of Patent Compulsory Licences.

Despite these encouraging efforts, further progress is needed. The government should continue to prioritise efforts to strengthen its system for IP rights protections and enforcement as an important part of its goal to improve the overall investment climate. IP rights commitments in trade and investment agreements such as the Regional Comprehensive Economic Partnership (RCEP) may be a way of focusing political will to improve the domestic framework. Stakeholders have also routinely encouraged the government to improve enforcement co-operation among agencies and improve the resources and capacities available to investigate IP rights infringements. The government should also develop roadmaps towards implementing additional international commitments, including the Geneva Act of the Hague Agreement Concerning the International Registration of Industrial Designs and the 1991 Act of the International Convention for the Protection of New Varieties of Plants. It should also recall the recommendations made in an OECD study published in 2014 on strengthening national innovation and growth through Indonesia's IP rights regime, all of which remain relevant today (Box 4.1).

Box 4.1. Improving Indonesia's IP rights regime in terms of contributions to innovation and economic development

An OECD study published in 2014 on "National Intellectual Property Systems, Innovation and Economic Development" considered the role of national systems of IP in the socio-economic development of emerging countries, notably through their impact on innovation. It presented a framework to identify the key mechanisms that enable IP systems to support emerging countries' innovation and development objectives. The report includes a country study of Indonesia to identify strengths and weaknesses in the IP system from the perspective of contributions to national innovation performance. This work forms part of the OECD-World Bank Innovation Policy Platform project, a web-based, interactive space that provides access to open-data, learning resources and opportunities for collective learning on innovation policy.

The report identifies five concrete policy recommendations for policy makers in Indonesia in their efforts to strengthen national innovation and growth through IP:

- Efforts aimed at standardising and automating procedures to increase the processing efficiency of IP applications should be a priority, as lengthy delays weaken incentives. Policy steps also have to be taken to avoid the potential exclusion of smaller entities, as well as businesses in remote geographic areas.
- Policies should encourage the use of IP by national actors, including the launch of IP awareness and capacity-building initiatives. Incentive schemes should give researchers a stake in the returns from their inventions, by rewarding most those who commercialise inventions with high industrial applicability. This requires resolving legal uncertainties regarding the licensing of IP generated from public funding sources.
- Embracing "new" types of IP, such as traditional knowledge, genetic resources, folklore and geographical indications, will be attractive for Indonesia, but these need to be used to generate value if they are to serve the innovation system. Indonesia's IP policy should take further complementary steps to support commercialisation.
- To achieve these objectives, the country's IP policy has to undertake a more coherent approach involving the various actors of Indonesia's innovation governance system.

Source: OECD (2014), National Intellectual Property Systems, Innovation and Economic Development with perspectives on Colombia and Indonesia, OECD Publishing, Paris, https://doi.org/10.1787/9789264204485-en.

Some incremental reforms have improved the court system but bold action may be needed to address long-standing concerns

The ability to make and enforce contracts and resolve disputes efficiently is fundamental if markets are to function properly. Good enforcement procedures enhance predictability in commercial relationships by assuring investors that their contractual rights will be upheld promptly by local courts. When procedures for enforcing contracts are overly bureaucratic and cumbersome or when contract disputes cannot be resolved in a timely and cost effective manner, companies may restrict their activities. Uncertainty about the enforceability of lawful rights and obligations raises the cost of capital, thereby weakening firms' competitiveness and reducing investment. It can also foster corruption in the court system.

The existing framework for domestic adjudication of civil disputes in Indonesia continues to suffer from a number of significant problems. Some of these issues seem to persist since the first OECD *Investment*

Policy Review (OECD, 2010). Government initiatives in the past two decades have led to some improvements. The “one-roof” reforms introduced in 1999 and implemented by 2004 re-established an independent judicial branch in Indonesia headed by the Supreme Court. These reforms largely freed the judiciary from the political interference of the Justice Ministry that was endemic under the New Order government. However, reforms since then have been gradual rather than sweeping and have encountered some resistance. Some stakeholders continue to perceive the court system as costly, cumbersome, corrupt and dominated by cronyism (US Department of State, 2020; AustCham, 2020; EuroCham, 2019b; Overseas Development Institute, 2016). Some foreign investors also cite concerns with the lack of transparent and fair treatment in Indonesian courts, with judges not bound by precedent and many laws open to various interpretations (US Department of State, 2020).

Several global indicators identify the weaknesses in the justice system. Indonesia ranks, for instance, 59th of 126 countries in the 2020 edition of the World Justice Project Rule of Law Index. While this places Indonesia 5th of 30 other lower middle-income countries covered by the indicator, Indonesia’s performance is below the group median for the civil justice system indicator. When compared to 15 other countries in the East Asia & Pacific region, Indonesia ranks poorly in three indicators: civil justice, criminal justice and absence of corruption. Only Cambodia ranks lower than Indonesia among these other countries in the region in terms of absence of corruption (127th of 128). The World Bank’s Doing Business 2020 indicators also point to problems in the effectiveness of contract enforcement mechanisms in Indonesia, ranking the country 139th of 190 countries covered in the indicator (using data from Jakarta and Surabaya). Indonesia scores better in several other indicators in the World Bank’s report (see Chapter 6 on investment promotion and facilitation). But enforcing contracts through the courts was assessed on average as costing around 70% of the claim value, which is about 1.5 times the regional average (47.2%), taking around 14 months to complete and subject to a quality of judicial process close to the median scores for 25 countries in the East Asia & Pacific region.[3]

The government is well aware of these problems and seeks to address them. The Long-Term National Development Plan (2005-2025) (Law 17/2007), the National Medium-Term Development Plan (2015-2019) and the National Medium-Term Development Plan (2020-2024) all identify the importance of establishing criminal and civil justice systems that are efficient, effective, and accountable for justice seekers, supported by lower levels of corruption and professional law enforcement personnel with integrity and independence. The government’s development plans specifically link improvements in the legal system to Indonesia’s economic development challenges, acknowledging that investors and the private sector cannot operate without legal and regulatory certainty. In pursuit of this goal, three specific objectives are stated: improved transparency, accountability and speed in law enforcement; improved effectiveness or corruption prevention and eradication; and respect, protection and fulfilment of human rights.

The establishment of specialised judges and courts has improved some court services. The Supreme Court has established at least six specialised courts with dedicated judges trained in their respective fields: the Anti-Corruption Court; the Commercial Court; the Industrial Relations Court; the Fishery Court; and the Taxation Court. A large number of other courts have also been established under the supervision of the Supreme and Constitutional Courts including appeal courts (34), general courts (330), administrative courts (26), religious courts (343) and *ad hoc* military courts. A small claims court was established in 2019 to handle disputes under IDR 500 billion. Some investors have brought cases before the administrative courts with claims relating to licence revocations and other government decisions; licence disputes involving investors have also been heard in the general courts and even subject to judicial review in the Supreme Court on occasion. But this disparate system of courts with overlapping jurisdictions in some instances creates complexity for investors needing to rely on it.

Other important incremental reforms and improvements have been achieved in recent years. Law 16/2011 on Legal Aid, together with accompanying implementing regulations, established a legal framework for government funding of legal aid. Various Supreme Court regulations and circular letters have established small claims courts, a specialised chamber system within the Supreme Court, and templates for court documents and decisions that have improved efficiency. The Supreme Court has also initiated several e-court programmes to improve access to court judgments through online databases and increase the use of electronic forms of case management. If implemented effectively, the e-Court system set out in Supreme Court Regulations 3/2018 and 1/2019 has the potential to be a breakthrough reform that reduces scope for corruption, improves accuracy and processing times and increases access to the justice. As of March 2019, 36% of Indonesian courts across all jurisdictions had adopted the e-Court system and nearly 16 000 lawyers and other advocates had registered for e-Court services (Australia-Indonesia Partnership for Justice, 2019). An ethics committee within the Supreme Court has worked with the Judicial Commission on developing an Ethics Code and Judicial Conduct Guidelines and has punished many court staff for violating the code. Stakeholder contributions have been significant in achieving these reforms and increasing public pressure for better governance, including through local civil society organisations and partnerships with foreign governments such as the Australia-Indonesia Partnership for Justice since 2014.

Despite these developments, significant reforms are still needed. The Supreme Court's 2010 Blueprint for Justice Reform (2010-2035), which was developed with the help of an external consulting company and a team of civil society organisations, identifies a number of important reforms that the government should continue to support. Some stakeholders consider, however, that the government will only be able to address the systemic issues that still hamper the Indonesian court system if it is prepared to rethink the core institutions, rules and attitudes that support it (Crouch, 2019; Lev, 2004). This would include a thorough review of the existing civil procedure rules, continual improvements to the system for judicial appointments and more wide-ranging initiatives to promote transparency and greater public scrutiny of court functions. Changes to legal education and public awareness are also key determinants in the success of any legal-institutional reforms and may be the only way to invert deep-seated attitudes regarding fairness and efficiency in the Indonesian justice system for future generations of judges, prosecutors, lawyers, police officials and, in some cases, members of parliament. Ongoing efforts by the National Development Planning Agency, the National Statistical Bureau and a consortium of civil society organizations and NGOs to develop a national Access to Justice Index should also be encouraged. Resources and technical expertise to implement the government's justice reform plans is likely to be an enduring issue. The government should continue to seek opportunities to collaborate with international partners on justice reform projects and maintain ties with existing donors in this area including various United Nations agencies, USAID, the European Commission and the governments of Australia, Japan, the Netherlands and Norway.

And many investors continue to prefer arbitration and other forms of alternative dispute resolution to litigation

Commercial disputes may arise for investors with joint venture partners, employees, local suppliers or contractors, or government agencies. The cheapest and quickest way to resolve disputes is by negotiation or mediation whenever possible, but if the parties cannot reach an amicable settlement by these means, then they have no choice but to pursue the issue in the courts or arbitration. Arbitration is possible only if the parties agree to it in an underlying contract or after a dispute has arisen between them. Article 32 of the Investment Law envisages that investor can rely on court or arbitration proceedings to settle any disputes that may arise with the government. The default option for domestic investors is court proceedings while the default for foreign investors is international arbitration.

Law 30/1999 on Arbitration and Alternative Dispute Resolution (the Arbitration Law) governs domestic and international arbitrations in Indonesia as well as the enforcement of foreign arbitral awards in line with the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). Unlike the arbitration laws in many other countries, the Arbitration Law is not based on the Model Law published by the United Nations Commission on International Trade Law (UNCITRAL) in 1985, which is designed to assist states in reforming and modernising their arbitration laws. It nonetheless provides a comprehensive framework for commercial arbitration and addresses the core topics covered in most arbitration laws on the constitution of arbitral tribunals, the role of the courts, arbitration procedures and enforcement of arbitral awards.

Stakeholders have reported relatively positive experiences with the Arbitration Law in practice and the government is not considering any major reform proposals at this time. However, the government may wish to consider amending the Law at an appropriate time in the future to clarify certain aspects of it. The Law does not expressly state that it applies to international arbitrations conducted in Indonesia even though in practice the Indonesia courts have interpreted it as covering both domestic and international arbitrations. Clarification of whether contract disputes involving claims based on tort or fraud fall within the definition of arbitrable disputes under Article 5 of the Law may also help to avoid unnecessary litigation on this issue. Some stakeholders have also reported difficulties in enforcing foreign arbitral awards against Indonesian debtors (US Department of State, 2020). Article 66 of the Law does not provide guidance on when the court should refuse to enforce an award that “conflict[s] with public order”. Guidance or clarification in the Law would help to reduce inconsistency in judicial interpretations and dissuade award debtors from filing frivolous defences to delay enforcement through costly and lengthy court procedures. Provisions allowing the enforcement of arbitral awards that grant interim relief or injunctive remedies might also be considered as the Law is silent on this issue.

A number of local institutions administer arbitrations and provide a range of alternative dispute resolution services. The Indonesian National Board of Arbitration (*Badan Arbitrase Nasional Indonesia* or BANI), established in 1977, is the oldest and most commonly used arbitration institution in Indonesia. BANI has its headquarters in Jakarta and regional offices in Bandung, Denpasar, Medan, Pontianak and Batam. It has administered more than 1000 cases to date. It maintains a roster of 150 arbitrators split equally between local and foreign arbitrators. Several other specialised arbitration institutions have also been established in recent years including the Capital Market Arbitration Board, the National Sharia Arbitration Board, the Arbitration and Mediation Board of Intellectual Property Rights and the Commodity Futures Trading Arbitration Board, among others. Many of the institutions also provide mediation and conciliation services, along with the dedicated National Mediation Centre. The Ministry of Public Works established the Construction Dispute Arbitration and Alternative Dispute Resolution Institution (BADPSKI) in August 2014 but this institution is not yet operational. Notwithstanding the growth of local arbitration institutions, many foreign investors still prefer to refer their disputes to institutions based in regional arbitration hubs like Hong Kong (China) and Singapore.

Sustained momentum is needed to improve the regulatory climate supporting the digital economy

Indonesia is home to the largest and fastest growing internet economy in the region, estimated at USD 40 billion in 2019 (Bain & Company et al., 2019; McKinsey & Company, 2018). Starting with its 14th economic package in 2016, the government has pursued a range of initiatives to promote the country’s potential as a leading digital economy including the National e-Commerce Roadmap, the 2020 Go Digital Vision, the Digital Talent Scholarship programme and the Indonesia 4.0 strategy aimed at implementing new manufacturing technologies. President Jokowi’s address at the Indonesia Digital Economy Summit 2020 reiterated these ambitions and noted the important challenges being tackled to achieve them (Cabinet Secretariat, 2020a, 2020b). One of these challenges is in developing and implementing a comprehensive regulatory framework for cybersecurity and data protection.

Together with a strong framework for IP rights, these aspects of the regulatory environment are of increasing importance for all investors, not just digital services and new technology firms. The Indonesia Security Incident Response Team on Internet Infrastructure recorded more than 207 million cyber attacks in Indonesia between January and October in 2018 (DetikInet, 2018). Recent high-profile examples include the WannaCry ransomware attack in May 2017 where hackers encrypted data and demanded ransoms from victims all round the world including several hospitals in Indonesia. Digital security incidents can have far-reaching economic consequences for investors in terms of disruption of operations (e.g. through inability to provide services or sabotage), direct financial loss, litigation costs, reputational damage, loss of competitiveness (e.g. in case of theft of trade secrets) and loss of trust among customers, employees, shareholders and partners. These concerns are amplified for digital and new technology firms. While investors must develop their own risk management and data integrity strategies, governments are increasingly being called upon to support investor efforts in this area with institutions to monitor and protect against cyber threats (OECD, 2012, 2015, 2018a).

The government has taken significant strides towards making cybersecurity a national policy priority. It established a National Cybersecurity Agency (BSSN) in 2017 under Presidential Regulation 53/2017 (amended by Presidential Regulation 133/2017). BSSN manages national, regional and international co-operation in cyber security affairs. It is also responsible for financing and overseeing the activities of the Security Incident Response Team on Internet Infrastructure, which was initially established in 2010 under a regulation issued by the Minister of Communication and Information Technology (16/PER/M.KOMINFO/10/2010). This team carries out a range of enforcement activities including monitoring and early detection of cybercrime incidents, responding to reports of cybercrimes by consumers and monitoring evidence of internet transactions. Security for classified government information is overseen by the National Encryption Agency (Lembaga Sandi Negara), whose functions will soon be transferred to the BSSN when it becomes fully operational. Separate cybercrime units also exist within the Ministry of Defence, national police and national armed forces to support specific operations. The government is also participating in several bilateral and multilateral co-operation efforts in this area including with ASEAN partners, the UN Open-Ended Working Group on Developments in the Field of Information and Telecommunications in the Context of International Security and bilateral dialogues on cybersecurity issues with Australia and Russia in 2017.

To date, however, there is still no overarching regulatory framework to co-ordinate these *ad hoc* initiatives. An existing law on Electronic Information and Transactions (Law 11/2008, amended by Law 19/2016) and a government regulation on the Organisation of Electronic Systems and Transactions (Regulation 71/2019) currently do not address cyber security issues. BSSN is leading efforts to complete a revised draft of a proposed Law on Cyber Security and Resilience by the end of 2020. The government included this project in the National Priority Legislation Program for 2020. The House of Representatives has considered earlier drafts of this law on several occasions since 2014. Ongoing revisions will reflect these discussions and comments received during public stakeholder consultations. Some stakeholders have suggested that further clarity is needed on the proposed functions and co-ordination between interagency institutions and safeguards to ensure respect for human rights, as well as a roadmap to building adequate institutional capacity and private sector engagement to implement the law effectively. BSSN is also preparing a draft presidential regulation on the protection of national critical information infrastructure and regulations affecting security audit powers and requirements for information security management systems that will apply to companies operating in Indonesia.

Progress in relation to personal data privacy regulation has been slower. Several existing laws and regulations address specific data protection issues for the financial, health and telecommunications sectors.[4] But unlike over 120 countries around the world, including within ASEAN, Indonesia has not yet adopted comprehensive data protection and privacy laws. Such protections are becoming increasingly essential for protecting both personal and non-personal data and improving trust for consumers and investors. The government submitted a draft law to parliament in January 2020 but its progress has been hampered by the disruptions caused by the COVID-19 pandemic. The draft law is based primarily on the European Union’s General Data Protection Regulation.

Investors will no doubt follow with great interest the passage and eventual implementation of these proposed new laws, as well as provisions under the Omnibus Law on Job Creation to provide further clarity on technology transfer obligations for investors. The government should continue to prioritise these efforts and learn from recent good practices around the world to maximise the impact of these laws during the implementation phase. It should continue to engage transparently and actively with stakeholders from the private sector regarding the impacts for investors under the proposed laws. Establishing legal frameworks for cybersecurity and privacy is an essential first step but the government should also account for considerable, additional work once the laws are in place to raise awareness among the private sector and users alike and nurture effective mechanisms in practice to deal with security and data breaches. All of these efforts should be tackled with a view to increasing economic and social prosperity and not simply for furthering criminal or national security-related aspects.

Recent trade and investment treaties are another means by which the government is seeking to strengthen coherence on domestic laws affecting investors in this area. Indonesia's new trade and investment treaty with Australia, which entered into force in July 2020, is a good example.[5] It includes provisions that require the treaty parties to remove data localisation barriers, prohibit forced technology transfers, establish adequate domestic safeguards for data privacy and/or enforce online consumer protections; other provisions create general exceptions for non-discriminatory regulation in this area or exclude it from ISDS. It also expressly recognises the importance of "building and maintaining the capabilities of their national entities responsible for computer security incident response, including through exchange of best practices; and using existing collaboration mechanisms to co-operate to identify and mitigate malicious intrusions or dissemination of malicious code that affect the electronic networks of the Parties" (Article 13.3). Recent trade and investment agreements concluded by other countries require the treaty parties to take into account international guidelines and standards when developing their national laws such as the OECD Recommendation concerning Guidelines governing the Protection of Privacy and Transborder Flows of Personal Data (2013) and the OECD Recommendation on Digital Security Risk Management for Economic and Social Prosperity (2015).

Ongoing efforts to tackle corruption, reduce bureaucracy and improve the regulatory framework for investors

Corruption has been a long-standing concern for investors in Indonesia. Although it is more than two decades since the end of the New Order regime, which was associated with rampant corruption at the top levels of government, Indonesia still suffers from a negative international image in terms of corruption. Recent high-profile cases include criminal convictions in the United States, the United Kingdom and France relating to bribes paid to Indonesian government officials by a multinational telecommunications company, a multinational airline manufacturer and a consortium of foreign investors seeking to secure a multi-million dollar contract to develop a power plant project (US Department of Justice, 2020, 2019; UK Serious Fraud Office, 2020). Indonesian authorities have also prosecuted a range of charges in recent years against government officials who allegedly accepted bribes or kickbacks for granting permits or contracts to investors and, in some cases, judges who accepted bribes to fix court rulings. If prosecution efforts are unable to keep pace with the extent of the offences, however, firms that refuse to make such payments can be placed at a competitive disadvantage when compared to firms in the same field that engage in such practices.

International indicators in this area attest to the problem. Indonesia ranked 85th out of 198 countries surveyed for the perceived levels of public sector corruption in Transparency International's 2019 Corruption Perceptions Index. Transparency International Indonesia, the national chapter of the international anti-corruption civil society organisation Transparency International, conducts the annual survey upon which Indonesia's assessment in the Index is based. The Index is one of the official key indicators for the Long-Term 2012-25 National Strategy on Prevention and Eradication Corruption, and has therefore become one of the most important governance indicators used by policy makers and the private sector in Indonesia to inform their decisions. Transparency International reports that nearly 700 out of 1000 Indonesian nationals that took part in a 2016 survey said they thought that the level of corruption had worsened in the last 12 months (Transparency International, 2017). Aside from the Index, Indonesia ranks 77th out of 141 countries for corruption indicators in WEF's 2019 Global Competitiveness Report. Foreign investors also routinely cite corruption among their top problems in others surveys about doing business in Indonesia (US Department of State, 2020; AustCham, 2020; EuroCham, 2019b; Overseas Development Institute, 2016).

The first *OECD Investment Policy Review* (2010) noted that the government had made fighting corruption a top priority. The government's Long-Term National Development Plan (2005-2025) (Law No. 17 of 2007) identifies "abuse of power in the form of corruption, collusion, and nepotism" as among the key challenges for reforming the government bureaucracy. The first *Review* addressed in detail the policies, laws and institutions that the government had established by 2010 to promote integrity within government, investigate and prosecute corruption offences, raise public awareness and assess continuously the impact of anti-corruption strategies. These efforts have led to significant progress. Transparency International reports that 64% of Indonesian national that took part in a 206 survey considered that the government was doing well in terms of fighting corruption (Transparency International, 2017). Public optimism may be due to the government's promotion of open government practices, improvement of institutional co-ordination for corruption prevention and empowerment of ombudspersons to investigate corruption, including at the subnational level.

Recent developments are also encouraging. The National Strategy of Corruption Prevention & Eradication Long-Term (2012-2025) provides a solid multi-stakeholder framework for monitoring and advancing integrity in government and society. It recognises that corruption is an important component of building the enabling environment for quality investment and responsible business conduct (see Chapter 5 on responsible business conduct). The Corruption Eradication Commission (KPK) plays a major role in building public awareness and confidence by steadfastly pursuing graft cases despite political backlashes. Many observers see KPK as a model of good practice by many countries, in particular because it does not shy away from difficult or sensitive cases (OECD, 2015b). The work of the KPK and the national anti-corruption courts has brought to light many high-profile cases, and they boast an impressive conviction rate – between 2003 and 2018, the KPK prosecuted and achieved a 100-percent conviction rate in 86 cases of bribery and graft related to government procurements and budgets. Presidential Regulation Nos. 13 and 54 of 2018 adopted the 2019-2020 Corruption Prevention Action Plan (which focuses on three areas – licenses, state finances and law enforcement reform) and introduced requirements for Indonesian companies in certain sectors to report beneficial ownership information as part of efforts to fight corruption and tax evasion. This information will be published in an electronic database accessible to the public by the end of 2020, which is hoped will improve transparency and encourage further policy input from civil society organisations and other stakeholders. This initiative is in line with the G20 Anti-Corruption Open Data Principles adopted in 2015.

The challenge for the government is to sustain momentum for building a culture of integrity in the public sector and throughout all levels of society. The National Strategy of Corruption Prevention & Eradication Long-Term (2012-2025) acknowledges that "[c]orruption is still massive and systematic". Unseating corrupt schemes and changing deep-rooted attitudes may involve taking brave stances against incumbent elites in public and private spheres, which can be a tricky and incremental process. In this context, the government should continue to allocate sufficient resources to the KPK and vigorously defend its independence. However, a new law passed in October 2019 (Law No. 19 of 2019) raises serious concerns about KPK's future (also discussed in Chapter 5 on responsible business conduct). Among other things, the new law creates a government committee to oversee KPK's activities, revokes KPK's authority to carry out independent audio surveillance of suspects, allows the government to place civil servants within KPK's staff and requires KPK to discontinue investigations and prosecutions that have lapsed for more than two years. It remains to be seen whether these changes will affect the KPK's effectiveness but investors are no doubt following these developments closely as a marker of the government's commitment to eradicate corruption. Aside from the KPK, the government should consider reinforcing funding and capacity needed for other anti-corruption institutions like the national police and Attorney General's Office that do not have the same resources or track-record as the KPK.

The government should also continue to engage with international partners, local businesses and civil society organisations in all aspects of the anti-corruption policy cycle (agenda setting, policy development, monitoring and evaluation). Indonesia ratified the UN Convention against Corruption in September 2006. The government attends some meetings of the OECD Anti-Corruption Working Group but it has not yet acceded to the OECD Anti-Bribery Convention. It also has not introduced criminal sanctions for bribery in international business and corporate liability for corruption offences as a signatory to UNCAC and a G20 member. Some action has been taken in line with the G20 Anti-Corruption Open Data Principles but more is needed, especially in terms of accessible datasets for lobbying registers, government spending, political financing, voting records and land registers. Government policy makers and the KPK should also continue to seek input from civil society organisations such as Transparency International Indonesia and Indonesia Corruption Watch throughout the policy cycle but perhaps most importantly in corruption investigations and agenda setting for law reforms.

The government has partnered with the OECD to develop recommendations for wider public sector reforms, including in relation to public integrity (Box 3.2. below). As a founding member of the Open Government Partnership (OGP) and a leading member of ASEAN, Indonesia has played a key role in disseminating open government principles and practices. Trust in government by Indonesian citizens is among the highest levels observed in OECD and strategic partner countries (OECD, 2019) but some indicators suggest that corruption and government effectiveness are clearly areas for improvement when compared to other ASEAN countries (OECD, 2016b). Government bureaucracy and unfair business practices are among the most pressing issues for foreign businesses operating in Indonesia (AustCham, 2020). Investors have also expressed concerns regarding inconsistent levels of stakeholder consultation in law making, the costs of bureaucratic red tape due linked to decentralisation of government services and a lack of coordination between central and local governments even after reforms introduced in November 2017 to address this issue (US Department of State, 2019).

The government has pursued a number of initiatives to address these challenges in line with the Presidential Priorities for 2019-2024, National Development Plans, OGP National Action Plan 2018-2020 and the Bureaucratic Reform Roadmap, including:

- establishing a centralised complaint mechanism for all government services, managed by the Ministry of Administrative and Bureaucratic Reform;
- identifying opportunities to reduce unnecessary burdens on business by repealing some government regulations and seeking to simplify others;
- improving coordination among ministries in the policy-making process;
- establishing a public consultation forum for discussion and exchange between public service administrators and civil society organisations;
- launching a web-based business licensing system in July 2018 known as the Online Single Submission (OSS), and periodically updating it, to simplify and expedite applications for business licences and permits;
- expanding e-government services and requiring all levels of government to implement online governance tools (e-budgeting, e-procurement, e-planning) to improve budget efficiency, government transparency, and the provision of public services; and
- various measures to improve access, management and quality of data collected by government ministries and institutions.

Chapter 6 discusses some of these initiatives, including the OSS, in detail and provides recommendations in relation to them. An OECD study published in 2016 on public governance in Indonesia also provides a comprehensive set of recommendations for public sector reforms (Box 4.2). The ongoing challenge will be for the government to ensure that its promising initiatives translate into better public services throughout the country, which may be easier said than done. The scale and complexity of regulatory and licensing reform efforts alone should not be underestimated: the government identified over 3 000 regulations to revoke as part of reforms in 2016 while a further 79 laws and 1194 articles have been identified under the Omnibus Law on Job Creation.

Box 4.2. OECD recommendations to strengthen open government in Indonesia

In order to support ongoing efforts to broaden and deepen the impact of its government reform initiatives, Indonesia requested the OECD conduct an Open Government Review (OG Review) to highlight its achievements in these areas and identify potential improvements. The OG Review, launched in 2016, provides a comprehensive, evidence-based assessment of Indonesia's open government reforms, with a focus on co-ordination, citizen engagement, integrity, digital government, budget transparency and innovation in the public sector.

The key finding of the OG Review was that Indonesia's policy and legal frameworks offer sound support for open government, though challenges remain to ensure that the various ongoing initiatives are implemented completely and effectively. To build a truly transparent and participative public administration, Indonesia will need to continue to promote a greater understanding of the value and importance of open government reforms within the public administration. It will also need to ensure that public officials have the necessary capacity to implement the reforms, both at national and local levels of government. For Indonesia to be successful in these efforts, it will have to rely more on its well-established civil society and encourage the emergence of more non-governmental actors capable of playing a positive role in the country's open government agenda. It must also continue to support the links between its open government reform efforts and other multilateral reform efforts, such as the United Nations Sustainable Development Goals (SDGs), to ensure that the various initiatives are mainstreamed into the country's national development processes.

The OG Review made a wide range of other specific recommendations, including:

- Strengthen the connections across, and mutual reinforcement of, different governance agendas, including the Presidential Priorities; Annual, Medium- and Long-term National Development Plans; OGP Action Plans; and other reform agendas such as the Bureaucratic Reform Roadmap;
- Improve co-ordination horizontally (between the central government and line ministries) and vertically (between central government and decentralised levels of government);
- Develop a more structured and consistent whole-of-government policy to streamline open government and civic engagement, including by clarifying guidelines for citizen participation;
- Continue to involve civil society organisations throughout the anti-corruption policy cycle, explore ways to make corruption reporting mechanisms more effective and improve the legal protections for whistleblowers;
- Recognise data as a strategic asset; develop governance frameworks, infrastructure and institutional capacities to support the strategic use of government data for decision making; and establish a dynamic open government data ecosystem;
- Improve the quality and quantity of data and information accessible for the public throughout the budget cycle; and strengthen public participation in the budget cycle.

- Take a coordinated approach to identifying and tackling the barriers to innovation creation and diffusion in the public sector; and insulate innovation efforts from changes in the policy cycle by, for example, identifying formal structures for ensuring coordination at the central government level.
- Continue to develop the links between open government reform efforts and the design and implementation of the SDGs.

Source: OECD (2016b), "Open Government in Indonesia", OECD Public Governance Reviews, OECD Publishing, Paris, https://doi.org/10.1787/9789264265905-en.

Indonesia's investment treaties

Indonesia is a party to 36 investments treaties that are in force today. These include 26 bilateral investment treaties (BITs), two bilateral trade and investment agreements,[6] six trade and investment agreements in the context of ASEAN and two multilateral investment agreements: the ASEAN Comprehensive Investment Agreement (ACIA) and the Organisation of the Islamic Conference (OIC) Investment Agreement (see summary table in Annex 4.A.).

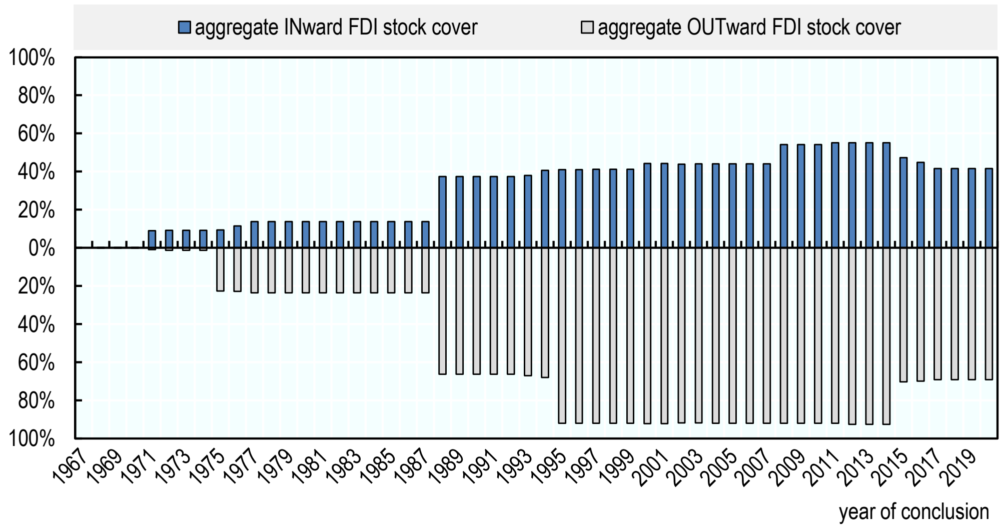
At a regional level, Indonesia is a party to seven investment agreements through its membership of ASEAN. ACIA is the foundational investment instrument that applies between the ASEAN member states. The ASEAN community has also signed six agreements concerning investment with third states (ASEAN+ agreements). ASEAN+ agreements with Australia/New Zealand (2009), Korea (2009), China (2009), India (2014) and Hong Kong, China (2017) all contain investment protections. The Indonesian government has not ratified the ASEAN+ agreements with China, India or Hong Kong (China). These agreements are therefore not currently in force for Indonesia even though they are in force for other treaty partners that have ratified them. An ASEAN+ trade agreement in force with Japan since 2008 did not originally contain investment protections or ISDS but an amending protocol signed in March 2019 adds these elements to the agreement. The amending protocol came into force on 1 August 2020 for Japan, Lao PDR, Myanmar, Singapore, Thailand and Viet Nam but Indonesia has not yet completed the ratification procedures as of October 2020.

At a global level, Indonesia has signed and ratified two important multilateral treaties related to enforcement of arbitral awards, including in ISDS cases under investment treaties – the New York Convention (in 1981) and the Washington Convention (in 1968). Indonesia is also a party to the OIC Investment Agreement (1981), which contains investor protections and provides for ISDS through investor-state arbitration. Investor claimants have invoked the OIC Investment Agreement in at least twelve ISDS disputes since 2011[7] (one of which involved Indonesia as a respondent) despite uncertainties in the agreement's appointing authority mechanism. OIC governments are currently discussing proposals to replace investor-state arbitration under that treaty.

Treaty coverage for Indonesia's inward and outward FDI stock

Indonesia has treaty protection in force for significant portions of its inward FDI stock (41%) and outward FDI stock (69%) (Figure 4.1).[8] FDI trends are discussed in further detail in Chapter 2, but for current purposes it is notable that these portions have fluctuated in recent years as treaties have entered and exited from force. Indonesia's treaty relationship with Singapore under ACIA (2009) covers the vast majority of total outward FDI stock (42%) and the largest portion of total inward FDI stock of any treaty partner (18%). This relationship may soon be covered by two investment treaties, with the Indonesia-Singapore BIT (2018) signed in October 2018 expected to be ratified and come into force in the near future.

Figure 4.1. Approximate evolution of Indonesia's inward and outward FDI stock coverage from investment treaties in force



Note*:* Percentages are based on matching aggregate immediate bilateral FDI data and treaty relationships as of October 2020.
Source: OECD calculations based on OECD investment treaty database. FDI data was taken from the OECD FDI database and IMF Direct Investment Positions reflecting FDI stock as of 2018 rather than historical values.

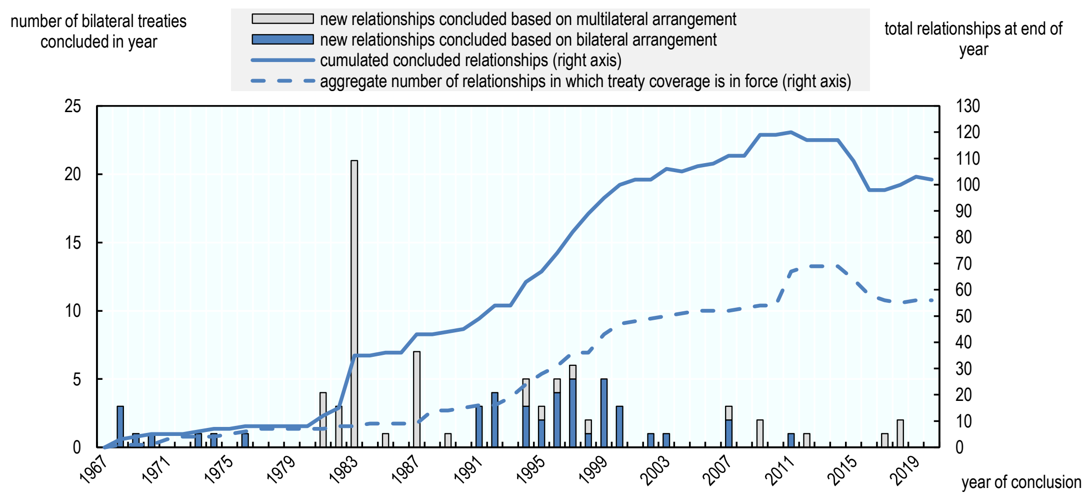
Three other treaty relationships – with Hong Kong (China) Japan, the Netherlands – account for significant portions of Indonesia's inward FDI stock. Many Indonesian investment treaties in force today cover none of Indonesia's FDI stock (inward or outward) or only negligible portions of it. This is a common phenomenon in many countries' treaty samples (Pohl, 2018). Significant inward FDI stock in Indonesia from Bermuda, Canada, Luxembourg, Seychelles and the British Virgin Islands, for example, is not covered by an investment treaty.

Developments since the first OECD Investment Policy Review

In the ten years since the first OECD *Investment Policy Review* (OECD, 2010), Indonesia has signed six new investment agreements: two BITs with Serbia (2011) and Singapore (2018); two ASEAN+ trade and investment agreements with India (2014) and Hong Kong (China) (2017); an investment-related amending protocol to the ASEAN+ agreement with Japan in 2019; and the Australia-Indonesia Comprehensive Economic Partnership Agreement (2019) (AI-CEPA). Only the AI-CEPA has been ratified by the government and entered into force (in July 2020).

In the same ten-year period, the government ratified and brought into force one previously-unratified treaty: the Indonesia-Qatar BIT (2000). Sixteen BITs have been signed but remain unratified and therefore not in force. A timeline of Indonesia's investment treaties appears in Figure 4.2.

Figure 4.2. Evolution of Indonesia's investment treaty relations (signed relationships shown with the dashed line; in-force relationships shown with the dark blue line)



Source: OECD calculations based on OECD investment treaty database.

In March 2014, the Ministry of Foreign Affairs and BKPM began a review of Indonesia's investment treaties. The review was intended "to evaluate the impact of existing IIAs on Indonesia's rights to regulate and pursue legitimate public policy objectives, as well as to modernise IIAs to include principles and provisions that strike a more equitable balance between the objectives of foreign investors and the host state" (Government of Indonesia, 2018). The government indicated publicly at the time that it considered many of Indonesia's existing treaties to be "outdated" and identified concerns regarding the unspecific scope of protections and ISDS (Amianti, 2015). It noted that while "Indonesia has not lost faith in IIAs in general […] [it] intends to modernize and to renegotiate its IIAs with a view to providing greater capacity to regulate in the public interest" (Ministry of Foreign Affairs, 2015). The Minister for Foreign Affairs noted during a press statement in 2015 that her intention was "to create a new regime for investment agreements between Indonesia and other countries" (Minister of Foreign Affairs, 2015). The government consulted widely during the review process, inviting contributions from academics, arbitration lawyers, non-governmental organisations (NGOs), inter-governmental organisations and business groups.

The review process involved three main work streams (Ministry of Foreign Affairs, 2015). A comprehensive assessment of investment protections and ISDS provisions was launched in order to compare the scope and different formulations of these provisions across all of Indonesia's investment treaties. The government established an inter-ministerial taskforce coordinated by BKPM to carry out this work. This taskforce was also responsible for updating Indonesia's model investment treaty to reflect the government's new priorities. As of May 2020, the new model investment treaty is not publicly available. A third line of work involved identifying existing treaties that could be allowed to lapse when they became due to expire under their validity provisions or, alternatively, where treaty partners should be approached regarding termination.

Following this review process, at least 23 Indonesian BITs were terminated between 2014 and 2020 (see summary table in Annex 4.A.). The immediate impact of this development remains somewhat limited. Most of these treaties contain provisions that guarantee the continuing application of protections and other provisions for investors with existing investments for 10 or 15 years after the termination date. Investors with existing investments in Indonesia may therefore still be able to bring ISDS claims against the government under recently terminated treaties until the expiry of the post-termination validity periods even if these treaties will not cover new investments made after the terminations took effect. The main exception is the Argentina-Indonesia BIT (1995), where the treaty partners agreed mutually to terminate the treaty, effective as of 19 October 2016, in such a way that the post-termination validity provisions no longer apply.

The government is currently negotiating or considering some new investment-related agreements. The Ministry of Foreign Affairs and BKPM are responsible for conducting investment treaty negotiations under the supervision of the Coordinating Economic Minister; negotiations regarding trade and investment agreements are undertaken in conjunction with the Ministry of Trade. Negotiations with the European Union regarding a comprehensive economic partnership agreement commenced in 2016. A tenth round of negotiations scheduled for March 2020 was postponed due to the COVID-19 pandemic. Following more than eight years of negotiations, ASEAN member states and five other Asia-Pacific countries (Australia, China, Japan, Korea and New Zealand) concluded the Regional Comprehensive Economic Partnership (RCEP) in November 2020. RCEP includes rules and disciplines on investment, while ISDS provisions are planned for future negotiations. A bilateral trade agreement signed with Chile in 2017 does not contain an investment chapter but the parties agreed to continue negotiations regarding a future possible investment chapter. The government is also assessing the merits of joining the Comprehensive and Progressive Trans-Pacific Partnership Agreement (2018); a detailed gap analysis between Indonesia's existing treaties and the CPTPP was published in 2018 (World Bank, 2018a). The Minister for Foreign Affairs announced in a press statement in January 2020 that the government intends to intensify its economic diplomacy efforts in 2020 (Minister of Foreign Affairs, 2020).

Treaty use: ISDS claims under Indonesia's investment treaties

Indonesia has had several first-hand experiences with defending legal claims by investors brought in formal proceedings under investment treaties. Based on publicly available information, foreign investors have filed at least eight treaty-based claims against Indonesia.[9] The first of these cases was commenced in 2004. The other seven cases were filed in a five-year period between 2011 and 2016. Six claims were filed under BITs and two were filed under multilateral treaties: the 1981 OIC Investment Agreement and the 1987 ASEAN Investment Agreement. Only two of these treaties (the Australia-Indonesia BIT (1992) and the OIC Investment Agreement) are still in force today.

Indonesia's ISDS disputes have primarily concerned investments in the banking, mining, construction and agriculture sectors. Some of the recent disputes involved claims relating to a failed palm oil and oleochemical project, the government's financial bailout of a local bank, the introduction of export restrictions on copper and alleged government interference in coal mining projects.

Aside from treaty-based claims, at least two contract-based claims have been brought against Indonesia relating to investments made in a hotel construction project.[10] As of October 2020, there were no publicly-known treaty-based investment claims brought against Indonesia's treaty partners by Indonesian investors operating abroad.

Indonesia's investment treaty policy

Many of Indonesia's investment treaties still in force today reflect the features often associated with older-style investment treaties concluded in great numbers in the 1990s and early 2000s. Such treaties are generally characterised by a lack of specificity of the meaning of key provisions and extensive protections for covered investors. ACIA, the ASEAN+ investment agreements and some of Indonesia's most recent BITs contain more precise approaches in some areas. However, a significant number of Indonesia's older BITs remain in force alongside these newer agreements despite the government's moves to terminate more 20 such BITs since 2014.

This scenario may expose Indonesia to a range of unintended consequences, especially given the potential scope for ISDS claims under older investment treaties. The balance of this section examines four key aspects of possible reform – the scope of three frequently-invoked protections (FET, MFN and indirect expropriation) as well as dispute settlement mechanisms and ISDS. It then briefly outlines some other possible aspects of investment treaty reform.

Vague provisions referring generally to "fair and equitable treatment" generate serious risks and costs, and should be addressed where possible

All but one of Indonesia's investment treaties currently in force contain provisions that require Indonesia to provide covered investors and their investments with FET.[11] Since the early 2000s, the FET standard has become the most-frequent basis for claims in ISDS. Most FET provisions were agreed before the rise of ISDS claims related to this treatment standard. Starting around 2000, broad theories for the interpretation of FET provisions by arbitral tribunals emerged as the number of ISDS cases increased markedly. While information on some cases remains confidential, investors in at least four of the eight ISDS cases brought against Indonesia are known to have invoked the FET standard.

Most FET provisions in investment treaties do not provide specific guidance on what treatment should be considered fair and equitable. Arbitral tribunals in ISDS cases under investment treaties have taken different approaches to interpreting such "bare" FET provisions. This creates considerable uncertainty and high litigation costs for governments and investors alike. It has also resulted in some broad interpretations of bare FET provisions that go beyond the standards of investor protection in some advanced economies. Governments have reacted to these developments in various ways, including by adopting more precise or restrictive approaches to FET or excluding FET in recent treaties (Box 4.3). Indonesia's varying approaches to FET in its existing treaties can usefully be compared with these recent approaches in broader treaty practice.

Box 4.3. Recent approaches to the FET provision and ISDS for FET claims

States are becoming more active in the ways in which they specify, address or exclude FET-type obligations in their treaties and submissions in ISDS. Dissatisfaction with and uncertainties about FET and its scope have also led some governments to exclude it from their treaties or from the scope of ISDS. Some important recent approaches are outlined below.

The MST-FET approach – express limitation of FET to the minimum standard of treatment under customary international law (MST). This approach has been used in a growing number of recent treaties, especially in treaties involving states from the Americas and Asia (Gaukrodger, 2017). In addition to using MST-FET, the CPTPP clarifies that the claimant must establish any asserted rule of MST-FET by demonstrating widespread state practice and opinio juris (see Article 9.6 (3)-(5), Annex 9A). Evidence of these two components has rarely been provided by claimants or arbitrators in ISDS cases. This approach has since been replicated by other states (e.g., Australia-Indonesia CEPA (2019), Article 14.7). The NAFTA governments have further reformed their approach to MST-FET claims in the USMCA (see below).

The definition approach – stating what FET means or listing its element(s). Recent treaties negotiated by the European Union, China, France and Slovakia contain defined lists for the elements of FET. This approach can vary greatly depending on the nature of the list. Some lists include elements such as a denial of justice, manifest arbitrariness, fundamental breach of due process, targeted discrimination on manifestly wrongful grounds, and/or abusive treatment of investors. This approach likely results in a broader concept of FET than MST-FET, especially if state practice and opinio juris must be demonstrated to establish rules under MST-FET.

Exclusion of FET from ISDS, investment arbitration or from treaties. The recently-concluded USMCA (replacing NAFTA) includes MST-FET but generally excludes it from the scope of ISDS (except for a narrow class of cases involving certain government contracts) (Article 14.D.3). ISDS under the USMCA generally applies only to claims of direct expropriation and post-establishment discrimination (and only to Mexico-United States relations); only state-to-state dispute settlement (SSDS) is available for MST-FET claims. India's Model BIT does not refer to FET and instead identifies specific elements; Brazil's model treaty and recent treaties also exclude FET.

Clarifications of treatment excluded from FET. Some recent treaties have also clarified that FET does not protect investors from certain types of treatment. Starting with the Australia-Singapore free trade agreement (FTA) as revised in 2016, and followed by the CPTPP signed in March 2018 and the Korea-United States FTA as revised in 2018, several treaties now exclude government measures that may be inconsistent with an investor's expectations concerning its investment from giving rise to a breach of the FET provision. Several recent treaties concluded by Australia clarify that the modification of government subsidies or grants is not protected under the FET provision.*

* Australia-Singapore FTA (2003), as amended in 2016, Article 6(5); Australia-Peru FTA (2018), Article 8.6(5); Australia-Uruguay BIT (2019), Article 4(5).

Several Indonesian investment treaties adopt some of these more precise or restrictive approaches to FET. The FET provisions in ACIA and all of the ASEAN+ treaties state that FET requires the treaty partners "not to deny justice in any legal or administrative proceedings in accordance with the principle of due process of law", which is generally understood to be a high standard. All of these treaties except ACIA (2009) and the China-ASEAN Investment Agreement (2009) also expressly limit FET to the customary international law standard for the treatment of aliens and clarify that it does not create additional substantive rights.[12]

Curiously, however, footnotes to the FET provisions in the ASEAN-Australia-New Zealand Free Trade Agreement (2009) (AANZFTA) and the ASEAN-Hong Kong Investment Agreement (2018) exclude these additional clarifications from applying where Indonesia is concerned. Indonesia's most recently-concluded investment treaty – the AI-CEPA (2019) with Australia – is the only Indonesian treaty that refers expressly to MST-FET and clarifies that breaches of an investor's expectations regarding its investment are not covered by the FET provision.

FET provisions in other Indonesian investment treaties may leave scope for broad interpretations by arbitral tribunals. Most of Indonesia's BITs still in force refer to "bare" FET without any further specific guidance on its meaning. Some contain several different references to "bare" FET in the same treaty.[13] The prevalence of "bare" FET provisions and of varying approaches more generally creates uncertainty as to the scope of these FET obligations and exposure to expansive interpretations by arbitral tribunals in ISDS cases. More specific approaches to FET provisions could improve predictability for the government, investors and arbitrators alike. They could also potentially contribute to preserving the government's right to regulate in the context of investment treaties (Gaukrodger, 2017a, 2017b). In some cases, agreement on new treaty language may be required to reflect government intent and preclude undesirable interpretations. In other cases, governments may be able to achieve greater clarity on the scope of FET by agreeing on joint government interpretations of provisions in existing investment treaties with treaty partners.[14]

Most-Favoured Nation treatment provisions in Indonesia's investment treaties may have a range of unintended consequences

Many of Indonesia's investment treaties provide for MFN treatment. Like national treatment provisions, MFN clauses establish a relative standard: they require Indonesia to treat covered investments at least as favourably as it treats comparable investments by investors from third countries. As with its FET provisions, most of the MFN obligations in Indonesia's investment treaties are vague with little guidance on how they are to be interpreted or applied. More specific approaches to MFN provisions could improve predictability for the government, investors and arbitrators alike (Box 4.4).

Box 4.4. Recent approaches to MFN treatment provisions and ISDS for MFN treatment

Recent investment treaty policies and debates over MFN have centred on three key issues outlined below.

MFN clauses and treaty shopping. ISDS arbitral tribunals have frequently interpreted MFN provisions to allow claimants in ISDS cases to engage in "treaty shopping".[15] These interpretations allow claimants to use MFN provisions to "import" provisions from other investment treaties that they consider more favourable than the provision in the treaty under which their case is filed.[16] This can create uncertainty and also dilute the effect of investment treaty reforms. While MFN claims in trade law have centred on domestic law treatment of traders from different countries, most claimant attempts to use MFN in ISDS have sought to use the clause to access other treaty provisions.

Some governments have clarified in recent treaties that MFN provisions cannot be used to engage in treaty shopping at all. Others have limited treaty shopping to the importation of substantive provisions or limited the application of MFN clauses to cases where government measures have been adopted or maintained under the third country treaty. Article 8.7(4) of the Comprehensive Economic and Trade Agreement (CETA) between Canada, the EU and EU Member States, for example, clarifies that "substantive obligations in other international investment treaties do not in themselves constitute 'treatment', and thus cannot give rise to a breach of [the MFN provision], absent measures adopted or maintained by a Party pursuant to those obligations". The CETA also prohibits "treaty shopping" for procedural provisions. The USMCA similarly clarifies that treaty shopping is excluded under its MFN clause for both substantive and procedural matters (Article 14.D.3(1)(a)(i)(A), footnote 22): "For the purposes of this paragraph […] the "treatment" referred to in Article 14.5 (Most-Favoured-Nation Treatment) excludes provisions in other international trade or investment agreements that establish international dispute resolution procedures or impose substantive obligations".

Comparison criteria in MFN treatment provisions. A second area of interest and government action with regard to MFN treatment provisions involves the determination of what investments or investors are comparable. Many older-style treaties do not provide any specificity on this issue, leaving it to arbitral interpretations in ISDS. Some recent treaties provide that comparability requires "like circumstances". Further clarifications have also been added. For example, some recent clarifications have stated that deciding on whether there are "like circumstances" requires, among other things, consideration of whether the relevant treatment distinguishes between investors or investments on the basis of legitimate public welfare objectives.[*]

Negative lists, carve-outs or conditions. A third area of interest and government action with regard to MFN treatment provisions involves exclusions or limitations. Some recent treaties include negative lists of exclusions from MFN clauses in their investment chapters. Thus, a schedule may specify exceptions to MFN treatment for existing benefits granted under customs unions, other international treaties or specific domestic law schemes.

* See, for example, United States-Mexico-Canada Agreement (2018), Article 14.5(4) ("For greater certainty, whether treatment is accorded in 'like circumstances' under this Article depends on the totality of the circumstances, including whether the relevant treatment distinguishes between investors or investments on the basis of legitimate public welfare objectives"); CPTPP (2018), "Note on Interpretation of 'In Like Circumstances'", https://www.mfat.govt.nz/assets/Trans-Pacific-Partnership/Other-documents/Interpretation-of-In-Like-Circumstances.pdf (accessed 28 May 2020).

Indonesia has had first-hand experience of treaty shopping using MFN in at least one ISDS case where an arbitral tribunal allowed the claimant to rely on an MFN provision to import a FET provision into the obligations owed by Indonesia under the OIC Investment Agreement (1981) – the only Indonesian investment treaty that does not contain a FET provision.[17]

Some of Indonesia's investment treaties include specifications or restrictions on MFN provisions that reflect these recent treaty practices and debates. ACIA (2009), the ASEAN-China Investment Agreement (2009), the ASEAN-Hong Kong Investment Agreement (2017) and the IA-CEPA (2019) clarify that MFN treatment does not extend to the ISDS provisions in other investment treaties but only the IA-CEPA (2019) expressly addresses the issue of "imports" of substantive clauses from other treaties rather than leaving the issue to arbitral interpretation. Benefits granted under existing customs, economic or monetary unions, double taxation agreements and multilateral investment agreements are excluded from MFN treatment in most Indonesian investment treaties. The Indonesia-Japan Economic Partnership Agreement (EPA) (2007), the ASEAN-Korea Investment Agreement (2009) and the IA-CEPA (2019) are among the few examples of Indonesian treaties that contain negative lists of sectoral exclusions from MFN treatment for investments. Only a few Indonesian treaties require MFN treatment to be assessed with respect to comparable investments, including the OIC Investment Agreement (1981), the Indonesia-Iran BIT (1994) and the Indonesia-Japan EPA (2007), but they do not clarify how this should be done.

At least four of Indonesian investment treaties do not contain an MFN provision: BITs with Tunisia (1992) and Qatar (2000); AANZFTA (2009); and the ASEAN-India Investment Agreement (2014). Some governments have decided to remove MFN provisions from their investment treaties to avoid unintended interpretations of these clauses by arbitral tribunals in ISDS cases.[18]

Indonesian treaties generally do not clarify the notion of indirect expropriation

All of Indonesia's investment treaties contain provisions that protect covered investments from expropriation without compensation. Many of these provisions refer to direct takings of investor property by the government (direct expropriation) as well as other government measures that have effects equivalent to a direct taking without a formal transfer or outright seizure (widely referred to as indirect expropriation). Provisions on indirect expropriation have become the second most frequently invoked basis for claims in ISDS cases after provisions on FET. As with FET and MFN treatment provisions, most of these provisions in Indonesia's treaties and the global sample of investment treaties are vague with little guidance on how to interpret or apply them.

Some governments have begun to introduce a range of clarifications on the scope of indirect expropriation provisions in investment treaties. The first example of such clarifications in the global treaty sample appears in an Exchange of Letters on Expropriation to the Singapore-United States FTA (2003). Clarifications in treaty practice since 2003 fall into four broad categories.

- **Positive definitions** of the concept of "indirect expropriation" that seek to define the treaty parties' understanding of the scope of this concept.[19]
- **Exclusive definitions** for measures that satisfy two of the four classic criteria of direct expropriation, namely non-discriminatory measures adopted in the pursuit of public welfare objectives. Some government have, for example, clarified that certain regulatory measures do not constitute indirect expropriation.[20]
- **Specifications on how the presence of an indirect expropriation is to be determined**. Some government have clarified the factors that should be considered when assessing whether an indirect expropriation has occurred or not.[21]
- **Restrictive provisions regarding assets covered**. Some governments have limited expressly the types of assets that may be subject to indirect expropriation, which in some cases are different from those that may comprise covered "investments" as defined elsewhere in the treaty.[22]

At least one government excludes indirect expropriation altogether from its investment treaties concluded since 2015 through clear language to that effect. This approach remains marginal as of August 2020, however, and limited to Brazil's treaty practice.

None of Indonesia's BITs in force today clarify the scope of indirect expropriation but clarifications appear in several of Indonesia's trade and investment treaties. ACIA (2009) and four ASEAN+ agreements – with Japan (as amended in 2019); Australia/New Zealand (2009), India (2014) and Hong Kong, China (2017) – contain clarifications in each of the four categories mentioned above.[23] The IA-CEPA (2019) also contains clarifications in each of these areas.

Clarifications such as these are likely to improve predictability as to the scope of indirect expropriation and reduce the possibility for unintended interpretations in ISDS cases. They are also likely to continue to feature in debates regarding the balance between investment protections and governments' rights to regulate in investment treaties, including as part of ongoing discussions in the OECD's Investment Committee in this area. The impact of these clarifications may depend, however, on the scope of other provisions in the same treaty such as FET that have often been invoked in ISDS cases as a substitute basis for indirect expropriation claims. It also remains to be seen how arbitrators interpret such provisions as very few investor-state arbitrations have been brought under treaties that contain these features. Diversity in the language used to express these clarifications across the global treaty sample but also in country-specific treaty samples may also affect the way arbitrators interpret these clarifications. Indonesia's trade and investment agreements, for example, address restrictive provisions regarding assets covered in different ways.[24]

There are relatively few specifications or clarifications for investor-state dispute settlement (ISDS) provisions in Indonesia's investment treaties

Many investment treaties allow covered foreign investors to bring claims against host states in investor-state arbitration, in addition or as an alternative to domestic remedies. Investor-state arbitration currently generally involves *ad hoc* arbitration tribunals that adjudicate disputes in an approach derived from international commercial arbitration. ISDS is included in all of Indonesia's BITs in force today, as well as in the OIC Investment Agreement (1981), ACIA (2009) and all of the ASEAN+ agreements.[25]

Recent treaty practice has seen both greater specification of ISDS and, in some cases, replacement of investor-state arbitration with more court-like systems. Treaties like the CPTPP and the EU-Canada CETA are among some recent treaties that have included investor-state arbitration reforms to reduce possible exposure to unintended consequences of ISDS. Common features in these treaties include time limits for claims, possibilities for summary dismissal of unmeritorious claims, mandatory transparency requirements, provisions for non-disputing party participation and the possibility for joint interpretations of the treaty by the state parties that are binding on the arbitral tribunal. The USMCA contains many similar investor-state arbitration reforms but has reduced the scope for ISDS claims to direct expropriation and post-establishment discrimination (and only to Mexico-United States relations); only state-to-state dispute settlement (SSDS) is available for claims under other provisions, such as MST-FET claims. The European Union, which supports the concept of a multilateral investment court, has included court-like dispute settlement in its all its recent investment protection treaties.[26] Brazil's treaties omit ISDS and designate domestic entities ("National Focal Points") to act as an ombudsperson by evaluating investor grievances and proposing solutions to a Joint Committee comprised of government representatives from both states.[27] Under this model, state-state dispute settlement is also available if necessary. South Africa has terminated its BITs with European countries. Domestic legislation governs the claims of foreign investors against the government in domestic courts and provides for the possibility of case-by-case agreement to arbitration.

Indonesia's bilateral trade and investment agreements with Japan and Australia as well as the three ASEAN treaties in force for Indonesia containing ISDS – ACIA, AANZFTA and the ASEAN-Korea Investment Agreement – include some specifications of ISDS reflecting recent treaty practices that address investor-state arbitration reforms. It is understood that Indonesia's most recent BITs concluded in 2018 with Singapore and the United Arab Emirates will also contain similar features in its ISDS provisions, but this BIT is not yet in force and their texts remain confidential as of September 2020.

By contrast, most of Indonesia's BITs in force today regulate ISDS provisions very lightly. Many of Indonesia's investment treaties therefore give claimants and their counsel substantial power over key procedural issues in addition to allowing them to choose when to claim. For example, in ISDS, the appointing authority in a case plays a key role notably because it chooses or influences the choice of the important chair of the typical three-person tribunal (Gaukrodger, 2018). Following NAFTA, many recent treaties provide for a single appointing authority for all cases. Only one Indonesian investment treaty – the Australia-Indonesia BIT (1992) – removes this choice by providing for a single forum for investor-state arbitration. Many other Indonesian treaties give claimants and their counsel a choice between different arbitration institutions at the time they file a claim. This allows them to choose or influence the choice of appointing authority and exacerbates the competition for cases between arbitration institutions (Gaukrodger, 2018). Even under ACIA, investors may decide whether to submit their dispute to domestic courts or tribunals, four arbitration fora specified in the treaty, "any other regional centre for arbitration in ASEAN" or any other arbitration institution that may be agreed by the disputing parties (Article 33(1)).

Multilateral reform efforts for ISDS are underway in the UNCITRAL Commission's Working Group III. Indonesia's written submissions in this process outline the government's main concerns with ISDS including frivolous claims, the threat of claims causing "regulatory chill", inconsistent arbitral interpretations and the overall credibility of the current system for investor-state arbitration (Government of Indonesia, 2018). The government supports a wide range of reforms including the introduction of safeguards to protect the right to regulate in the public interest, mandatory pre-arbitration mediation, establishing guidelines on how arbitrators should assess damages claims and requiring investors to exhaust local remedies. Other possible reforms under consideration (no decisions have yet been reached) include both structural type reforms (a permanent multilateral investment court with government-selected judges or a permanent appellate tribunal) as well as more incremental reforms such as a code of conduct for arbitrators or adjudicators.

Other possible aspects of investment treaty reform

Clearer specification of investment protection provisions would help to reflect government intent and ensure policy space for government regulation

Specifications on key provisions in investment treaties play an important role calibrating the balance between investor protection and governments' right to regulate. In its recent submissions to UNCITRAL Working Group III and after its treaty review process in 2014-2016, the government expressed its desire to identify "a more balanced approach" to BITs in particular and to modernise its existing investment treaties "to include more safeguards in both substantive and ISDS provisions" (Government of Indonesia, 2018; Ministry of Foreign Affairs, 2015). Specifications should reflect policy choices informed by Indonesia's priorities. Policy-makers need to consider the costs and benefits of these choices and their potential impact on foreign and domestic investors, together with Indonesia's legitimate regulatory interests and potential exposure to ISDS claims and damages.

There are a range of techniques that governments can use to affect the balance between the right to regulate and investor protections under investment treaties (Gaukrodger, 2017a). The most obvious technique involves decisions about whether to include or exclude particular provisions, whether to draft them narrowly or broadly, precisely or in vague terms. The most important provisions in this regard are likely to be those most often the focus of alleged breach in investor claims such as the FET provision.

Depending on whether the parties wish to clarify original intent or revise a provision, it may be possible to clarify language through joint interpretations agreed with treaty partners. If revisions, rather than clarifications of original intent is desired, then treaty amendments may be required. These types of government action have been relatively rare in recent years, however, and can require significant time and resources to engage with individual treaty partners. Replacement of older investment treaties by consent – which appears to be the approach Indonesia has taken in respect of its newest BIT with Singapore – may also be appropriate in some cases.

The government's experiences with the COVID-19 pandemic may cause it to recalibrate the appropriate balance between investor protections and the right to regulate. Measures taken by governments to protect their societies and economies during the pandemic affect companies and investors. Investment treaties should be drafted with sufficient precision to provide flexibility for governments to respond effectively to the crisis and to take vital measures such as securing quick access to essential goods and services. While it may be too early to assess the consequences of the pandemic for investment treaty makers, it is likely that experiences with the crisis may refocus government attention on the balance between investor protection and governments' right to regulate, especially in times of crisis (OECD, 2020). Governments have been addressing the balance between investment protection and the right to regulate in investment treaties through analysis and discussion at the OECD (Gaukrodger, 2017a, 2017b).

Investment treaties can be used as tools to liberalise domestic investment regimes

While liberalisation provisions are common features of international trade agreements, they have been much less common in BITs. They have become more frequent components of investment chapters in broader trade and investment treaties like ACIA, the ASEAN+ treaties and Indonesia's bilateral trade and investment agreements. Investment treaties can be used to liberalise investment policy by facilitating the making or establishment of new investments (Pohl, 2018). This can be achieved by extending the national treatment (NT) and MFN treatment standards to investors seeking to make investments (i.e. the pre-establishment phase of an investment) or by expressly prohibiting measures that block or impede market access.[28]

Two BITs and five trade and investment treaties in force for Indonesia today grant so-called pre-establishment NT or MFN treatment, or both, to investors.[29] The provisions are subject to SSDS, like in trade agreements; only two treaties would allow an investor to bring an ISDS claim.[30] Some of the market access obligations in these five treaties are accompanied by certain exclusions and reservations (Box 4.5). Indonesia may wish to consider whether entering into liberalisation obligations aligns with its policy goals when signing new investment treaties in the future.

Box 4.5. Negative and positive list-approaches to NT and MFN exceptions

When countries grant national and/or most-favoured nation treatment, whether pre- or post-establishment, they typically do so subject to exceptions or reservations adopted under one of two different approaches.

A *negative list-approach* typically provides that MFN and NT are granted subject to specific exceptions or reservations (negative lists) that are often contained in detailed annexes to the treaty. Article 9 of the ASEAN-Korea Investment Agreement, for example, provides that the governments may adopt and maintain measures in certain sectors that do not confirm with the MFN and NT provisions and identify sectors in a Schedule of Reservations for which they wish to reserve full policy space.

A *positive-list approach* involves limiting the application of MFN and NT liberalisation provisions to specific identified sectors (positive lists). Article 3(3) of ACIA is an example of a positive list. Generally, the negative list-approach is seen as more conducive to investment liberalisation particularly over time. New areas of economic activity are not covered by negative lists.

Addressing the unique approach to claims for reflective loss in ISDS

Indonesia should continue to engage in multilateral fora such as at the OECD and UNCITRAL to develop proposals to address the unique approach to claims for shareholders' reflective loss in ISDS. Shareholders incur reflective loss if a company in which they hold shares suffers a loss that results, in turn, in the shareholders suffering a commensurate loss, typically a loss in value of the shares. In contrast to the approach of domestic laws in many countries, many investment treaties have been interpreted to allow ISDS claims by covered shareholders for losses incurred by companies in which they own shares.

Governments have been considering these issues at the OECD since 2013 (OECD, 2016; Gaukrodger, 2014a, 2014b, 2013; Summary of 19th FOI Roundtable, October 2013, pp. 12-19; Summary of 18th FOI Roundtable, March 2013, pp. 4-9). Ongoing discussions at UNCITRAL's Working Group III on ISDS Reform are considering possible reforms to address these issues, which were underlined in a recent UNCITRAL Secretariat note (UNCITRAL, 2019d). At the request of the Working Group, these discussions are being conducted jointly with the OECD. Given that the current approach towards reflective loss in ISDS provides claimants with exceptional benefits and greatly expands the number of actual and potential ISDS cases, however, only government-led reform is likely to address the issues.

Opportunities for investment treaties to address investor responsibilities

The OECD Investment Committee is currently considering how trade and investment treaties can affect business responsibilities including through their impact on policy space for governments, their provisions that buttress domestic law or its enforcement, or their provisions that directly address business by, for example, encouraging observance of responsible business conduct (RBC) standards (Gaukrodger, 2020). Ongoing work will take account of input received during an OECD public consultation on this topic in January-February 2020.

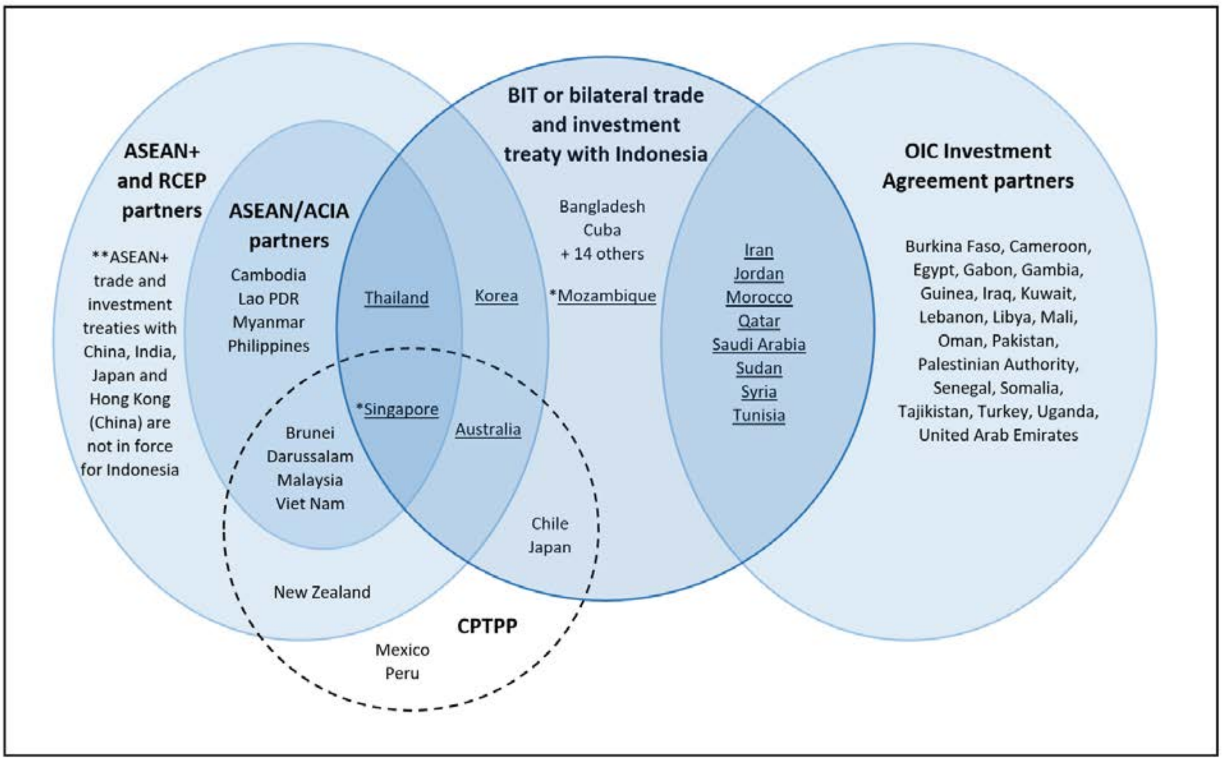
None of Indonesia's BITs in force makes express references to business and human rights or RBC-related objectives but several references appear in its trade and investment treaties. Some of these treaties contain language establishing that non-discriminatory environmental measures taken in order to protect public welfare objectives do not constitute indirect expropriation or language aimed at preserving space for policy-making in areas important to RBC.[31] Others clarify the parties' understanding that it is inappropriate to encourage investment by relaxing environmental or health measures,[32] reaffirm the importance of encouraging companies to respect corporate social responsibility norms,[33] or exclude investments procured by corruption from the scope of ISDS.[34] These provisions vary in terms of scope and level of generality; some are binding on arbitral tribunals in ISDS or SSDS but others may not be. Indonesia's recent trade agreements, including with Chile (2017), contain other provisions regarding inter-governmental cooperation on issues relating to global value chains as well as environmental and labour issues.

Investment treaties concluded by some other governments impose obligations on investors to uphold human rights and maintain an environmental management system;[35] exclude the possibility for ISDS in relation to government measures relating to the treaty's environmental and labour provisions;[36] refer to the parties' commitments to implement international standards related to RBC;[37] and recognise that investments should contribute to the economic development of the host state[38] (Gordon et. al., 2014). Some of Indonesia's treaties also stipulate expressly that only investments made in accordance with host state laws will be protected under the treaty (see, e.g., Denmark-Indonesia BIT (2007), Article 1(1)). Such requirements may incentivise investors to respect domestic law obligations by conditioning access to treaty protections on compliance.

Evaluating overlaps between investment treaties

Indonesia has two or more investment treaties in force with eleven countries – eight of its OIC partners (Iran, Jordan, Morocco, Qatar, Saudi Arabia, Sudan, Syria and Tunisia), two ASEAN+ partners (Australia and Korea) and one ASEAN partner (Thailand). This list may soon include Singapore and Mozambique if the government ratifies new treaties with these partners signed in 2018 and 2019, respectively. ASEAN countries and five ASEAN+ partners are also part of RCEP (see Figure 4.3).

Figure 4.3. Overview of Indonesia's overlapping investment treaty relationships in force today



Note: This figure includes the Parties to the Comprehensive and Progressive Trans-Pacific Partnership Agreement (2018) (CPTPP), which is marked with the dashed line for illustrative purposes only. As of October 2020, Indonesia is not a party to the CPTPP but the government has expressed interest in becoming a party in the future. Underlined text in this figure denotes countries that have two or more investment treaties in force with Indonesia. Only OIC counties that have signed and ratified the OIC Investment Agreement (1981) based on publicly available information are included in this figure.
*If Indonesia ratifies the Indonesia-Singapore BIT (2018) and Indonesia-Mozambique Free Trade Agreement (2019) as expected in the near future.
Source: OECD Secretariat based on OECD investment treaty database.

Overlapping investment treaties that apply to investments by investors from the same country may raise some policy concerns. As a general matter, Indonesia should strive to minimise inefficient inconsistencies between international obligations entered into with different countries. Investors from countries with two or more treaties in force may be able to rely on more favourably-worded provisions in Indonesia's older BITs in their dealings with the government or in ISDS disputes. This approach could also potentially undermine reform efforts in some of Indonesia's newer treaties if investors can circumvent newer, more nuanced investment treaties by relying on older BITs that are still in force.

Any significant differences between Indonesia's BITs, ACIA and the ASEAN+ agreements are also unlikely to contribute to the goals of ASEAN member states in strengthening common rules on investment protection and liberalisation at a regional level. While Indonesia recently terminated older BITs with Cambodia, Lao PDR, Malaysia and Viet Nam, an older BIT with Thailand is still in force concurrently with ACIA and a new BIT concluded with Singapore may soon be in force. Indonesia may wish to engage with these treaty partners to review whether their respective international obligations reflect current priorities.

Depending on whether the parties wish to clarify original intent or revise a provision, it may be possible to clarify language through joint interpretations agreed with treaty partners. If revisions, rather than clarifications of original intent are desired, then treaty amendments may be required. Where new treaties are concluded, some governments have included provisions in new treaties regarding the replacement of older treaties in force between them and transitional arrangements (see, e.g., USMCA, preamble, Annex 14-C, Article 34.1; EU-Canada CETA, Article 30.8, Annex 30-A). Others have exchanged side letters alongside the new treaty to replace or clarify the status of the older treaty (see, e.g. side letters between Indonesia and Australia in February 2020 regarding the replacement of their BIT with the AI-CEPA and side letters between various parties to the CPTPP). Relationship clauses such as Article 1.3 of the IA-CEPA (2019), which envisage consultations between the treaty parties where one of them considers that the new treaty is inconsistent with an existing treaty commitment between them, may help to clarify some issues with overlapping treaties. However, they do not preclude covered investors from relying on provisions in older BITs that remain in force concurrently with newer treaties.

Despite the concerns that may arise with overlapping treaties, some governments may consider that they need to provide certain extra incentives or guarantees to some treaty partners over others in order to attract FDI. This may be because they expect that investors from those countries are less likely to invest their capital in the absence of such treatment or assess that the broader benefits associated with attracting FDI from those countries are particularly lucrative. Some governments may also consider that similar provisions in different treaties, while framed differently, are likely to be interpreted in a consistent way. The balance between these interests and assessments is a delicate one and may evolve over time.

Evaluating overlaps between investment treaties and domestic law

The scope of investor protections and obligations under Indonesia's domestic laws and its investment treaties overlap in some respects. Some overlaps appear to give rise to inconsistencies in approach. The 2007 Investment Law does not contain guarantees of post-establishment non-discrimination and FET that appear in Indonesia's investment treaties. Likewise, the protection from expropriation is narrower under domestic law than under many of Indonesia's investment treaties. In terms of dispute resolution, many of Indonesia's investment treaties provide the government's consent to investor-state arbitration which is not provided under domestic laws. Investment contracts that the government enters into with specific investors could create an additional layer of contractual rights and obligations for specific investors.

Differences between the domestic laws on investor protection and investment treaties may create more favourable legal regimes that apply to some investors and not others based on their nationality. It may also prompt some investors to structure their investments through a company in one of Indonesia's treaty partner countries to seek to benefit from treaty protections and/or treaty-based ISDS if they perceive these to be more favourable than protections and dispute resolution options under domestic laws. The government may therefore wish to conduct a gap analysis between domestic laws on investor protection and investment treaty provisions to consider the implications of any differences and ensure that these different regimes continue to reflect the government's current priorities.

Developing approaches to prevention of ISDS claims and ISDS case management

Indonesia may wish to prioritise the development of strategies for prevention and early settlement of investment-related disputes and its approach to case management of ISDS cases. Whatever approach the government adopts towards international investment agreements, complementary measures can help to ensure that treaties are consistent with domestic priorities and reduce the risk of disputes leading to international arbitration. The government has recently proposed that UNCITRAL's Working Group III should consider reforms relating to mandatory pre-arbitration mediation as a means to prevent investment disputes from escalating into a costly and unnecessary legal dispute (Government of Indonesia, 2018).

Aside from participating in inter-governmental fora on these topics, the government may wish to consider taking certain steps at a domestic level. In terms of dispute prevention, it may be worth exploring options to build awareness within government ministries, agencies and local or sub-national government entities regarding Indonesia's obligations under investment treaties and the potential impact that government decisions may have on investor rights under these treaties. Internal written guidelines or a handbook could be a useful way to disseminate this information and encourage continuity of institutional knowledge as personnel changes occur over time.

Indonesia may also wish to consider drawing on examples of institutional frameworks for the prevention of investment disputes in other countries. At a domestic level, some countries, such as Colombia and Peru, have adopted comprehensive legislative and regulatory frameworks to encourage the early detection and resolution of investment disputes (OECD, 2018b; Joubin-Bret, 2015). Other countries, such as Chile, have opted for an informal prevention system where sectoral agencies directly manage disputes with investors. Some governments have reported successful outcomes with inter-ministerial committees established to advise line agencies on investor grievances, propose strategies for reforming investment treaty policy and domestic legal frameworks for investment protection, and supervise the government's defence of ISDS cases. As noted above, Brazil does not include ISDS in its investment treaties but instead establishes with each treaty partner a Focal Point or ombudsman within each government to address investor grievances, with a Joint Committee of government representatives to oversee the administration of the agreement. Korea has also had a successful track-record of early dispute resolution with its Foreign Investment Ombudsman since it was established in 1999 (Nicolas, Thomsen and Bang, 2013).

The government may also wish to explore ways to share and learn from its experiences with ISDS and those of other governments. Several states that have been frequent respondents in ISDS cases – including Argentina, Spain, the United States, Canada and Mexico – have developed dedicated teams of government lawyers to advise the government on investment disputes and investment treaty policy. Nurturing an internal expertise to evaluate investor claims candidly before a legal dispute arises can be an important step in preventing a protracted and costly legal process.

Procedural considerations: exit and renegotiation

A growing number of countries like Indonesia are considering ways to replace, update or exit older investment treaties that no longer reflect governments' current priorities. Review and renegotiation of investment treaties takes time, however, and the option to terminate a treaty is not necessarily available at any moment, as the relevant provisions on temporal validity in the treaty may place limits on exit options (Box 4.6). The government assessed a number of issues related to temporal validity as part of its review of existing BITs in 2014-2016 (Ministry of Foreign Affairs, 2015).

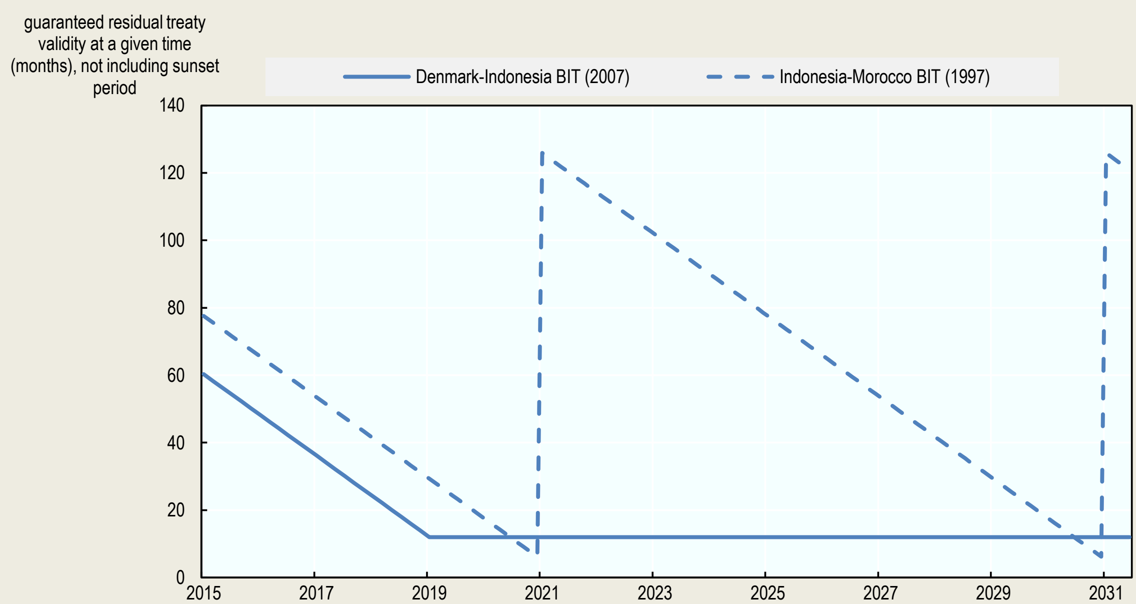
Many Indonesian investment treaties in force today contain temporal validity provisions that will operate to delay possibilities for unilateral exit from the treaty. Most of Indonesia's investment treaties contain an initial validity period of between five and 15 years; eight treaties have no initial validity period. Nineteen of Indonesia's investment treaties in force today provide for an automatic renewal period after the period of initial validity and allow either treaty party to denounce the treaty within 6 or 12 months (depending on the treaty) of the expiry of the renewed period. Treaties that renew for fixed terms require more monitoring, as they limit the possibilities to update or unilaterally end the agreement. If no termination occurs in the defined notice period, the treaty automatically renews for the agreed period, thereby committing Indonesia to these treaties for a further 15 years in some cases before the next opportunity to terminate the treaty will arise.

Box 4.6. Designs of temporal validity provisions in investment treaties

Unlike most international treaties, which can be denounced at relatively short notice, investment treaties typically contain clauses that extend their temporal validity for significant periods of time. Three designs can be found, often cumulatively in the same agreement: First, most investment treaties set and initial validity period of often 10 years or more, counting from the treaty's entry into force; after that period, many treaties only allow states parties to denounce the treaty at the end of specific intervals of often 10 years or more; finally, treaty obligations almost universally continue to apply for a sunset period after the termination of the treaty, again for periods of typically 10 years or more. Many treaties thus bind the states parties for at least two decades, and in some extreme cases for up to 50 years.

Treaty designs that automatically extend the validity of the treaty for fixed terms are included in around 30% of the global treaty stock, but this design is used less frequently in recent times. This design tends to prolong the period for which states parties are bound without granting additional benefits in terms of predictability for investors: on the contrary, the oscillating residual treaty validity is hard to predict without detailed study (see illustrative comparison in the figure below).

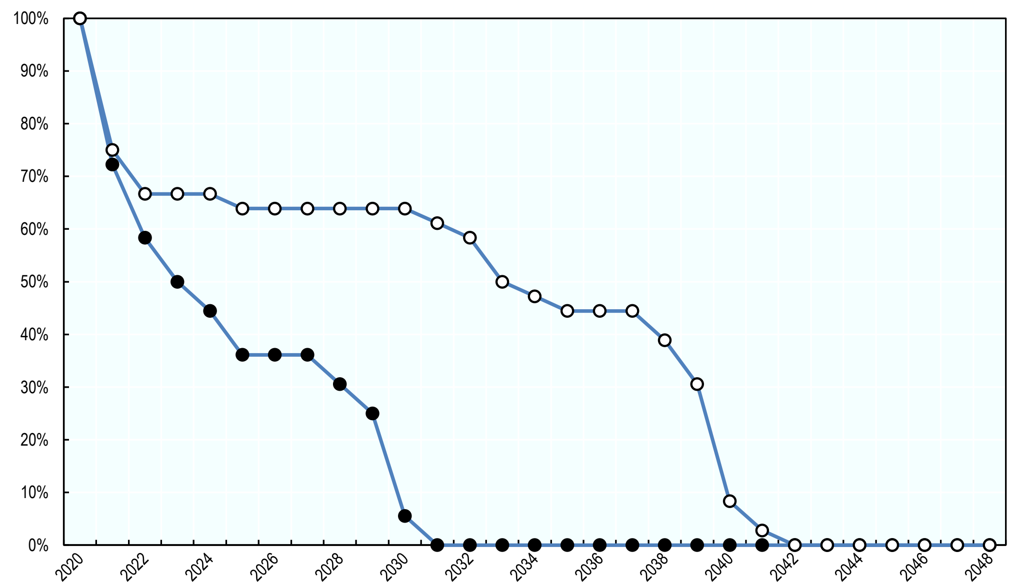
Figure 4.4. Different approaches to residual treaty validity



Note: Adapted from OECD work on temporal validity of investment treaties (Pohl, 2013).
Source: Calculations based on OECD investment treaty database.

Even if Indonesia were to terminate unilaterally some or all of its treaties, almost all will continue to apply for a survival period of at least 10 years or more in the majority of cases. These provisions are often intended to provide a measure of legal certainty for investors who frequently make long-term capital commitments in the host country. This situation may leave the government potentially exposed to ISDS claims for alleged breaches of obligations far beyond the termination date. As a hypothetical example to illustrate the possible effects of these clauses, as of October 2020 the earliest occasion that Indonesia could unilaterally withdraw from all of its investment treaties is 2030 (taking into account the automatic renewal periods in some treaties) and the effects of post-termination sunset periods could last under 2041 even if appropriate actions were started today (Figure 4.5). Treaty partners may be able to agree mutually to replace or exit an older treaty in such a way that the survival provisions no longer apply, as happened for the Argentina-Indonesia BIT (1995).

Figure 4.5. Projection of the temporal validity of Indonesia's investment treaties



Note: Projections based on a hypothetical scenario of unilateral denunciation of all treaties in the available sample at the earliest possible occasion as of October 2020.
Source: Calculations based on OECD investment treaty database.

Unilateral action is not the only option to update or address older investment treaties but the impact of temporal validity provisions may influence how treaty amendments or agreed exits can be negotiated with treaty partners, especially if the renewal period is imminent. Indonesia may therefore wish to consider whether the current design of its temporal validity provisions can serve its interests in discussions with treaty partners. The process of updating Indonesia's model BIT may also be an appropriate place to reassess the government's approach to temporal validity in its investment treaties.

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Annex 4.A. Summary of Indonesia's investment treaties

Annex Table 4.A.1. Bilateral investment treaties – in force

No	Treaty partner	Date of signature	Date of entry into force
1	Bangladesh	09/02/1998	22/04/1999
2	Cuba	19/09/1997	29/09/1999
3	Czech Republic	17/09/1998	21/06/1999
4	Denmark	22/01/2007	15/10/2009
5	Finland	12/09/2006	02/08/2008
6	Iran	22/06/2005	28/03/2009
7	Jordan	12/11/1996	09/02/1999
8	Korea	16/02/1991	10/03/1994
9	Mauritius	05/03/1997	28/03/2000
10	Mongolia	04/03/1997	13/04/1999
11	Morocco	14/03/1997	20/03/2002
12	Mozambique	26/03/1999	25/07/2000
13	Poland	07/10/1992	01/07/1993
14	Qatar	18/04/2000	17/02/2018
15	Russian Federation	06/09/2007	15/10/2009
16	Saudi Arabia	15/09/2003	05/07/2004
17	Sri Lanka	10/06/1996	21/07/1997
18	Sudan	10/02/1998	17/08/2002
19	Sweden	17/09/1992	18/02/1993
20	Syria	27/06/1997	20/02/1999
21	Thailand	17/02/1998	30/10/1998 or 05/11/1988[39]
22	Tunisia	13/05/1992	04/06/1993 or 12/09/1992
23	Turkmenistan	02/06/1994	20/10/1999
24	Ukraine	11/04/1996	22/06/1997
25	Uzbekistan	27/08/1996	27/04/1997
26	Venezuela	18/12/2000	23/03/2003

Annex Table 4.A.2. Bilateral investment treaties – terminated

No	Treaty partner	Date of signature	Date of entry into force	Effective date of termination	Type of termination
1	Argentina	07/11/1995	01/03/2001	19/10/2016	Mutual consent
2	Australia	17/11/1992	29/07/1993	06/08/2020	Replaced by new treaty
3	Belgium	15/01/1970	17/06/1972	16/06/2002	Expired
4	Bulgaria	13/09/2003	23/01/2005	25/01/2015	Unilaterally denounced
5	Cambodia	16/03/1999	21/09/2000	07/01/2016	Unilaterally denounced
6	China	18/11/1994	01/04/1995	31/03/2015	Unilaterally denounced
7	Denmark	30/01/1968	02/07/1968	15/10/2009	Replaced by new treaty
8	Egypt	19/01/1994	29/11/1994	30/11/2014	Unilaterally denounced

No	Treaty partner	Date of signature	Date of entry into force	Effective date of termination	Type of termination
9	Finland	13/03/1996	07/06/1997	02/08/2008	Replaced by new treaty
10	France	14/06/1973	29/04/1975	25/04/2015	Unilaterally denounced
11	Germany	08/11/1968	19/04/1971	02/06/2007	Replaced by new treaty
12	Germany	14/05/2003	02/06/2007	01/06/2017	Unilaterally denounced by Indonesia
13	Hungary	20/05/1992	13/02/1996	12/02/2016	Unilaterally denounced
14	India	08/02/1999	22/01/2004	22/03/2017[40]	Unilaterally denounced
15	Italy	25/04/1991	25/06/1995	23/06/2015	Unilaterally denounced
16	Kyrgyzstan	19/07/1995	23/04/1997	18/02/2018	Unilaterally terminated
17	Lao PDR	18/10/1994	14/10/1995	13/10/2015	Unilaterally denounced
18	Malaysia	22/01/1994	27/10/1999	20/06/2015	Unilaterally denounced
19	Netherlands	07/07/1968	17/07/1971	01/07/1995	Replaced by new treaty
20	Netherlands	06/04/1994	01/07/1995	30/06/2015	Unilaterally denounced
21	Norway	26/11/1969	-	01/10/1994	Replaced by new treaty
22	Norway	26/11/1991	01/10/1994	30/09/2004	Unilaterally denounced
23	Pakistan	08/03/1996	03/12/1996	02/12/2016	Unilaterally denounced
24	Romania[41]	27/06/1997	21/08/1999	07/01/2016	Unilaterally denounced
25	Singapore	28/08/1990	28/08/1990	20/06/2006	Replaced by new treaty
26	Singapore	16/02/2005	21/06/2006	20/06/2016	Unilaterally denounced
27	Slovakia	12/07/1994	01/03/1995	28/02/2015	Unilaterally denounced
28	Spain	30/05/1995	18/12/1996	11/11/2016[42]	Unilaterally denounced
29	Switzerland	06/06/1974	09/04/1976	08/04/2016	Unilaterally denounced
30	Turkey	25/02/1997	28/09/1998	07/01/2016	Unilaterally denounced
31	United Kingdom	27/04/1976	24/03/1977	23/03/2017	Unilaterally denounced
32	Viet Nam	25/10/1991	03/04/1994	07/01/2016	Unilaterally denounced

Annex Table 4.A.3. Bilateral investment treaties – signed but not in force

No	Treaty partner	Date of signature	Date of entry into force
1	Algeria	21/03/2000	-
2	Chile	07/04/1999	-
3	Croatia	10/09/2002	-
4	Democratic People's Republic of Korea	21/02/2000	-
5	Guyana	30/01/2008	-
6	Jamaica	10/02/1999	-
7	Libya	04/04/2009	-
8	Philippines	12/11/2001	-
9	Serbia	06/09/2011	-
10	Singapore	11/10/2018	-
11	Sudan	10/02/1998	-
12	Suriname	28/10/1995	-
13	Tajikistan	28/10/2003	-
14	Turkmenistan	02/06/1994	-
15	Yemen	20/02/1998	-
16	Zimbabwe	08/02/1999	-

Annex Table 4.A.4. Trade agreements containing investment protections, investment liberalisation provisions and/or ISDS

No	Treaty	Date of signature for Indonesia	Date of entry into force	Date of entry into force for Indonesia
1	Regional Comprehensive Economic Partnership	15/11/2020	-	-
2	Indonesia-Mozambique Free Trade Agreement	27/08/2019	-	-
3	Australia-Indonesia Comprehensive Economic Partnership Agreement	04/03/2019	10/02/2020	05/07/2020
4	First Protocol to the ASEAN-Japan Economic Partnership Agreement (including provisions on investment protection)	27/02/2019 (Japan); March and April 2019 (ASEAN members)	01/08/2020	-
5	ASEAN-Hong Kong, China SAR Investment Agreement	18/05/2018	17/06/2019	-
6	Chile-Indonesia Comprehensive Economic Partnership Agreement	15/12/2017	10/08/2019	10/08/2019
7	ASEAN-India Investment Agreement	12/11/2014	01/07/2015	-
8	ASEAN-China Investment Agreement	15/08/2009	01/01/2010	-
9	ASEAN-Korea Investment Agreement	02/06/2009	01/09/2009	20/05/2010
10	ASEAN-Australia-New Zealand Free Trade Agreement	27/02/2009	01/01/2010	08/01/2012
11	ASEAN Comprehensive Investment Agreement	26/02/2009	24/02/2012	24/02/2012
12	ASEAN-Japan Economic Partnership Agreement	28/03/2008	01/12/2008	-
13	Indonesia-Japan Economic Partnership Agreement	20/08/2007	01/07/2008	01/07/2008
14	ASEAN Investment Agreement	15/12/1987	02/08/1988 (terminated and replaced by ACIA on 24/02/2012)	02/08/1988 (terminated and replaced by ACIA on 24/02/2012)
15	Organisation of the Islamic Conference Investment Agreement	01/05/1983 (first signed by other countries on 05/06/1981)	25/02/1988	25/02/1988

Notes

1 See Bank Indonesia Regulation No. 16/21/PBI/2014 on the Implementation of Prudential Principles in Managing Offshore Borrowings by Non-Bank Corporations (Regulation 16/21); Bank Indonesia Regulation No. 16/22/PBI/2014 on the Reports of Foreign Exchange Traffic Activities and the Prudential Principles Implementation Report in Managing Offshore Loan for Non-Bank Corporation (as amended) (Regulation 16/22); Bank Indonesia Circular Letter 17/18/DKEM of 2015 on the Implementation of Prudential Principles in Managing Offshore Borrowings by Non-Bank Corporations; Bank Indonesia Regulation No. 17/3/PBI/2015 on Mandatory Use of Rupiah Within the Territory of the Republic of Indonesia (PBI 17/2015).

2 These treaties include the Berne Convention for the Protection of Literary and Artistic Works (in 1997), the Paris Convention for the Protection of Industrial Property (in 1950), the Patent Cooperation Treaty (in 1997), the Patent Co-operation Treaty (in 1997), the Trademark Law Treaty (in 1994), the WIPO Copyright treaty (in 1996), the WIPO Performances and Phonograms Treaty (in 1996), the Nairobi Treaty on the Protection of the Olympic Symbol (in 1981), the Madrid Protocol Concerning the International Registration

of Marks (in 2017) and the Marrakesh Treaty to Facilitate Access to Published Works for Persons Who are Blind, Visually Impaired or Otherwise Print Disabled (in 2013).

3 The cost dimension of the indicator on contract enforcement refers to average cost of court fees, attorney fees (where the use of attorneys is mandatory or common) and enforcement fees expressed as a percentage of the claim value. The time take to resolve a dispute is counted from the moment the plaintiff decides to file the lawsuit in court until payment, and covers both the days when actions take place and the waiting periods in between. The quality of judicial processes index measures whether each economy has adopted a series of good practices in its court system in four areas: court structure and proceedings, case management, court automation and alternative dispute resolution. For more information on the methodology, please refer to the World Bank's Doing Business website at: https://www.doingbusiness.org/.

4 Financial Services Authority (OJK) Regulation 1/POJK.07/2013, Article 31; Bank Indonesia Regulation 18/40/PBI/2016, Article 25; Law 36/2009 Concerning Health, Article 57; Law 36/1999 Concerning Telecommunications, Article 40.

5 See, for other recent examples, EU-Canada CETA, Articles 13.15(2), 28.3(2); CPTPP, Chapter 14; IA-CEPA, Chapter 13, Article 17.2(3); USMCA, Chapter 19, Article 32.8. The EU's proposals in May 2020 for the modernisation of the Energy Charter Treaty (available at https://trade.ec.europa.eu/doclib/docs/2020/may/tradoc_158754.pdf) include a proposal to exclude non-discriminatory regulation in the area of "privacy and data protection" from the scope of indirect expropriation.

6 Indonesia-Japan Economic Partnership Agreement (2007); Australia-Indonesia Comprehensive Economic Partnership Agreement (2019). A bilateral trade agreement with Chile (2017) does not contain an investment chapter but the parties agreed to continue their negotiations regarding a future possible investment chapter. Similarly, the Indonesia-EFTA Comprehensive Economic Partnership Agreement (2018) and the Indonesia-Pakistan Preferential Trade Agreement (2012) do not contain investment provisions. The text of a trade agreement signed between Indonesia and Mozambique in August 2019 is not publicly available as of May 2020; it is unknown whether this treaty addresses investment issues. Indonesia has signed several other bilateral treaties relating to investment cooperation that do not contain investment protections or ISDS. These include an Economic Partnership Agreement between Indonesia and the EFTA States (2018); various framework agreements, including with the European Economic Community (1980) and several ASEAN+ partners; memoranda of understanding on investment cooperation and/or promotion, including with Australia, Belgium, Brazil, China, Ecuador, Korea, Malaysia, Mongolia, Morocco, Philippines, Poland, Portugal, Qatar, Russia, Saudi Arabia, Turkey, the United Arab Emirates and the United Kingdom; a foreign investment insurance agreement with Canada (1973); and an investment support agreement with the United States (2010).

7 Hashem Al Mehdar (1), Mohamed Al Mehdar (2), Badr Al Mehdar (3) and Betoul Al Mehdar (4) v Egypt (ad hoc, four separate cases filed in 2014); Hesham Talaat M. Al-Warraq v Republic of Indonesia (ad hoc, UNCITRAL, final award rendered in December 2014); Kontinental Conseil Ingénierie v. Gabonese Republic (ad hoc, UNCITRAL, final award rendered in 2017); D.S. Construction FZCO v Libya (ad hoc, UNCITRAL, claim filed in October 2016); Itisaluna Iraq LLC, Munir Sukhtian International Investment LLC, VTEL Holdings Ltd., VTEL Middle East and Africa Limited v Republic of Iraq (ICSID Case No. ARB/17/10, final award rendered in April 2020); Omar Bin Sulaiman v Sultanate of Oman (ad hoc, UNCITRAL, claim filed in 2017); beIN Corporation v Kingdom of Saudia Arabia (ad hoc, UNCITRAL, claim filed in October 2018); Trasta Energy Ltd v Libya (ad hoc, UNCITRAL, claim filed in January 2019); Members of Gargour Family v Libya (ad hoc, tribunal constituted in late 2019); Navodaya Trading DMCC v Gabonese Republic (ad hoc, UNCITRAL, claim filed in 2018); Hilal Hussain Al-Tuwairqi and other v Pakistan (ad hoc, claim filed in 2018, jurisdictional hearing held in 2019).

8 The coverage is assessed based on FDI stock data (2017 or, where 2017 data was unavailable, data of preceding years, giving preference to more recent data, based on data released by OECD and IMF) and investment treaties in force in September 2019. For several reasons, reported FDI stock data is not a valid measure for assets that benefit from treaty protections (Pohl, 2018) and available data does not allow to determine ultimate ownership of assets. The proportions of FDI stock data may nonetheless serve as a rough approximation of stock held by the immediate investing country to illustrate features and outcomes of Indonesia's past investment treaty policies.

9 See Cemex Asia Holdings Ltd. v. Republic of Indonesia (ICSID Case No. ARB/04/3); Rafat Ali Rizvi v. Republic of Indonesia (ICSID Case No. ARB/11/13); Churchill Mining Plc and Planet Mining Pty Ltd., formerly ARB/12/14 v. Republic of Indonesia (ICSID Case No. ARB/12/14 and 12/40); Nusa Tenggara Partnership B.V. and PT Newmont Nusa Tenggara v. Republic of Indonesia (ICSID Case No. ARB/14/15); Oleovest Pte. Ltd. v. Republic of Indonesia (ICSID Case No. ARB/16/26); Hesham Talaat M. Al-Warraq v. The Republic of Indonesia (ad hoc, UNCITRAL); Indian Metals & Ferro Alloys Ltd. v. Republic of Indonesia (PCA Case No. 2015-40). The discussion here refers only to known claims. Under many Indonesian investment treaties, claimants can often select arbitration rules under which claims must remain confidential. Governments also can prefer individual claims to remain confidential. The number of actual ISDS claims against Indonesia may be higher on account of confidential pending cases. While there are no publicly-known ISDS cases involving Indonesian nationals investing abroad, one contract-based arbitration case is known to exist in which the provincial government of East Kalimantan brought unsuccessful claims under the ICSID Convention against Australian and British investors operating a coal mining project through an Indonesian joint venture company: see Government of the Province of East Kalimantan v. PT Kaltim Prima Coal, Rio Tinto plc, B.P. plc, Pacific ReSources Investments Limited, B.P. International Limited, Sangatta Holdings Limited and Kalimantan Coal Limited (ICSID Case No. ARB/07/3), Award on Jurisdiction, 28 December 2009.

10 Amco Asia Corporation and others v. Republic of Indonesia (ICSID Case No. ARB/81/1) (a first case was filed in 1981 followed by a resubmitted case filed in 1987 after the arbitral award in the first case was annulled by an ad hoc ICSID annulment committee in 1986).

11 The OIC Investment Agreement (1981) does not contain a FET provision.

12 Although the text is not publicly available at the time of writing, it is understood that the Indonesia-Singapore BIT (2018) will contain a similar FET provision to these ASEAN+ treaties.

13 For example, Indonesia's BITs with Bangladesh (1998), Cuba (1997), Jordan (1996) and Korea (1991).

14 Gaukrodger, D. (2016) (reviewing the applicable law on joint interpretations of investment treaties without express provisions on the issue); Gordon, K. and Pohl, J. (2015). For a recent example of a joint interpretation, see the Joint Interpretative Declaration between Columbia and India (2018) regarding the Columbia-India BIT (2009).

15 Treaty shopping is a phrase used broadly herein to describe the power for a beneficial owner of an investment to choose between investment treaties or between provisions of different investment treaties. See further detail on treaty shopping below.

16 For a recent discussion of the uncertainty surrounding the interpretation of MFN clauses in ISDS, see Batifort, S. and Benton Heath, J. (2018) "The New Debate on the Interpretation of MFN Clauses in Investment Treaties: Putting the Brakes on Multilateralization", American Journal of International Law, Volume 111, Issue 4 (October 2017), pp. 873-913.

17 Hesham Talaat M. Al-Warraq v Republic of Indonesia (ad hoc, UNCITRAL), Final Award, 15 December 2014, paras 540-555.

18 India omitted MFN from its 2015 model BIT in response to what it considered was an unduly expansive interpretation of an MFN provision by an arbitral tribunal. In the White Industries case, the arbitral tribunal allowed the investor to import an "effective means" clause from a third-party treaty via the MFN clause in the India-Australia BIT with no analysis of how it considered the relevant MFN clause to operate: White Industries Australia Limited v. Republic of India, UNCITRAL, ad hoc, Final Award, 30 November 2011, paras 11.2.1-11.2.9.

19 See, for example, the Australia-Indonesia CEPA (2019), Annex 14-B: Expropriation and Compensation: "2. Article 14.11.1 of this Chapter addresses two situations: (…) 2. the second situation is where an action or series of related actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure."

20 See, for example, the USMCA (2018), Annex 14-B: "(b) Non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations, except in rare circumstances".

21 See, for example, the Canada-EU CETA (2016), Annex 8-A: "2. The determination of whether a measure or series of measures of a Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that takes into consideration, among other factors: (a) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred; (b) the duration of the measure or series of measures of a Party; (c) the extent to which the measure or series of measures interferes with distinct, reasonable investment-backed expectations; and (d) the character of the measure or series of measures, notably their object, context and intent".

22 See, for example, Australia-Indonesia CEPA (2019), Annex 14-B: Expropriation and Compensation: "1. An action or a series of related actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in a covered investment".

23 The ASEAN-Korea Investment Agreement (2009), which has been in force for Indonesia since 2010, does not contain include these clarifications although the parties agreed to conduct further negotiations regarding an additional annex on expropriation and compensation (see Article 27 of the agreement).

24 For example, the first protocol to the ASEAN-Japan EPA (as amended in 2019) and the IA-CEPA (2019) provide that indirect expropriation can only arise where "an action or a series of related actions by a Party … interferes with a tangible or intangible property right or property interest in a covered investment" (emphasis added) while the ASEAN-India Investment Agreement (2014) refers only to interference with a "tangible or intangible property right".

25 The treaty Parties to the ASEAN-Hong Kong (China) Investment Agreement (AHKIA) have not yet agreed on an ISDS mechanism but have scheduled this item for discussion as part of their ongoing Work Programme under the treaty. See AHKIA, Article 20.

26 See EU-Canada CETA (2016); EU-Singapore Investment Protection Agreement (2018); EU-Mexico Agreement (2018); EU-Viet Nam Investment Protection Agreement (2019).

27 See, for example, Brazil-Chile FTA (2018), Article 15; Brazil-Angola BIT (2015), Article 15.

28 See, for example, EU-Canada CETA (2016), Article 8.4; EU-Vietnam FTA (2018), Article 8.4.

29 Finland-Indonesia BIT (2006), Articles 3(1), 3(2); Denmark-Indonesia BIT (2007), Articles 3(1), 3(2); Indonesia-Japan EPA (2007), Articles 58(g), 59, 60; ACIA (2009), Articles 3(3), 5, 6; ASEAN-Korea Investment Agreement (2009), Articles 3, 4; AANZFTA (2009), Chapter 11, Article 4; IA-CEPA (2019), Article 14.5.

30 Japan-Indonesia EPA (2007); IA-CEPA (2019). ACIA, AANZFTA and the ASEAN-Korea Investment Agreement exclude pre-establishment NT and MFN from the scope of the ISDS provisions in those agreements by allowing claims to be brought by investors only in relation to loss or damage suffered "with respect to the management, conduct, operation or sale or other disposition" of a covered investment (c.f. admission or establishment): see ACIA, Article 32(a); ASEAN-Korea Investment Agreement, Article 18(1); AANZFTA, Chapter 11, Article 20(a). Indonesia's BITs with Denmark and Finland arguably exclude pre-establishment claims by limiting the scope of ISDS disputes to those "arising directly from an investment", i.e. the post-establishment phase of an investment.

31 See, for example, AANZFTA (2009); ACIA (2009), Article 17 and Annex 2; ASEAN-Korea Investment Agreement (2009), Article 20; IA-CEPA (2019), Articles 14.6, 14.16 and Annex 14-B.

32 Indonesia-Japan EPA (2007), Article 74.

33 IA-CEPA(2019), Article 14.17.

34 IA-CEPA(2019), Article 14.21.

35 Morocco-Nigeria BIT (2016), Article 18.

36 See, e.g., Belgium/Luxembourg-Colombia BIT (2009), Articles VII(5) and VIII(4).

37 See, e.g., Chile-United States FTA (2003), Article 18.1. The trade agreement between Indonesia and the EFTA states signed in 2018 refers to the UN 2030 Agenda for Sustainable Development.

38 See, e.g. China-Peru FTA (2009), which states in the preamble that the State Parties "RECOGNIZE that this Agreement should be implemented with a view toward raising the standard of living, creating new employment opportunities, reducing poverty and […]".

39 There is a discrepancy between the date listed in the Ministry of Foreign Affair's treaty database (30/10/1998) and the date listed in the treaty database maintained by Thailand's Ministry of Foreign Affairs (05/11/1988).

40 The termination date for the India-Indonesia BIT has been reported as 7 April 2016 in some third-party websites. India's Department of Economic Affairs states that the termination date was 22 March 2017 (https://dea.gov.in/bipa?page=2, accessed on 11 May 2020).

41 The Romania-Indonesia BIT (1997) was amended by an additional protocol signed between the parties in Bucharest on 7 December 2005.

42 Third-party treaty databases list the date of termination for the Indonesia-Spain BIT as either 11 November 2016 or 18 December 2016.

5 Promoting and enabling responsible business conduct

This chapter focuses on how promoting and enabling responsible business conduct in Indonesia as part of COVID-19 recovery measures could lead to far-reaching and strategic successes for promoting a more sound and sustainable investment climate, upgrading in global supply chains, encouraging the private sector contribution to the Sustainable Development Goals, while also protecting Indonesia's resources for the future.

Summary

Promoting and enabling responsible business conduct (RBC) is of central interest to policy-makers wishing to attract and keep investment and ensure that business activity contributes to broader value creation and sustainable development. RBC expectations are prevalent throughout global value chains and refer to the expectation that all businesses – regardless of their legal status, size, ownership structure or sector – avoid and address negative consequences of their operations, while contributing to sustainable development where they operate. RBC is an entry point for any company that wishes to contribute to the Sustainable Development Goals (SDGs) or to achieve specific economic and sustainability outcomes.

The COVID-19 crisis has exposed significant vulnerabilities in company operations in global value chains, including as related to disaster preparedness and supply chain continuity and resilience. Evidence has already shown that companies that are responsible have been better able to respond. An RBC lens can help them make more balanced decisions, while ensuring that further risks to people, planet and society are not created or contribute to further destabilising supply chains down the line.

Indonesia has historically promoted corporate social responsibility (CSR) and was one of the first countries to integrate CSR and corporate philanthropy within the legal framework during the previous decade. Recent efforts have looked to expand more toward RBC, notably in sustainable finance and business and human rights. A notable effort has also been Indonesia's ambition to introduce transparency of beneficial ownership information. RBC-related activities in Indonesia have also been undertaken by the private sector and civil society.

These activities are positive and should be encouraged; however, a more strategic and coherent approach to promoting implementation of RBC across sectors by the government may be warranted, particularly in light of the heavy social impact COVID-19 has had on Indonesia's manufacturing sector and the high environmental costs that growth so far has brought. International RBC standards, which address responsibility throughout the whole supply chain, can provide a useful framework for finding solutions to mitigate the worst impacts of COVID-19 in the short term and to help stakeholders avoid making harmful unilateral decisions. In the medium- and long-term, benchmarking sustainability efforts with international RBC standards can lead to more clarity in the market and promote trade and investment.

The *Review* suggests a bold policy direction where RBC can help ensure ongoing industrial strategies are stronger and fit-for-purpose for today's global economy; reframe the conversation around existing business operations in sectors where risks are high; help re-orient the financial sector toward sustainable finance; give a signal to the market by directing state-owned enterprises (SOEs) on RBC and ensuring future growth does not exacerbate existing challenges; lead by example in key structural sectors like infrastructure; and fighting corruption and promoting integrity.

Main policy recommendations on responsible business conduct

- Promote RBC and communicate clearly to businesses and investors government expectations on RBC in the context of the main national policies such as the 2015-2035 Master Plan of National Industrial Development and the efforts to promote the SDGs (in particular the follow up efforts to the 2019 Voluntary National Review and actions by the National Coordination Team for SDGs Implementation).
- Promote broad dissemination and implementation of the practical RBC tools and instruments, such as the OECD due diligence guidances which are designed to support businesses. Support and facilitate collaborative industry and stakeholder initiatives on RBC.
- Integrate explicit references to and expectations on RBC due diligence in *Making Indonesia 4.0* strategy (including as related to the implementation of sectoral objectives) and promote industry

alignment with global practice through the cross-sectoral national initiative to improve sustainability standards.

- Ensure that the implementing regulations for the Omnibus Law on Job Creation include due consideration of environmental and social impacts of business operations and that streamlining of administrative procedures does not come at the expense of labour and environmental protection and an inclusive and sustainable development pathway. Consider making RBC due diligence a standard operating procedure in this context. Broad consultations with a wide range of stakeholders and at national and regional levels, including trade unions, civil society, affected stakeholders, and academia in addition to the business community, should be early, systemic, meaningful, and transparent.
- Prioritise action on RBC in key sectors, notably agriculture, mining and garment and footwear sectors. Consider undertaking an alignment assessment of the Indonesian Sustainable Palm Oil standard with the *OECD-FAO Guidance for Responsible Agricultural Supply Chains.*
- Accelerate efforts to promote environmental, social and governance (ESG) considerations and RBC in the financial sector in line with international standards. Assess in particular the extent of barriers for integrating these factors in the market, notably when it comes to long-termism and quality of reporting and rating frameworks.
- Pursue the development of the *National Action Plan on Business and Human Rights* in line with international best practice and with inter-ministerial involvement and consultation. Ensure that the scope of the plan is broad enough to capture the most relevant RBC-related issues. Ensure that the process supports a wide consultation with stakeholders.
- Direct SOEs to establish and undertake RBC due diligence, publicly disclose these expectations and establish mechanisms for follow-up.
- Lead by example and ensure integration of RBC in the high-profile Indo-Pacific Infrastructure and Connectivity strategic objectives. RBC due diligence should be a baseline and entry point for businesses wishing to participate in these efforts.
- Strengthen implementation of the UN Convention against Corruption and closer alignment with the OECD Convention on combating Bribery of Foreign Public Officials in International Business Transactions by criminalising bribery of foreign public officials and enacting corporate liability for corruption offences.

Scope and importance of responsible business conduct

Promoting and enabling RBC is of central interest to policy-makers wishing to attract and keep quality investment and ensure that business activity in their economies contributes to broader value creation and sustainable development. RBC expectations are prevalent throughout global value chains and increasingly in international trade and investment agreements and national development strategies, laws, and regulations. They are also affirmed in the main international instruments on RBC – notably the OECD *Guidelines for Multinational Enterprises* (OECD *Guidelines*), the UN *Guiding Principles on Business and Human Rights* (UN *Guiding Principles*), and the ILO *Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy* – which align and complement each other (see OECD/OHCHR/ILO, 2019).

RBC centres around an expectation that all businesses – regardless of their legal status, size, ownership structure or sector – avoid and address negative consequences of their operations, while contributing to sustainable development where they operate. This means integrating and considering environmental and social issues within core business activities, including throughout the supply chain and business relationships. A key element of RBC is risk-based due diligence – a process through which businesses identify, prevent and mitigate their actual and potential negative impacts and account for how those impacts are addressed. Many businesses also find that responsible business is good business, beyond ensuring respect for human rights and compliance with relevant laws and regulations. Understanding, addressing, and avoiding risks material to business operations in a more comprehensive way – that is, beyond financial risks – can often lead to a competitive advantage.

The term corporate social responsibility (CSR) has historically been used to describe business interactions with society. Over the last years, CSR is increasingly being used alongside RBC and business and human rights, i.e. highlighting that environmental and social issues are not an add-on, but rather a core issue, to business operations. These concepts should not be understood to be equivalent to philanthropy.

From risk to resilience: RBC and COVID-19

The COVID-19 crisis has caused a major disruption to global supply chains and exposed significant vulnerabilities in company operations, including related to disaster preparedness and supply chain continuity and resilience. In addition to the health impact, entire supply chains have come to a halt and placed millions of companies and workers at economic risk (OECD, 2020a). The crisis has also increased vulnerability of already vulnerable populations such as migrant workers (IOM, 2020).

RBC standards and tools can help governments and companies make decisions that balance environmental, social and governance issues in the crisis, while ensuring that such responses do not create further risks to people, planet and society – or contribute to further destabilising supply chains down the line (e.g. resurgence of forced or child labour in certain strategic sectors). COVID-19 recovery plans will place governments in a particularly strategic position to steer the economy toward long-term value creation (including reduced greenhouse gas emissions, worker skills and benefits and emergency preparedness). Governments should consider in their recovery policies that many companies might not commit of their own accord to an RBC approach in their response to COVID-19, either because of a lack of incentive, capacity, resources or knowledge. This may be especially exacerbated in contexts where awareness of RBC is low. Government support for an RBC approach will be essential for ensuring coherence between their own policies in response to the crisis and their expectations of how businesses should act, including as part of industrial policies. Government should ensure that measures do not exacerbate negative impacts of the crisis, but rather incentivise companies to mitigate any potential harms and maximise the positive impacts of their response.

For businesses, RBC should not be seen as an additional burden in lieu of focusing on business continuity, but rather a strategic orientation that can encourage a more systemic and dynamic crisis response, discourage a ‘go-at-it-alone’ position (Barry, 2020), and bring short and long-term benefits to the company as it designs its crisis response. For example, working out contingency plans with workers and suppliers may make more commercial sense than paying the price of disbanding large segments of a workforce that took years to build and train. Furthermore, information from supply chain due diligence (e.g. on origin of raw materials, and other traceability data) when overlaid with risks related to COVID-19 (such as infection rates, government restrictions and associated disruptions in production or distribution channels) can be used to understand short and medium term vulnerabilities in the supply chain, and support continuity planning to manage disruptions. Notably, it can also contribute to disaster preparedness and resilience overall, which is especially useful considering the risks of disruptions by climate change.

Indonesia has historically promoted social responsibility in business operations

Indonesia was one of the first countries to integrate expectations on corporate social responsibility and corporate philanthropy within its legal framework during the previous decade. CSR was enshrined in several laws in the 2000s, notably in the Company Law in 2007 (40/2007), which made it an obligation for companies operating in the natural resource sector, as well as the Investment Law (25/2007) and the Law on Mineral and Coal Mining (4/2009) (OECD, 2010). Although these efforts may have been limited by implementation challenges and sometimes opposing views about their efficiency, they are an important tradition which has in certain thematic areas continued in recent years and which gives a good basis for continued efforts by the government on RBC.

More recently, in October 2019, the Law and Human Rights Ministry announced that it will explore the development of a National Action Plan on Business and Human Rights (NAP), to focus on plantations, mining and tourism (JP, 2019). This follows earlier efforts in 2017 by the National Commission on Human Rights and the Institute for Policy Research and Advocacy, who submitted recommendations to the government in different areas related to business and human rights (see FIHRRST, 2017) as part of efforts to promote development and launch of the NAP.

The development of the NAP would be an important opportunity to promote more coherence among government agencies at this critical juncture in Indonesia’s development trajectory. Indonesia’s ASEAN neighbours have also been acting in this regard. For example, on 29 October 2019, Thailand became the first country in Asia to adopt a standalone *National Action Plan on Business and Human Rights (2019-2022)*. With this action, Thailand joins the 22 countries which have developed a standalone NAP on RBC or business and human rights, following a recommendation by the UN to do so as part of the state responsibility to disseminate and implement the UN *Guiding Principles*.

Considering Indonesia’s economic landscape, ensuring that the NAP covers the broad range of RBC policy areas would be particularly relevant. The scope of NAPs varies from country to country. Some go beyond the theme of business and human rights by encompassing the environment (for example France and Italy) or RBC more generally and anti-corruption, such as the United States.

Indonesia has also spearheaded other important efforts. Notably, it was an early leader on promoting sustainable finance. Otoritas Jasa Keuangan (OJK), Indonesian financial services authority, launched a Sustainable Finance Roadmap as early as December 2014 when efforts to promote sustainable finance were still growing globally. Financial institutions have a key role to play in driving sustainability through directing financing towards measures to achieve the SDGs and the transition to a low carbon economy. In 2017, OJK set out a new regulation, which came into force in 2019, making it mandatory to submit an annual plan on implementation of sustainable finance as well as a sustainability report. The efforts to engage the financial sector as a whole show an important vision in the country on sustainability that is commendable. The private sector has also supported these efforts. For example, the Indonesia Sustainable Finance Initiative was launched in 2018 and sets out a partnership between WWF Indonesia and eight national banks with accumulative assets reaching up to 46% of total banking assets (WWF, 2018).

In addition, OJK also issued regulation on green bond issuance that enables issuers to offer bonds that meet sustainability criteria and has provided incentives to issuers in this regard (e.g. discounts on registration statement fees for green bond). Additionally, OJK also has coordinated with other agencies/institutions on such an incentive (e.g. Indonesia Stock Exchange provides discounted annual listing fee for green bonds).

Another notable effort by the government has been to promote SDGs. Indonesia has undergone two Voluntary National Reviews (VNR) in 2017 and 2019, which looked at Indonesia's achievements in implementing SDGs, coordinated by Ministry of National Development Planning/National Development Planning Agency and supported by the Ministry of Foreign Affairs and the National Coordination Team for SDGs Implementation. The 2019 VNR summarises efforts by various actors and notes that philanthropy and CSR in the country are growing. It also summarises key challenges in the country that are hindering social progress.

The important role of the private sector in delivering and financing the SDGs as well as in various means of SDG implementation (e.g. public-private partnerships or blended finance) is explicitly recognised by the Agenda 2030 (see UN A/RES/70/1 which calls "upon all businesses to apply their creativity and innovation to solving sustainable development challenges"). A number of SDGs refer to responsible production patterns, inclusive and sustainable economic growth, employment and decent work for all. The Paris Agreement on climate change also underlines the critical role of business in tackling climate change, including through reducing greenhouse gas emissions and improving environmental performance. Implementing RBC principles and standards can help companies operationalise the SDGs and ensure their most significant impacts are prioritised (for more information, see OECD, 2019a).

Notwithstanding the initiatives by the government, RBC-related activities in Indonesia have also been undertaken by the private sector and civil society. Indonesia Business Links (IBL) has been operating since 1999 to promote better business practices in the country and implements a number of RBC-related initiatives. These include important efforts on business integrity, which is implemented at a subnational level in six provinces and will include further guidance on promotion of anti-corruption. IBL has also promoted the green economy concepts, targeting adoption by Bappenas, as well as creating a philanthropy platform for the SDGs. There have also been sector or thematic policy commitments, such as the ILO/IFC Better Work Programme, through which Indonesia aims to improve working conditions and respect of labour rights for workers, and to boost the competitiveness of apparel businesses. Indonesia has also been supporting international initiatives promoting responsibility in business operations (Box 5.1).

Box 5.1. Indonesia's support for sustainability in global economic initiatives

Indonesia has also supported promoting sustainability in the global economic agenda, notably supporting efforts at the G20. The G20 has recognised in several statements the critical role of RBC in investment and global supply chains. Under the 2016 Chinese G20 Presidency, G20 Trade Ministers reinforced their determination to "promote inclusive, robust and sustainable trade and investment growth" and agreed on G20 Guiding Principles for Global Investment Policymaking. The Principles state that "investment policies should promote and facilitate the observance by investors of international best practices and applicable instruments of responsible business conduct and corporate governance" (G20, 2016a). G20 Leaders also acknowledged in their annual Communique "the important role of inclusive business in development" (G20, 2016b). This was followed by further commitments in 2017 under the German Presidency to foster "the implementation of labour, social and environmental standards and human rights in line with internationally recognised frameworks", including the OECD *Guidelines* (G20, 2017a). Indonesia also supported the 2017 G20 Hamburg Climate and Energy Action Plan for Growth, which highlights the need to align financial flows (from both public and private institutions) to promote environmental goals and achieve the objectives of the SDGs. (G20, 2017b).

A similar direction can be seen at the regional level. For example, as a response to increasing demands by businesses, civil society and other stakeholders to take more strategic measures and emphasise company responsibility for economic, social and environmental impacts, references to CSR and key RBC concepts have been included in the ASEAN Economic, Socio-Cultural, and Political Security Community Blueprints 2025 (for more information on regional efforts, see OECD, 2019b).

COVID-19 has placed Indonesia at a critical juncture in its economic and social progress

These activities are positive and should be encouraged; however, a more strategic and coherent approach to promoting implementation of RBC across sectors by the government may be warranted, particularly in light of the heavy social impact COVID-19 has had on Indonesia's manufacturing sector and the high environmental costs that growth so far has brought (see OECD, 2019c). There is a need to better align sector policies with social and environmental sustainability. Alignment with RBC principles and standards in this regard can be both a signal to international investors, as well as a practical tool and a bridge between what the private sector does and what the government's strategic sustainability goals are.

Take Indonesia's manufacturing sector. The garment and footwear industry in particular has reported as of May 2020 that 80% of its workforce (2.1 million workers, mainly women) is not operational (Fairwear, 2020a). Throughout all economic sectors, Ministry of Manpower has reported that job losses since mid-March have been 3 million (Fairwear, 2020a). These immediate and serious consequences for millions of workers have exposed major vulnerabilities in company operations and supply chains, linked to work conditions and lack of resilience across the chain to withstand economic shocks, as well as the failure of employers and governments to ensure garment workers are paid wages that meet their needs. The devastating impact of the crisis on the economy in the short term also raises questions about feasibility of a return to normal following the peak of the pandemic, with the longer term impact on consumer patterns, structure and viability of different business models, investor priorities and environmental and socio-economic impacts on the sector difficult to assess. For example, Indonesian business associations are already projecting that up to 70% of textiles firms may close permanently due to COVID-19 (JP, 2020a). Considering that textile, apparel, and footwear industry in Indonesia is a priority industry in the 2015-2035 Master Plan of National Industrial Development, these effects are serious.

There is an urgent need to strengthen the social safety net to ensure workers livelihoods and protection, and invest in long-term mutually beneficial supply chain partnerships, reduce the environmental impacts of the sector, and develop capacity to prepare for future disruptions. Linked to this, buyers are still not fulfilling their responsibility to ensure their pricing models account for the cost of wages, benefits and investments in decent work, which includes social security as well as respecting rights to freedom of association and collective bargaining. Taking an RBC approach provides the opportunity to learn from this crisis and rebuild the sector based on equitable and more collaborative supply chain relationships and adaptation of business models to withstand future economic and environmental shocks (see Lovell, 2020).

International RBC standards, such as the *OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector*, which address responsibility throughout the whole supply chain, provide a useful framework for finding solutions to mitigate the worst impacts in the short term and to help buyers and suppliers avoid making harmful unilateral decisions. As governments and business plan for the recovery phase, applying an RBC lens can help address these vulnerabilities to create a more resilient value chain, which protects workers and the environment.

Across the global supply chain, businesses and stakeholders have come together to clarify expectations and in some cases already to make commitments. For example, the Sustainable Textile of Asian Region (STAR) Network, a network of Asian manufacturers, has issued a joint statement to lay down expectations of buyers (STAR, 2020). A group of thirteen multi-stakeholder initiatives in the sector also produced a statement laying out joint priorities for the sector (Fairwear, 2020b). A global call to action, which includes a series of priorities and commitments, has been negotiated by the International Organisation of Employers, the International Trade Union Confederation and IndustriALL Global Union, with the International Labour Organization (ILO) as technical partner, and now endorsed by more than 60 companies and organisations (ILO, 2020).

Some of Indonesia's neighbours are also taking a strategic approach to the sector in this regard. For example, Viet Nam has set out a strategy for textiles, garment and footwear which explicitly integrates RBC (benchmarked against international standards) expectations and highlights RBC as a strategic response to implementation of the SDGs and addressing social and environmental risks in the sector.

The crisis has also focused attention on the nexus between business activity and declining biodiversity, degradation of natural resources and the contribution to climate change, which also threaten the future of the supply chain. In the short term, the sector has seen decreased production and transport and a drop in air pollution, but the concerns that restarting of industry could easily make emissions higher than before the crisis are prevalent, especially if factories need to use more polluting fuels because of supply disruption (see Lovell, 2020).

This issue is not only relevant for manufacturing but also on businesses operating in natural resource-based activities, which has already put enormous pressure on Indonesia's ecosystems. Even prior to COVID-19 crisis, annual deforestation was among the world's highest, threatening Indonesia's unique and globally important biodiversity. According to OECD data, 95% of the population was exposed to harmful levels of air pollution (above the WHO guideline value) in 2017. Forest and peat fires have been driving year-to-year variability and pollution peaks across Indonesia and neighbouring Malaysia and Singapore, although efforts to reduce fires have started to bear fruit (see OECD, 2019c)

Better balancing economic, social and environmental objectives in land use has become a government priority, which is important, considering for example that palm oil is Indonesia's major primary agricultural commodity and that Indonesia is also the second-largest rubber producer in the world. Both productivity levels and productivity growth rates are low, however, and both sectors have attracted international attention. While palm oil as a primary cooking oil plays an important role in food security and nutrition, conversion of land use for palm oil production is frequently cited as a driver of deforestation. The palm oil industry is also seen as a major contributor to greenhouse gas emissions, biodiversity loss and air pollution.

The government is aware of the need to improve sustainability of industry. *Making Indonesia 4.0* strategy, which focuses on technology and productivity upgrades in five key manufacturing industries (food and beverages, textiles and garments, automobiles, electronics, and chemicals) includes a cross-sectoral national initiative to improve sustainability standards. It calls on embracing sustainability as a national priority, as well as recognising the need to attract top global firms and investors in order to realise the broader objectives of the strategy (see Chapter 2 for more information on the role of FDI in the strategy). COVID-19 has only underlined how urgent these needs are. Indonesia has also stepped up efforts to clarify land rights and strengthen law enforcement. Moratoriums on use of primary forest and peatland, as well as timber and palm oil certification programmes, help protect valuable ecosystems. Expansion of protected areas and use of payments for ecosystem services offer good potential to complement these efforts (see OECD, 2019c).

However, the recent Omnibus Law on Job Creation may present additional challenges in this regard and should be seen in this context. While the need for regulatory reform of the business environment is well-diagnosed and well-recognised, the Law has drawn criticism from environmental and social groups about its potential effects on the environment and the labour market, including concerns about how environmental permits would be structured as well as the extent of de-regulation affecting working conditions and pay. In addition to non-governmental organisations (NGOs) and trade unions, a group of 36 investors representing approximately USD 4.1 trillion in assets under management called on the government to support the conservation of forests and peatlands; uphold human rights and customary land rights of indigenous peoples; hold proper consultations with environmental and civil society groups and investors on the Law and its implementation; and take a long-term approach to recovery from the pandemic.[1]

Economic development and protection of the environment and workers are not mutually exclusive goals. In a broader COVID-19 context, where FDI has plummeted globally and where significant adverse impacts on inclusive growth are expected, the government should consider that the Omnibus Law on Job Creation

– if the concerns about the environmental and social issues are not taken into account – may have the opposite effect than intended on investment. Furthermore, the long-term effects of COVID-19 on the economy are still to be seen and there is a risk that future shocks could be as severe. Countries with well-functioning social protection programmes and good implementation infrastructure pre-COVID seem to have fared better so far (see World Bank, 2020). There is a direct line between the quality of the social protection net and the resilience of the economy and ability to deal with future shocks.

Benchmarking sustainability efforts with international RBC standards can lead to more clarity in the market and promote trade and investment

Mainstreaming RBC as part of core business could bring significant benefits to addressing climate change risks as well as promoting better community engagement in the context of investments. The below sections focus on key areas where implementation of international RBC principles and standards could make a marked difference in the market.

Integrate explicit references to RBC in key ongoing strategies and efforts

In the context of *Making Indonesia 4.0* and the 2015-2035 Master Plan of National Industrial Development, explicit references to the main international standards on RBC would contribute toward Indonesia's stated goal of becoming one of the largest ten economies by 2030. Evidence from COVID-19 experience is already showing that more resilient production networks can be achieved through better risk management strategies at the firm level, with the emphasis on risk awareness, greater transparency, and agility (OECD, 2020d).

RBC can provide a framework for multiple stakeholders (including buyers, suppliers, foreign investors, NGOs and trade unions) to align on common parameters and to promote collaborative initiatives, which are particularly important when it comes to identifying and addressing complex and systemic risks that cannot be addressed by one actor alone. For example, businesses and stakeholders can pool knowledge on sector risks and solutions in order to make due diligence more efficient for all. This can also facilitate cost sharing and savings. The government should use its convening role in order to assess where the gaps in the industry still exist and where the opportunities would be for its support. Experience from other governments in this regard can be useful.

Furthermore, in the context of the Omnibus Law on Job Creation, the RBC framework could help clarify concrete actions that could be taken to address potential effects on the environment and the labour market. RBC instruments look at a whole-of-supply chain perspective to address the responsibilities of different actors in face of impacts that do not neatly fit within a specific country jurisdiction, sector, or even among business relationships.

Several elements could be considered in this regard. First, while the process of recentralisation of responsibilities is expected to streamline procedures and bring more clarity, it should not be divorced from considerations of how to ensure protection of the people and the planet. As Chapter 7 highlights, Indonesia is still challenged with finding the right balance in the sharing of investment policy responsibilities across different tiers of government. This is a delicate balance, which has broad implications beyond the investment regime. Although the implementing regulations are still to be determined, it will be important to ensure that there is a feedback loop in the context of the new business registration requirements that would allow stakeholders and local authorities to be able to communicate concerns about environmental and social impacts. Additionally, providing further clarity on the provisions that only high-risk investments must be authorised and are subject to an environmental impact study should be prioritised.

Chapter 7 highlights that under the right conditions, local bodies may be better placed to assess land use and environmental risks and that building their capacity is a more sustainable option in the longer-term. At the same time, higher levels of government should have the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors, and a possible race to the bottom in environmental or other sustainability standards. This is particularly relevant considering that availability of complete, comparable and up-to-date information on the quality of the business climate in Indonesian regions is still a challenge.

Many investors are already implementing RBC due diligence and through that process prioritise how to deal with most significant risks and impacts. Indonesia should consider making RBC due diligence a standard operating procedure in the context of the Omnibus Law and the implementing plans.

Reframing the conversation around existing business operations

Beyond forward-looking strategic actions that the government can take on RBC, there is also a need to speed up action to address the negative impacts of existing business operations. Despite attempts by the government to address major sustainability issues, major challenges remain in terms of creating an enabling framework for RBC. Societies can benefit from investment in many ways, but the relationship between the volume of investment and the benefit from that investment is not necessarily linear. More investment does not automatically lead to productivity growth, more competitive local firms or a more inclusive workforce. In certain cases, particularly when there are large-scale negative impacts associated with projects, investment can make host economies worse off. High-profile disputes, frayed industrial relations, and significant environmental issues suggest that the benefits of existing investments are not being maximised in Indonesia.

It would be worthwhile to consider whether introducing RBC due diligence as a standard operating procedure would be warranted in light of Indonesia’s position on the SDGs, its social initiatives, as well its ongoing challenges with addressing environmental impacts.

Experience from the palm oil industry could be interesting in this regard. The industry is key for Indonesia’s sustainable development and inclusive growth and one of the sectors where the government has already been taking steps to promote RBC due to its importance in Indonesia’s trade and investment portfolio. The share of agriculture in the country’s GDP declined from 13.9% in 2010 to 12.8% in 2018 (World Bank, 2018), yet the sector still employed 28.5% of the total population in 2019 (ILO, 2019), with 3.7 million people in the palm oil industry (Noor et al., 2017) and many more indirectly. Indonesia is the world’s largest producer of palm oil, and accounts for 85% of the world’s palm oil production and generates together with Malaysia (UNDP, 2020). Palm oil production continues to grow strongly, with increasing consumption and demand for vegetable oils domestically and globally, including China, India and the EU. Exports of palm oil were worth over USD 16.5 billion in 2018 (United Nations, 2018) and constitute nearly 9% of the country’s total exports, after coal. Given the complexity of the palm oil supply chain, implementation of risk-based due diligence as recommended by the *OECD-FAO Guidance for Responsible Agricultural Supply Chains* can help business address RBC risks.

While palm oil is the most profitable among vegetable oils thanks to its land use efficiency and high yields, a rapid expansion of palm oil production has brought particular attention to RBC risks along its supply chain, including environmental protection and sustainable use of natural resources, human rights, labour rights, food security and nutrition, tenure rights over and access to natural resources, among others. While palm oil as a primary cooking oil plays an important role in food security and nutrition, conversion of land use for palm oil production is frequently cited as a driver of deforestation. The palm oil industry is also seen as a major contributor to greenhouse gas emissions, biodiversity loss and air pollution. In recent years, Amnesty International highlighted the industry-wide systemic issues, such as child labour and forced labour, below minimum wages, poor occupational health and safety (Amnesty International, 2016). The Danish Institute for Human Rights cited lack of access to grievance mechanisms and meaningful stakeholder engagement which should be addressed (The Danish Institute for Human Rights, 2018). Land grabbing in the context of plantation expansions continues to be reported by civil society organisations.

With a view to the industry's sustainable growth, the Indonesian government has introduced a wide range of policies and legislation (Andoko and Zmudczynska, 2019), such as Republic of Indonesia Law 39/2014 concerning Plantations. Ensuring that Indonesia's palm oil production is addressing deforestation and the other RBC risks identified in its supply chain is paramount in all regards, including respecting Indonesian legislation, meeting international standards, alleviating poverty, achieving the Nationally Determined Contributions to the Paris Climate Agreement, and better positioning in global supply chains. The Indonesian Sustainable Palm Oil (ISPO) standard introduced in 2011 by the government is mandatory for any size of oil palm producers – from smallholders to large-scale plantations – operating in Indonesia. It is aligned with existing national regulations and aims to ensure sustainable palm oil production and to reinforce the industry's competitiveness. Large-scale producers were mandated to comply with the ISPO standard by 2014 and 400 oil palm plantation companies were certified by December 2015 while the Ministry of Agriculture has set a target by 2020 for smallholders to be certified (Efeca, 2015). The government should consider whether alignment of the ISPO standard with the recommendations set out in internationally recognised due diligence standards, such as the OECD-FAO *Guidance*, can help suppliers and businesses along the palm oil supply chain communicate expectations on how they are addressing RBC risks. Additionally, the OECD-FAO *Guidance* can be useful for building common understanding among all relevant stakeholders along the global palm oil value chain and the industry's capacity of effective due diligence implementation.

Setting and communicating clear expectations more broadly about what constitutes RBC is key to ensure the sustainability of Indonesia's palm oil industry. Given a proven contribution to the decline of deforestation by 45% within the moratorium area (World Resource Institute, 2019), a moratorium to ban the new clearance of primary forest and peatland for activities such as palm oil plantation was issued by President Joko Widodo in 2018 to further limit deforestation and lower greenhouse gas emissions. It required all levels of governments to forgo issuing any permits for new clearance inside the moratorium area which covers around 66 million hectares of primary forest and peatland (World Economic Forum, 2019). The government could use this important momentum to encourage the industry to come together on due diligence to address broader RBC risks – not limited to deforestation, but also industry-wide challenges and systemic issues. Supporting producers and businesses along the palm oil supply chain to improve their responsible business practices in line with the OECD recommendations on RBC can help foster the industry's continued growth and increase its contribution to achieving the SDGs.

This is also quite important in the context of ensuring future growth does not exacerbate existing conditions. The production of some agricultural commodities leads to soil degradation, water resource depletion and deforestation. The OECD estimates that by 2050 over 40% of the world's population are likely to be living in river basins under severe water stress. Overall water demand is projected to increase by 55%. Surface water quality outside the OECD is expected to deteriorate in the coming decades, through nutrient flows from agriculture and poor wastewater treatment. The consequences will be increased eutrophication, biodiversity loss and disease. Micro-pollutants (medicines, cosmetics, cleaning agents, and biocide residues) are an emerging concern in many countries (OECD, 2012). At the same time, while negative impacts are serious, agriculture can also positively affect the environment, for instance by trapping greenhouse gases within crops and soils, or mitigating flood risks through the adoption of certain farming practices (OECD, 2019d).

Furthermore, this is not just a matter of agriculture. For example, in May 2020, the government amended the 2009 Coal and Mineral Mining Law as part of reforms to improve the investment climate. Some groups have criticised these swift changes as short-sighted and too lax on the environment (Reuters, 2020). The swift speed of the reforms in light of COVID-19 crisis has also been raised as a significant concern by stakeholders. Civil society groups have challenged the Law in the Indonesian courts and have requested that the elaboration of the mining government regulation (PP) be delayed until the judicial review has been completed (JP, 2020c-d).

Accelerate efforts on RBC in the financial sector

As indicated above, Indonesia was an early leader on promoting sustainable finance. OJK efforts are commendable. As Indonesia considers COVID-19 recovery, it will be especially important to accelerate efforts on environmental, social and governance (ESG) and RBC in the financial sector. Risk aversion in the financial markets due to COVID-19 has reached levels not seen since the global financial crisis in 2008. Stock markets have declined over 30% and volatility has spiked to crisis levels (OECD, 2020c). Good news, however, is that early reports already suggest that interest in RBC has significantly increased and that RBC is being seen in the market as a marker for long-term performance of companies. ESG funds have already outperformed traditional funds during the crisis, in line with existing evidence on the business case for RBC.[2]

Increasing interdependence in the Asian financial markets (Box 5.2) can mean that dealing with different legal and regulatory frameworks (including also when it comes to RBC) can be a challenging prospect for financial institutions. Alignment with international practice can also be useful for integrating the sector further in global markets. For example, the recommendations outlined in the OECD paper on *Responsible Business Conduct for Institutional Investors* have been endorsed by leading investment managers[3], pension funds,[4] and recently referenced in an *EU Regulation for Sustainable Disclosure,* which calls on the EU institutional investors and other financial market participants to report on their due diligence processes. The new regulation sets out how financial market participants and financial advisors must integrate ESG risks and opportunities in their processes, including reporting on adherence to internationally recognised standards for due diligence. It calls on financial market participants and advisors to report on due diligence processes “to take into account the due diligence guidance for responsible business conduct developed by the [OECD].” [5]

Box 5.2. Asian financial markets are increasingly integrated

The importance of the financial sector in Asia is significant and increasing. According to the 2019 OECD Equity Market Review of Asia, the average annual amount of equity capital raised by Asian companies increased from USD 46 billion (2000-2008) to USD 67 billion (2009-2018). The opposite trend holds in the United States and Europe, with the respective numbers at USD 78 billion (2000-2008) to USD 51 billion (2009-2018). Additionally, and contrary to the trends in the US and Europe, there is an increasing number of new listings by Asian companies. While these developments are largely due to companies from large Asia markets like China, India, Korea, and Japan, a closer look at the regional IPO activity also reveals that several emerging markets, including in Indonesia, rank higher in terms of IPOs than most advanced economies.

Another finding from the OECD review is that stock markets are increasingly integrated. A growing share of public equity investments are being made across borders, plus companies are also taking advantage of foreign equity markets to raise capital. At the end of 2018, 510 Asian companies were listed on a market other than the domestic market, without having a domestic listing, while 120 Asian companies were cross-listed on the domestic and foreign markets.

Furthermore, a recent report by WWF on sustainable banking in ASEAN showed that most ASEAN banks have not adequately mitigated risks from their clients and may not be aware of the extent of their risk-exposure. It could be useful to consider whether alignment with the *OECD Due Diligence for Responsible Corporate Lending and Securities Underwriting* can be useful in this regard. Published in October 2019, the *Guidance* provides a common global framework for financial institutions to identify, respond to and publicly communicate on environmental and social risks associated with their clients. The report helps banks and other financial institutions implement the due diligence recommendations of the *OECD Guidelines for Multinational Enterprises* in the context of their corporate lending and underwriting activities.

Efforts by OJK and stakeholders should be encouraged and supported as a priority, as well as reinforced among other key financial institutions. Indonesia should assess whether further assessment and removal of barriers in integrating ESG factors in the activities of financial sector practitioners in the Indonesian market is needed (Box 5.3). Indonesian regulators may wish to assess and analyse to what degree the current framework allows for long-termism. A growing body of empirical evidence suggests that investments which take ESG factors into account can add value and lead to higher risk-adjusted returns net of expenses. RBC factors appear to have, at best a positive relationship with corporate financial performance and at worst a neutral relationship (OECD, 2017).

Promoting alignment and being explicit on what RBC due diligence means in practice in line with international principles and standards can further introduce clarity in the market. An additional emerging issue with existing ESG reporting and rating frameworks is ambiguity around the materiality of the data provided. Ensuring that reporting frameworks be explicit about whether they are focused on (only) ESG issues which create a financial risk for the company or actual ESG performance (and whether they report information related to these issues separately) will be critical as well. Indonesia should assess whether this clarification is indeed needed in Indonesia.

Box 5.3. RBC in the financial markets is growing, but practitioners still face barriers to implementation

Investors and other stakeholders have identified various challenges to integrating ESG factors in the activities of financial sector practitioners. Among these challenges are poor understanding of ESG risks and lack of standardised approaches to ESG risk management (see for example State Street Global Advisors, 2018); governance frameworks which are not explicitly compatible with ESG strategies; and lack of quality data and comparative metrics on ESG issues (see Morgan Stanley, 2018).

When it comes to interpretation and design of existing governance frameworks, some investors continue to perceive legal barriers between the responsibility to protect the financial interests of beneficiaries and consideration of ESG factors, even when these do not exist in practice. OECD research has found that this is partially because investment governance regulatory frameworks and risk-based controls generally do not explicitly refer to ESG factors. This gap has meant that investors and other financial institutions have had to interpret for themselves the extent to which responsible investment strategies are possible or permitted (OECD, 2017a).

Another challenge is the tension between ESG objectives (which are viewed as important to long-term value creation) and investment horizons (which seek to maximise shareholder value in the short-term). In a survey by State Street, 47% of asset owners and 43% of asset managers indicated that they believe that the proper timeframe for expecting responsible investment strategies to outperform is five years or more, but only 10%-20% use these time frames for actually evaluating performance. Investment performance is still generally measured and reported on 1, 3 and 5-year horizons (Cappucci, 2017).

Nevertheless, it is possible for regulators to promote long-termism even when taking this context into account. The market, by its nature, is unlikely to deliver such a change. Moving from the current mind-set to a longer-term investment environment requires a new “investment culture”. Further analysis and recommendations on how regulators can promote long-termism by institutional investors are available in OECD brief on Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies (OECD, 2011).

Finally, lack of quality data when it comes to responsible investment strategies and measuring the financial performance of such strategies has also been raised by practitioners as a central challenge, mirroring experience globally. For example, 68% of asset owners surveyed in a Morgan Stanley study noted that a lack of availability of quality ESG data is the leading challenge to responsible investment

(Morgan Stanley, 2018). Many investors currently rely on ESG data providers and raters; however, a lack of agreed sustainability disclosure metrics at an international level has resulted in a high level of subjectivity in ESG scoring that hinders the ability to assess performance and risk. These issues are compounded by issues with quality, comparability and availability of ESG data, and the lack of standardised disclosures on ESG data by ESG data providers and issuers.

Resolving challenges with ESG data will be an ongoing process that requires collaboration across policymakers, investment practitioners, ESG data providers and corporates. Policy makers can further encourage quality data and reporting through mandating reporting against widely used and recognised frameworks, such as those developed by the Task Force on Climate Related Disclosures, Global Reporting Initiative, Sustainability Accounting Standards Board and OECD due diligence reporting recommendations. Establishing classification and benchmarking systems for sustainability factors, e.g. GHG emissions and climate performance, should also be considered. For example, such efforts are underway in the EU as part of the EU Sustainable Finance Action Plan which includes establishing an EU classification system for sustainable activities (Action 1); creating standards and labels for green financial products (Action 2); developing and harmonising sustainability benchmarks related to carbon (Action 5); and strengthening sustainability disclosure and accounting rule-making (Action 9). The EU has recently introduced a taxonomy to reflect commonly agreed principles and metrics for assessing whether economic activities can be considered environmentally sustainable for investment purpose.

An additional emerging issue with existing ESG reporting and rating frameworks is ambiguity around the materiality of the data provided. Currently, a lack of clarity exists on two aspects: how ESG products reflect environmental and social performance and impacts and how financial materiality related to ESG factors is assessed. Ensuring that ratings agencies and reporting frameworks be explicit about whether they are focused on (only) ESG issues which create a financial risk for the company or actual ESG performance (and whether they report information related to these issues separately) will be critical for bring clarity to the market.

Giving a signal to the market by directing SOEs on RBC and ensuring future growth does not exacerbate existing challenges

State-owned enterprises play a strong role in Indonesian economy. The 2015 OECD *Guidelines on Corporate Governance of State-Owned Enterprises* recommend that the state ownership policy fully recognise SOE responsibilities towards stakeholders and request that SOEs report on their relations with stakeholders, as well as making clear any expectations the state has in respect of RBC by SOEs (OECD, 2015: V). The *SOE Guidelines* further recommend, and rely in this regard on the Board of Directors to the executive management, extensive measures to report on foreseeable risks, including in the areas of human rights, labour, the environment, as well as risks related to corruption and taxation. These expectations are in line with the OECD *Guidelines for Multinational Enterprises* (which apply to all entities within the enterprise in all sectors, whether of private, state or mixed ownership) as well as the UN *Guiding Principles on Business and Human Rights*, which apply to all states and all enterprises. UN Guiding Principle 4 stipulates that states “should take additional steps to protect against human rights abuses by business enterprises that are owned or controlled by the State, or that receive substantial support and services from State agencies such as export credit agencies and official investment insurance or guarantee agencies, including, where appropriate, by requiring human rights due diligence” (UN, 2011). A 2016 report by the UN Working Group on Business and Human Rights examined the practices with respect to current RBC and business and human rights practices of SOEs and found that there is a general lack of attention to RBC issues and that policies, guidelines and good practices are lacking at both the international and national levels (UN, 2016).

Considering the importance of SOEs in the Indonesian economy, directing SOEs to explicitly implement RBC due diligence principles would give an important signal to the market.[6] Integrating practices like due diligence for environmental and social risks, improving processes related to stakeholder engagement, and promoting disclosure and transparency, could go a long way in mitigating risks. This would be particularly important in priority sectors such as infrastructure where Indonesia has already set out strategic objectives. SOEs operate in almost all sectors of the economy – ranging from manufacturing and construction to agriculture – but they play a particularly important role in infrastructure, notably transport (OECD, 2018b). Listed SOEs represent almost one-quarter of equity market capitalisation.

Giving a definition and direction to exactly how SOEs are supposed to be responsible (e.g. on RBC due diligence) and aligning with internationally accepted corporate governance and responsible business conduct standards could also help offset and alleviate the concerns about balancing the desire to protect the local economy from foreign investment, on the one hand, and the willingness for the economy to further benefit from foreign direct investment. Additionally, in light of the IDR 44 trillion for the SOE stimulus after COVID-19, RBC can help SOEs maximise their contribution to sustainable development along with the government's stated objectives (see JP, 2020b).

Leading by example to ensure that infrastructure and connectivity efforts are sustainable

Indonesia is expected to host the first Indo-Pacific Infrastructure and Connectivity Forum in 2020. This Forum is a strategic push by the President to present an ASEAN-centric outlook on maritime security, connectivity and sustainable development under a new Indo-Pacific co-operation concept (see Diplomat, 2020). Indonesia could take advantage of these high-profile efforts to lead by example on sustainable development and highlight concrete commitments to promoting responsible business conduct principles and standards, notably RBC due diligence, as a baseline and entry point for businesses wishing to participate in these efforts. Clearly communicating information on the UN Guiding Principles and the OECD Guidelines as well as making RBC a standard operating procedure for infrastructure projects would be beneficial beyond setting a strategic vision.

Social and environmental risks in the infrastructure sector are notable. Globally, construction ranks second only to domestic work for prevalence of forced labour, at 18% and 24% respectively (ILO and Walk Free Foundation, 2017). Transparency International estimates that corruption is a bigger problem in construction than in mining, real estate, energy or the arms market. Furthermore, the environmental and social impacts of concrete – a major input – are well-documented. Among materials, only coal, oil and gas are a greater source of greenhouse gases; and mining of sand, without which concrete cannot be made, is reportedly increasingly controlled by organised crime groups (see The Guardian, 2019). Equally, environmental aspects are significant. For example, the International Transport Forum estimates that CO_2 emissions from transport (e.g. roads, rail, aviation, maritime, freight/logistics) could increase 60% by 2050, despite the significant technological progress already assumed in baseline modelling scenarios (OECD/ITF, 2017).

A 2019 report by the UN Office of the High Commissioner for Human Rights and the Heinrich Boell Foundation surveyed human rights risks and opportunities in the energy, transport and water sectors at the macro-, meso- and project levels and published the results in a joint report entitled *The Other Infrastructure Gap: Sustainability: Human Rights and Environmental Dimensions*. The research showed that large infrastructure projects have been associated with serious and sometimes irreparable harm to people and the environment. In many cases, human rights risks were ignored or downplayed in the project risk calculus, and were repeated in future projects. OHCHR has cautioned that without explicitly and systematically acknowledging and addressing human rights in infrastructure policy frameworks and practices, at best the enormous potential of infrastructure as a facilitator for the SDGs will not be realised, and at worst infrastructure development will actually undermine the SDGs. One of the main recommendations of the report was that those implementing and financing large infrastructure projects carry out explicit due diligence on human rights (see UN OHCHR-hbs, 2019).

Fighting corruption and promoting business integrity

Another area of particular relevance is Indonesia's ongoing fight against corruption, which despite significant efforts since early 2000s, remains a massive endeavour (see also Chapter 4). Indonesia ranked 85th out of 180 countries on Transparency International's Corruption Perception Index in 2019, gradually improving its position from 137th in 2005, 110th in 2010 and 88th in 2015.

Tackling corruption is another important component of building the enabling environment for quality investment and RBC. The OECD RBC instruments emphasise that bribery and corruption discourage investment and distort international competitive conditions. In particular, the diversion of funds through corrupt practices undermines attempts by citizens to achieve higher levels of economic, social and environmental welfare and impedes efforts to reduce poverty. Both businesses and governments have a role to play in addressing corruption. For example, RBC standards specify that enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage, and should also resist solicitation of bribes and extortion. Governments also have a responsibility to ensure that a legal and regulatory framework is in place and enforced to deter corruption. They can also lead by example by observing the highest integrity standards in their own actions as economic actors.

The National Strategy of Corruption Prevention & Eradication Long-Term (2012-2025) provides a solid multi-stakeholder framework for monitoring and advancing integrity in government and society. It recognises that combating corruption is an important component of building the enabling environment for quality investment and RBC. The Corruption Eradication Commission (KPK), created in 2002 to investigate and prosecute corruption cases and to monitor the governance of the state, has in particular been a pillar of these efforts and has been well-regarded and well-respected. The new KPK law passed in September 2019 led to demonstrations and calls from stakeholders that KPK influence and independence have been jeopardised.[7]

One particular area of note is Indonesia's efforts on beneficial ownership information. This is a priority under the Presidential Regulation 54/2018 on the National Strategy of Corruption Eradication (prioritising licensing and commerce, state finance, and law enforcement and bureaucratic reform) and was directly addressed in the Presidential Regulation 13/2018, requiring all legal persons to disclose their beneficial owner and to provide beneficial ownership electronically. This information is expected to be published in an electronic database accessible to the public by the end of 2020. This is an important leap forward in terms of transparency (see Stranas PK, 2019).

Efforts are also ongoing to promote regional action. KPK is spearheading efforts to promote regional collaboration as well, notably spearheading a capacity building programme to promote and improve collaboration between members of the ASEAN Parties Against Corruption (ASEAN-PAC) in preventing and eradicating corruption (KPK, 2019). The recent efforts encompass efforts to promote integrity in the private sector. KPK itself has called on Indonesia to consider a regulation on embezzlement, bribery, accepting bribery, and facilitating bribery in the private sector. KPK also played an important role in the creation of the Online Single Submission (OSS) with other government bodies, which was set up to improve the efficiency and transparency of business procedures (see Chapter 6 on investment promotion and facilitation policies). According to KPK, the OSS, by centralising business procedures in an online system, helps reducing avenues for corruption.

Indonesia should criminalise the bribery of foreign public officials and enact corporate liability for corruption offences as a Party to UNCAC and a G20 member. Indonesia's neighbours are also taking steps to implement such provisions. Malaysia, for example, under Section 17A of the amended Malaysian Anti-Corruption Commission Act 2009, started enforcing corporate liability in June 2020.

These legislative changes would also position Indonesia to request accession to the OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions (the Anti-Bribery Convention), which focuses on combating the supply of bribes to foreign public officials in international business. Parties must make foreign bribery a criminal offence, individuals and companies must be subject to effective sanctions and bribes must be explicitly non-tax deductible. The 44 Parties that make up the OECD Working Group on Bribery in International Business Transactions (Working Group) include most of the world's major economies, including eight non-OECD countries. Fifteen G20 members are Parties to the Convention. Four Parties to the Convention belong to the Asia-Pacific region (Australia, Japan, Korea and New Zealand).

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Notes

[1] See: https://www.greencentury.com/wp-content/uploads/2020/10/Indonesian-Omnibus-Investor-Letter.pdf.

[2]According to research from Bloomberg Intelligence, "so far in 2020, 59% of U.S. ESG ETFs are doing better than the S&P 500 Index while 60% of European ESG ETFs have beat the MSCI Europe Index". See Claire Ballentine (31 March 2020), "ESG Stock Resilience Is Paving the Way for a Surge in Popularity" *Bloomberg* https://www.bloomberg.com/news/articles/2020-03-31/esg-stock-resilance-is-paving-the-way-for-a-surge-in-popularity. See also Saijel Kishan and Emily Chasan (13 March 2020), "Older ESG Funds Outperform Their Newer Rivals in Market Tumult", *Bloomberg* https://www.bloomberg.com/news/articles/2020-03-13/older-esg-funds-outperform-their-newer-rivals-in-market-tumult?sref=wingcnxe and Jon Hale (16 March 2020), "Sustainable Equity Funds are Outperforming in Bear Market", *Morningstar* https://www.morningstar.com/articles/972475/sustainable-equity-funds-are-outperforming-in-bear-market

[3] For example, Blackrock, NBIM, APG were key partners in developing the paper. Additionally, investors representing $ 1.9 trillion in AUM have also released a formal statement endorsing the recommendations in the paper as best practice.
See: https://investorsforhumanrights.org/sites/default/files/attachments/2019-04/IAHR_Making%20Finance%20Work%20for%20People%20and%20Planet_FINAL.pdf

[4] In 2018 the Federation of the Dutch Pension Funds, non-governmental organisations (NGOs), trade unions and the Dutch government signed a Responsible Business Conduct Agreement on responsible investment by Pension Funds rooted in the recommendations of the paper. See: https://www.imvoconvenanten.nl/pensioenfondsen?sc_lang=en

[5] See https://data.consilium.europa.eu/doc/document/ST-7571-2019-ADD-1/en/pdf

[6] Some ASEAN Members have already acted in this regard. For example, Thailand has directed Thai SOEs to follow RBC principles and standards according to international RBC standards.

[7] See for example UNCAC Civil Society Coalition https://uncaccoalition.org/uncac-coalition-statement-on-threats-to-the-independence-of-indonesias-corruption-eradication-commission-kpk/.

6 Investment promotion and facilitation in Indonesia

This chapter examines investment promotion and facilitation policies in place in Indonesia. It analyses the institutional framework for investment promotion and facilitation, with a particular emphasis on the role and activities of BKPM, Indonesia's investment promotion focal point, which it benchmarks against other agencies in the world. It highlights key reforms and measures implemented by the government to improve the business environment and facilitate the process for incoming investors as well as to attract foreign investment. It also examines the tax regime and the role of tax incentives for investment in support of foreign investment promotion. The chapter identifies remaining challenges and proposes recommendations to address them.

Summary and main recommendations

Investment promotion and facilitation policies, including well-designed tax incentives for investment, can contribute to the competitiveness of a country by attracting quality and innovative investors and by making it easier for businesses to establish or expand their operations. Such initiatives are particularly important to respond to the crisis provoked by the COVID-19 pandemic, which poses significant challenges to public authorities. The economic contraction, drop of foreign direct investment (FDI), pressure on public budgets and the need to deliver on sustainable development goals are just some areas that will have an impact on institutions in charge of promoting and facilitating investment in Indonesia. Investment promotion and facilitation measures can not only support a sustainable recovery by creating an attractive economy, but also by helping ensure that foreign investments support national development objectives and generate positive spillovers through the development of less developed areas, linkages with local companies and skills transfer. It is important, however, that investment tax incentives are used cautiously due to increased pressure on public budgets. Investment promotion and facilitation efforts should also complement – and not replace – measures to ensure a sound investment policy framework.

Within Indonesia's institutional framework governing investment, the Indonesian Investment Coordinating Board or BKPM (for *Badan Koordinasi Penanaman Modal*,) is the government's implementing arm on investment promotion, facilitation and regulation. BKPM is a large organisation with a large number of official mandates, more than in many other investment promotion agencies (IPAs) around the world. Its regulatory and policy-oriented characteristics have been dominating the agency's mind-set and strategic orientations over the past decades, and have been instrumental in increasingly establishing a business-friendly environment in Indonesia, including for FDI.

BKPM aims to play a co-ordinating role within a multifaceted, if not fragmented, institutional landscape, where multiple public entities have a say on investment policies or on their implementation. These different roles and tasks across government actors can sometimes be complementary but can also overlap or be inconsistent with each other. This complexity at the central level is amplified by the important role played by local governments in investment promotion and facilitation.

Improving the business environment has been a top priority of the President since he took office in 2014 and which was then further emphasised at the beginning of his second term. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms aiming at improving transparency, streamlining licences and creating mechanisms to ease the business creation process. One of these recent flagship reforms is the Online Single Submission (OSS), an online business licensing system, which has allowed the business licensing process to become more efficient and more transparent.

In practice, however, investors have still been relying on too many procedures and requirements that cannot be processed by the OSS and that has hampered the efficiency of the system. Additionally, the OSS, by replacing a system that was put in place only a few years earlier and still well-established in certain cities and districts, is not without implementation problems and local resistance. The government is thus seeking to standardise further the licensing process by providing increased authority to BKPM. In parallel, it has prepared two Omnibus laws – one on job creation and one on taxation – which are seeking to modernise the regulatory framework.

The Omnibus Law on Job Creation, among various objectives, seeks to ease and harmonise the business licensing process by amending 76 laws related to a wide array of economic sectors. Its effective implementation remains nonetheless to be seen. In the future, the government may consider adopting the reverse sequencing of reforms: starting with assessing the regulatory stock and burden for businesses, then cutting unnecessary licences and administrative requirements, and finishing by implementing a top-notch online mechanism to start a business.

These reforms are taking place in an environment where stakeholder consultations are vital. While BKPM takes its role as an intermediary between the government and the private sector very seriously and organises business consultations on a regular basis, a key challenge lies precisely in reconciling sometimes conflicting views on investment-related matters across different market participants.

In terms of FDI attraction goals, the government has progressively taken a more proactive stance on investment promotion over the past years, but remains relatively less advanced than some of its peers. Led by BKPM, the government has collegially developed a strategy with priority sectors based on some well-defined criteria, but the focus remains too wide for BKPM's investment generation activities to be impactful and measurable. A large part of the agency's efforts are still dedicated to image building, while more specific targeting and attraction activities would be necessary, as is the case in more modern fully-fledged IPAs that are seeking to achieve similar goals. As the pipeline of new FDI projects is likely to drop due to the pandemic, an effective prioritisation strategy for investment promotion is an important success factor in the government's recovery efforts.

Tax reform is another pillar of Indonesia's strategy to enhance the investment climate and to promote the country as an attractive investment destination. In recent years, significant changes have been introduced through the gradual review and expansion of Indonesia's tax incentives. Broader tax reforms are also planned under the Omnibus Law on Taxation. The policy response to the COVID-19 economic crisis accelerated some reforms planned under the law to provide tax relief to affected businesses.

Indonesia's tax incentives are among the most generous in the region. Tax incentives' potential to attract investment, create jobs, acquire knowledge, skills and technology, and boost economic growth must be weighed against the resulting costs in terms of tax complexity, neutrality and revenue forgone. In Indonesia, tax incentives for investment continue to be at the core of the strategy to improve the business environment, but substantial changes have been introduced since 2018 in their design and in the targeted activities.

New cost-based incentives were introduced to promote labour-intensive sectors and activities with socio-economic spillovers, such as research and development (R&D) and vocational training, which has been a positive development. At the same time, previously existing incentives were also expanded to include new priority sectors under both the tax holiday and investment allowance schemes. The successive expansion of prioritised sectors (under the so-called *pioneer* and *certain* industries policies) make the intended policy objective less clear, however. For example, the 30% investment allowance was expanded to additional sectors and all new investment projects (rather than limited to newly registered firms), which creates unequal competition among firms that are granted incentives and those that are not.

The wider tax incentive scheme continues to be complex due to multiple – in some cases, overlapping – incentives and the density of the current legal framework. Tax incentives in Indonesia are introduced through multiple legal instruments, including laws and regulations. They can be modified by further regulations – for example, introducing additional requirements – that amend prior ones, which makes it difficult for investors to have a full overview of how incentives apply. While relevant regulations are available online, official English translations are not always available, which can create additional uncertainty. Significant efforts have nevertheless been made to increase transparency and communicate incentives more clearly. Investor guides provide a good overview but cannot capture some of the details and complexities of the regulations.

Main recommendations on investment promotion and facilitation

- Ensure BKPM's leadership role on investment promotion and facilitation is well recognised and that it has the means to co-ordinate the dialogue between all parties. While it has been a good development to integrate increased licensing responsibilities within the agency, its exact role within government remains sometimes unclear.

- To conclude ongoing discussions in the cabinet on the status of BKPM, decide whether to fully upgrade BKPM to ministerial level or to keep it as an operational agency. The first option would allow it to better fulfil its co-ordinating role and drive policy reform. If the second option is maintained, consider providing it with more autonomy, to reduce the number of mandates and to provide more responsibility to the Investment Committee. The committee could be upgraded to a board, to align it with good IPA international practices, and should include business representatives from all segments of the economy as well as representatives of academia and civil society.
- Given the rapid pace of ongoing reforms to facilitate investment, notably the establishment of the OSS and the Omnibus Law on Job Creation, ensure that officials in the national and regional administrations have sufficient and adequate resources, capacities and information to properly implement the new regulations and adapt to the new tools. This would help overcome the operational challenges of the OSS and make it more efficient. A review of the implementation and impact of reforms could be envisaged to understand whether these measures achieved their objectives.
- Provide clear rules and guidelines to investors on the use of the OSS and consider establishing information services. The implementing regulations of the Omnibus Law on Job Creation that relate to business licensing and forthcoming changes to the OSS also need to be well-discussed and communicated in advance. Ensure that increasing predictability and transparency in investment procedures – including to reduce corruption risks – continue driving ongoing and new investment facilitation reforms.
- Continue streamlining redundant and overly burdensome business licences and administrative procedures to provide a healthy business environment to both incoming and already-established investors. This, however, should not come at the expense of much needed labour and the environmental protection safeguarding a more inclusive and sustainable development pathway (see also Chapter 5 on responsible business conduct). In this light, while the preparation of the Omnibus Law on Job Creation seeks to ease the process of doing business, the reform should not be limited to amending sectoral laws, but focus on systematically identifying business regulations that could be eliminated and those that need to be preserved.
- Ensure that ongoing investment climate reform efforts, including implementing regulations of the Omnibus Law on Job Creation, are accompanied by wide-ranging and meaningful stakeholder consultations and communication campaigns. Involve all relevant stakeholders, including trade unions, civil society, affected stakeholders and academia in addition to the business community, more systematically and as early as possible in policy design, even if conflicting views sometimes occur, to maintain a constructive dialogue and reach an environment of trust. Diversify the number of interlocutors and ensure all the spectrum of stakeholders, including at the local levels, are involved and represented. Ensure that consultation remains transparent and that information on how stakeholder inputs were used is publicly available.
- In the context of its aftercare services, BKPM could strengthen its business matchmaking programme to foster the creation of linkages between foreign affiliates and domestic firms. In addition to matchmaking services, this programme could include the preparation of suppliers' databases, which, on the one hand, may reduce foreign firms' transaction costs and, on the other hand, can help providing opportunities for local firms. Greater co-ordination with similar initiatives across government would avoid overlaps and reinforce the implementation and monitoring of the linkage programme.
- In terms of investment promotion efforts, continue moving away from costly image building campaigns and adopt a more focused approach. BKPM could consider better prioritising its FDI attraction measures to complement the recent and ongoing improvements conducted to facilitate inward investments. Proactive FDI attraction should focus on targeted sectors and projects, which support the country's sustainable development goals and an inclusive and resilient recovery from

the pandemic. Focus should be given to industries where foreign investments' performance is proven to be higher than domestic ones in terms of productivity and innovation, wages and skills development, and environmental preservation.

Main recommendations on tax incentives for investment

- Monitor effects of tax reform on Indonesia's tax base. Lower tax revenues can constrain government spending on infrastructure and social services, which in turn can hamper progress toward improving the business environment in the long-run.
- Continue to shift towards cost-based tax incentives. New tax incentives introduced since 2018 have all been cost-based, but profit-based incentives (tax holidays) remained in place or were expanded to additional industries. Authorities could consider limiting profit-based incentives to high priority investments. In the medium-term, once recovery from the COVID-19 crisis strengthens, consider reducing the number of promoted *pioneer industries*.
- More clearly define the policy objective for the 30% investment allowance to *certain industries*. Authorities could consider more clearly communicating the policy's intention and how it differs from other sector-based incentives (i.e. *pioneer industries* incentives). The latest restructuring of the incentive has significantly expanded the qualifying industries under this tax incentive, which risks creating an uneven playing field relative to non-promoted ones.
- Consolidate tax incentive regulations in the relevant tax law. In Indonesia, tax incentives are introduced and regulated through multiple legal instruments: laws, government, Ministry of Finance and BKPM regulations. Consolidating tax incentive regulations can increase transparency and reduce policy overlaps.
- Facilitate foreign investors' access to implementing regulations. BKPM could consider producing additional in-depth guides on how incentives apply, explaining differences between incentive regimes. Official translations of all relevant regulations and business segment lists (that include industry codes of eligible industries under each incentive) can also enhance transparency.
- Introduce sunset clauses on tax incentives to promote regular policy reviews. These can help identify new sector priorities as well as incentives that are no longer needed.
- Continue to conduct and publish annual tax expenditure reports and expand their analysis to include new tax incentives and forgone tax revenues within special economic zones.
- Continue to engage in regional and international dialogue on taxation. Regional forums provide a space for discussion on potentially harmful tax competition, as well as sharing information on good practice examples from other regions. Regional dialogue and tax co-operation will be even more important in the COVID-19 context, as a way to avoid tax disputes that could harm economic recovery.

Overview of the institutional framework for investment promotion and facilitation in Indonesia

Recognising the importance of private investment for economic and social development, most countries in the world have established IPAs dedicated to promoting and facilitating investment, often with a particular emphasis on attracting multinational enterprises (MNEs) and capturing the benefits of FDI. IPAs are never the sole actors and other public entities often also play complementary – sometimes overlapping – roles to promote and facilitate investment.

The way governments around the world organise their institutional framework for investment promotion and facilitation responds to their policy objectives and the priority they give to investment. These choices can greatly influence their success in attracting investment in the most efficient and effective manner.

In Indonesia, the investment promotion and facilitation landscape is dominated by BKPM, the Indonesian Investment Coordinating Board, which is the main government agency in charge of implementing investment-related policies at national level. BKPM is a large organisation that has had various responsibilities over the past decades. It was initially established in 1967, as the Technical Committee on Investment and then replaced by BKPM in 1973. It is only in 2001 that it began to focus its role on investment promotion and facilitation tasks, when it was reshaped as an independent agency and when a Presidential Decree created the first National Single Window for investment. Since 2014, its three main tasks are as follows: *i)* licensing simplification; *ii)* assisting and facilitating investment projects; and *iii)* improving investment attraction results.

BKPM's tasks are supplemented by a number of other public entities that play a central role on investment promotion and facilitation:

- The Coordinating Ministry for Maritime Affairs and Investments is, since the new Cabinet is in place, overseeing the work of BKPM and given special authority to facilitate inter-ministerial co-ordination and ensure policy enforcement;
- The Coordinating Ministry for Economic Affairs (Menko) has traditionally always been a key player on many areas affecting investment. It has notably been playing an important role in liberalisation efforts by driving and co-ordinating the revision of the Negative Investment List (DNI). It has also been at the forefront of the recently established Online Single Submission system and has been driving the preparation of the Omnibus Law on Job Creation. It is also in charge of the new regime for special economic zones;
- The Ministry of Foreign Affairs is leading the country's economic diplomacy agenda and is often involved in investment promotion missions abroad. In the new Cabinet, it has been given the task to improve Indonesia's trade and investment relations with other countries;
- The Executive Office of the President provides guidance on national priority programmes and strategic issues. It has a dedicated Deputy Chief of Staff in charge of the management of strategic economy issues, which include investment;
- The Ministry of Finance is in charge of designing the investment tax incentives scheme while BKPM is in charge of preparing the operational regulations that apply to the eligible sectors accordingly. They co-operates with each other and line ministries to ensure and monitor the fiscal incentives regime's effective implementation;
- The Ministry of Industry is responsible for the country's industrial policies and notably in charge of the management of the 'real estates', which are specific zones where a high number of firms, especially in the manufacturing sector, decide to locate;
- The Ministry of National Development Planning (Bappenas) is designing long- and short-term development plans across all public policy areas, among which investment is increasingly becoming a key component;
- Local governments – at the provincial, district and municipal levels – have acquired a high level of decision-making power since the initiation of decentralisation programmes in the 2000s. They are essential players to make the local investment climates healthy and can play an important role to promote and facilitate investments.

Although investment promotion and facilitation often involves a network of various ministries and public agencies, the case of Indonesia is particularly multifaceted and co-ordination needs to be optimal to respond to investors' needs while also serving the government's short- and long-term national development objectives. BKPM needs to play a key role in this regard.

BKPM as the main national IPA: benchmarking and analysing its characteristics

Large differences exist across IPAs in terms of institutional settings, governance policy, strategic priorities, and investment promotion tools and activities. To better understand the characteristics of investment promotion and facilitation dynamics in Indonesia and to compare its main national IPA with international peers, Indonesia recently participated in a survey of IPAs conducted by the OECD (Box 6.1). The results serve as the basis of the comparative analysis conducted in this chapter and allows benchmarking BKPM against its peers from the OECD and from other regions.

Box 6.1. The OECD-IDB survey of investment promotion agencies

The OECD and the Inter-American Development Bank (IDB) have partnered to design a comprehensive survey of IPAs. The questionnaire provides detailed data that reflect rich and comparable information on the work of national agencies in different countries. The survey was displayed in the form of an online questionnaire and divided into nine parts:

- Basic profile;
- Budget; Personnel;
- Offices (home and abroad);
- Activities;
- Prioritisation;
- Monitoring and evaluation;
- Institutional interactions; and
- IPA perceptions on FDI.

In 2017-2018, the survey was shared with IPA representatives from 32 OECD and 19 Latin America and Caribbean (LAC) countries. In 2018, 10 national agencies from the Middle East and North Africa (MENA) participated in the same survey and 10 additional countries from Eastern Europe, Southern Caucasus and Central Asia (Eurasia) joined the same exercise the following year.

The results of the survey are presented in comprehensive IPA mapping reports, which provide a full and comparative picture of IPAs in selected regions (http://www.oecd.org/investment/investment-promotion-and-facilitation.htm). The reports are benchmarking agencies against each other as well as the average IPA in a region against other regions.

Indonesia's main national IPA – BKPM – participated in the survey in 2019 in the context of this second Investment Policy Review. The results are used to provide an in-depth analysis of the agency and compare it with other agencies in the world.

Key organisational features

Scope and diversity of BKPM's mandates

IPAs can be either fully dedicated to the attraction and facilitation of inward foreign investment or be part of a broader agency that includes additional mandates, such as the promotion of exports, innovation, regional development, outward investment and domestic investment, among others. In practice, for reasons of efficiency and synergies, most IPAs around the world have multiple mandates and conduct activities that go beyond inward foreign investment promotion.

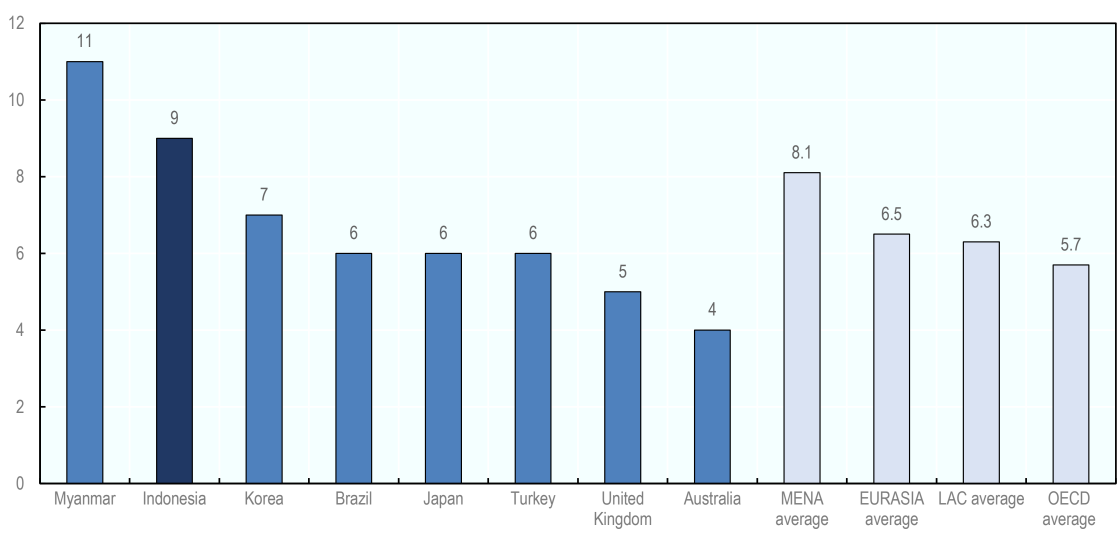
BKPM reported in its responses to the IPA survey to have nine official mandates (out of 18 possible mandates):

1. Inward foreign investment promotion
2. Outward investment promotion
3. Domestic investment promotion
4. Operation of one-stop shop
5. Screening and prior approval of investment projects with foreign participation or investor registration
6. Issuing of relevant business permits
7. Negotiation of international trade, investment or other agreements
8. Granting fiscal incentives
9. Promotion of regional development

Although large differences exist across agencies, including within the same regions of the world, IPAs in OECD, LAC and Eurasia countries have generally fewer mandates, with an average of 5.7, 6.3 and 6.5 different mandates respectively under the agency's responsibility (Figure 6.1). As reflected on the figure, the size of the economy does not necessarily have an implication on the number of mandates.

Figure 6.1. Number of mandates of BKPM and selected other national IPAs

(Out of 18 possible mandates)

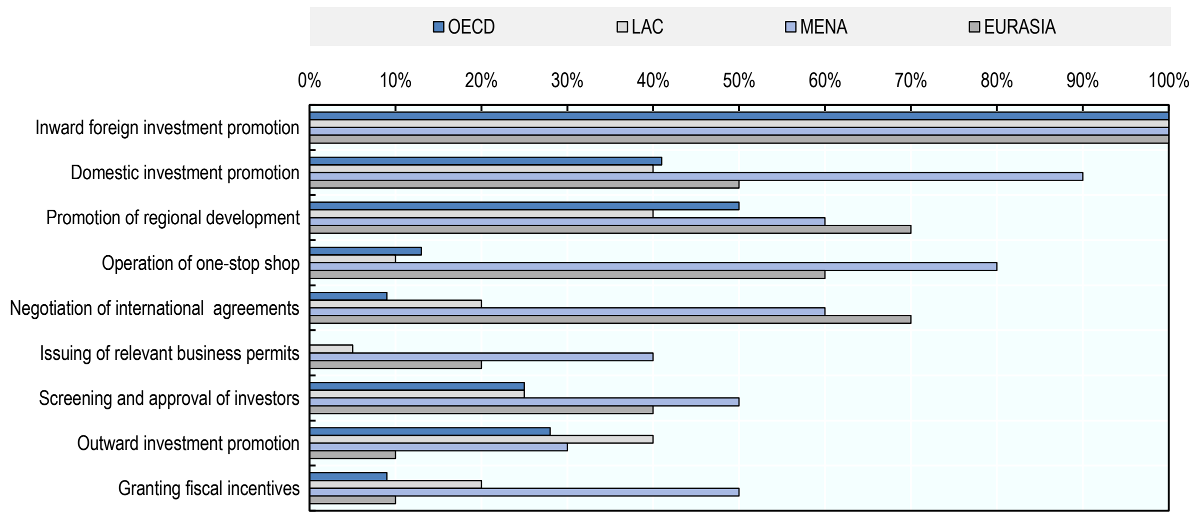


Note: 32 countries are included in the OECD group, 19 in LAC, 8 in MENA and 10 in Eurasia.
Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

BKPM's relatively large number of mandates reflects its wide scope of responsibilities and activities, which are strongly articulated around investment, as no other policy area (such as export promotion, for example, which is often combined with investment promotion) is included in its official mandates. This reflects the importance of investment in the government's overall development policy and demonstrates a coherent approach to making investment work for growth and prosperity – notably by including foreign investment promotion, domestic investment promotion, regional development and the operation of a one-stop shop under the same umbrella.

Many of BKPM's official mandates are more frequently executed by agencies in the MENA and Eurasia regions than in OECD countries (Figure 6.2). This is the case for the vast majority of its mandates, but particularly striking for domestic investment promotion, operation of one-stop shop, negotiation of international agreements and issuing of relevant business permits.

Figure 6.2. BKPM's mandates and their frequency across IPAs in other regions



Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

One-stop shops, for example, are often established within IPAs in MENA and Eurasia to facilitate business transactions and reduce the cost of doing business by avoiding excessive bureaucracy and red tape, as in the case of Indonesia. It is a key difference with OECD IPAs, where only 13% of which operate one-stop shops (OECD, 2018a). This difference is likely due to generally more complex institutional bureaucracies in large emerging markets.

On the contrary, in OECD economies, the most frequent combination of mandates in IPAs are with export promotion (56% of agencies) and with innovation promotion (same percentage) (ibid.). In the LAC region, two agencies out of three have decided to merge investment and export promotion. In these two regions, IPAs are often the operational arms of ministries and are in charge of implementing – not designing – the policies. This is one of the reasons why several disciplines can be found under the same roof, while those touching upon regulation or policymaking (e.g. operation of one-stop shop, issuing or relevant licences, negotiation of international treaties, screening and prior approval, etc.) are taken care by ministries.

In many emerging countries, such as Indonesia, IPAs are fully fledged investment agencies with a high number of promotional and regulatory mandates. While it gives a strong leadership on investment to a single government entity, it can also lead to potential risks of mixing regulatory or policy-related functions and promotional activities. Some studies show that those IPAs focusing exclusively on investment promotion achieve significantly higher results in attracting investors than those which carry out both regulatory/policy and promotional tasks (World Bank, 2011). The reason behind this finding is that attracting FDI and ensuring that investors comply with legal requirements are two different functions with different objectives and that require different skillsets. Investors contacted by the IPA may wonder whether it is intended to solve their problems or to create new ones. The IPA is often expected to represent private investors' interests within government and it will be less credible to do so and to influence policymaking if it is the same agency that regulates them. This is why countries like Malaysia, Singapore and a vast majority of OECD members have separated their investment ministry – in charge of policymaking, treaty negotiation and regulatory tasks – from their IPA – in charge of investment promotion and facilitation (also often slightly more autonomous from the government).

In Indonesia, BKPM is doing what, in other countries, both the ministry and the IPA would be doing distinctly. BKPM is a large organisation in charge of a high number of different mandates. It thus requires both a wide scope of skillsets and a clear strategic orientation that all divisions and units can hang on to. In this context, it could be envisaged to upgrade BKPM to fully-fledged ministerial level to help the agency fulfil its co-ordinating role, drive policy reform and conduct all its mandates effectively. A distinct unit would be fully dedicated to the agency's promotional activities and could, in the future, take gradually more autonomy – like in many other more advanced IPAs.

Another challenge is that the multiplicity of mandates may lead to a duplication of tasks with other government entities, particularly if institutional co-ordination mechanisms are poorly designed. According to the IPA survey, a number of BKPM's mandates are also carried out by other national agencies or ministries as well as by sub-national authorities (Table 6.1). The prominent role of sub-national authorities in investment promotion and facilitation testifies of their commitment to making investment work for regional development but can also raise questions about potential co-ordination challenges (as further examined in Chapter 7 on the local dimension of investment policy in Indonesia). Since 2019, however, the ease of doing business reform was granted to BKPM (by virtue of Presidential Instruction No.7 of 2019), which was meant to strengthen its convening power and position to co-ordinate inter-ministerial dialogue on investment and licensing, including on investment promotion and facilitation.

Table 6.1. Other government entities in Indonesia with the same mandates

	Other national entity with this mandate	Other sub-national entity with this mandate
Inward foreign investment promotion	NO	YES
Outward investment promotion	YES (Ministry of State Owned Enterprises)	YES
Domestic investment promotion	YES (Ministry of SMEs, Indonesia Agency for the Creative Economy)	YES
Operation of one-stop shop	NO	YES
Screening and prior approval of investment projects	YES (Line ministries)	YES
Issuing of relevant business permits	YES (Line ministries)	YES
Negotiation of international agreements	YES (Ministry of Trade)	NO

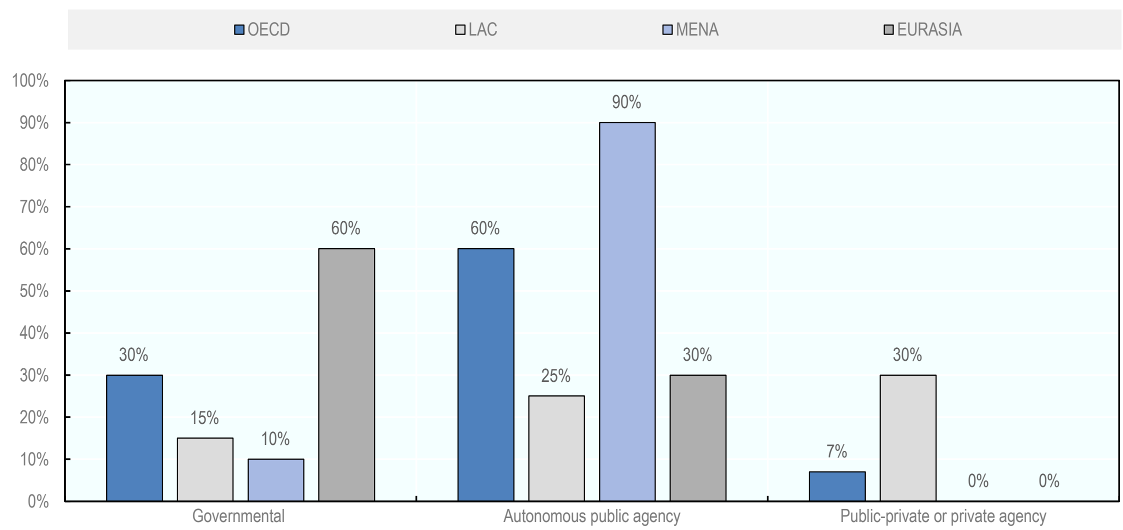
Source: OECD-IDB Survey of Investment Promotion Agencies: Indonesia, 2019.

BKPM's governance policy

The governance of an IPA relates to the way it is supervised, guided, controlled and managed. An IPAs' governance policies are often dictated by their institutional context and broader political choices. The governance policy of an IPA is important because it affects its legal status, reporting lines and managerial structure. It can thus have an impact on the degree of autonomy the IPA has from the government, particularly in terms of financial and human resources management.

The legal status of IPAs can vary. They are usually created either as: *i)* a governmental body (e.g. ministry or a unit within a ministry); *ii)* an autonomous public agency; *iii)* a joint public-private body; or *iv)* a fully privately-owned organisation. BKPM belongs to the first category, as it is a non-ministerial government agency, which has been reporting directly to the President of the Republic until 2019. It is now under the authority of the Coordinating Ministry for Maritime Affairs and Investments. IPAs with this legal status, due to their governmental nature, are the least autonomous types of agencies. In other regions of the world, IPAs with similar legal status are in the minority, with the exception of the Eurasia region (Figure 6.3). In Southeast Asia, national IPAs from Cambodia, Lao PDR, Myanmar and Viet Nam are governmental agencies, while those from Malaysia, the Philippines, Thailand and Singapore have more autonomous settings.

Figure 6.3. IPAs' legal status across other regions



Note: Some regions do not add up to 100% because some IPAs are categorised as "others".
Source*: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).*

Another component of an IPA's governance policy is the existence and role of a board. When a board exists, it is meant to supervise or advise the work of the agency, or both, with a somehow independent perspective. Boards vary greatly from one IPA to another; they can be of an advisory nature or with a high degree of decision-making power. A vast majority of IPAs around the world have a board in place – 69% in OECD countries, 86% in LAC and all agencies surveyed in MENA.

Being a co-ordinating board itself, BKPM's role is to co-ordinate with other ministries and agencies and to consult and collaborate with external public entities on a regular basis. As such, BKPM did not have a board for a long period of time, but it established in 2019 an Investment Committee composed of external private sector representatives and professionals advising the Chairman of BKPM and its technical staff on investment policy and promotion related issues. BKPM was well advised to establish an Investment Committee of external advisers to provide guidance and advice on its promotion and facilitation activities. Having stakeholder representatives on the board can help ensure that the views and interests of different market players, including businesses, are taken into consideration in BKPM's overall strategic directions. In OECD IPAs, boards are composed of approximately 10 people on average and are dominated by representatives from the private sector (41% on average) and the public sector (38% on average), the remaining being representatives of research and academia, civil society or other areas.

One last important element is that it is not only private and autonomous agencies that have boards. As in the case of BKPM, governmental IPAs also have boards even if they are less autonomous from the government. For example, half of governmental IPAs in OECD countries have a board whereas, by definition, they are less autonomous – their boards tend to be of an advisory nature rather than a supervising board of directors to which IPAs have to report.

Breakdown of BKPM's activity mix

Within their main investment promotion and facilitation mandate, IPAs are usually major players in the implementation of four core functions:

- *image building* consists of fostering the positive image of the host country and branding it as a profitable investment destination;
- *investment generation* deals with direct marketing techniques targeting specific sectors, markets, projects, activities and investors, in line with national priorities;
- *investment facilitation and aftercare* is about providing support to investors to facilitate their establishment phase as well as retaining existing ones and encouraging reinvestments by responding to their needs and challenges; and
- *policy advocacy* includes identifying bottlenecks in the investment climate and providing recommendations to government in order to address them.

While the first two functions relate to investment promotion (i.e. attracting new investment to support national development objectives), the latter two rather deal with investment facilitation (i.e. making it easy for investors to establish, operate and expand). Investment promotion is meant to attract potential investors that have not yet selected a destination, whereas facilitation starts at the pre-establishment phase, when an investor shows interest in a location. As such, investment promotion and attraction is primarily the business of IPAs while facilitation often involves a whole-of-government approach (Novik and de Crombrugghe, 2018).

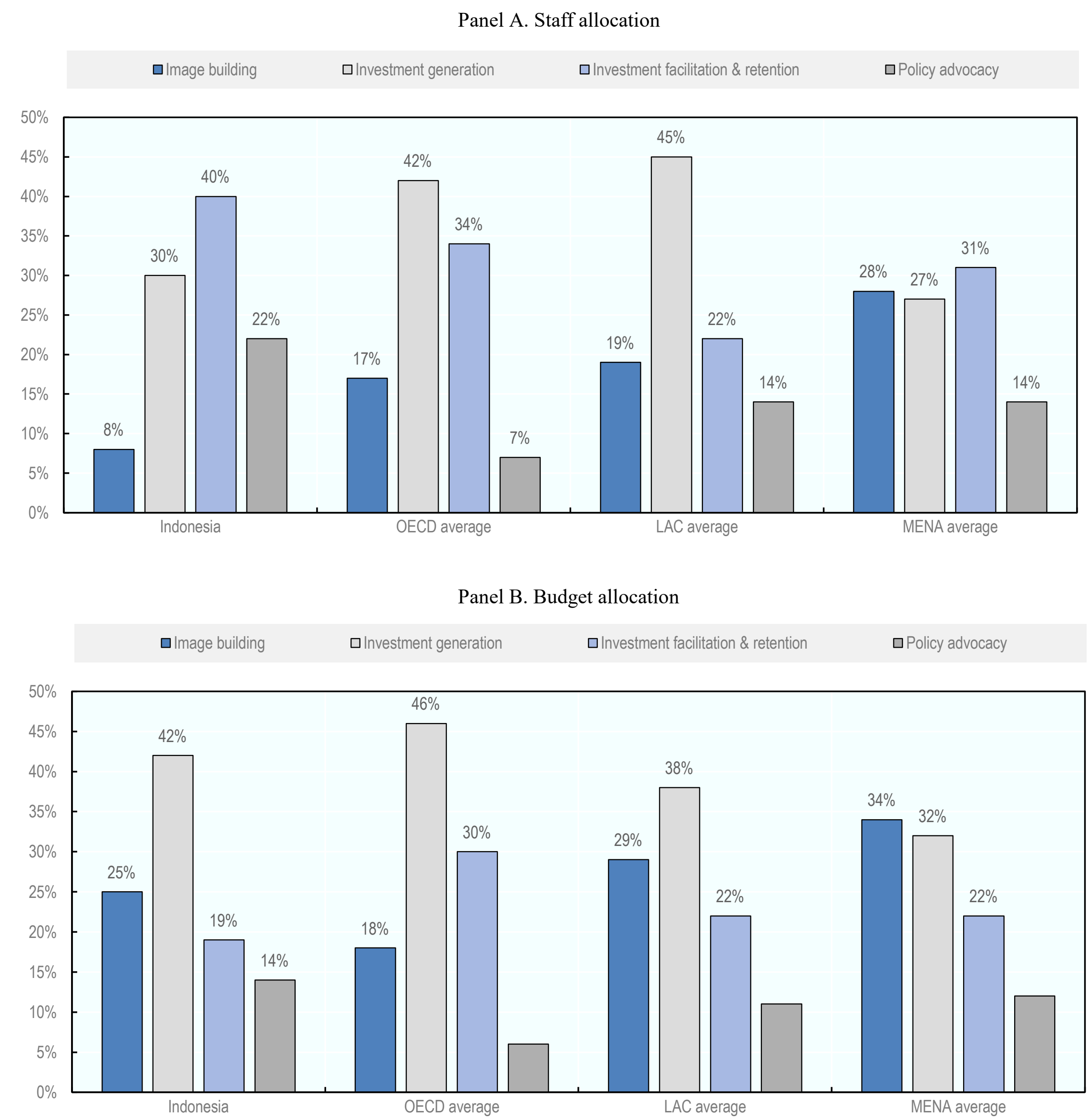
According to the OECD survey of IPAs, BKPM allocates a higher share of its employees to investment facilitation and retention (40% of staff) than to investment generation (30%), which is the opposite trend to that observed in OECD and LAC agencies (Figure 6.4 – Panel A). As discussed in the above section on mandates, this reflects the importance given by BKPM to supporting licensing and requirements to start a business, including with the successive one-stop shops that it has been hosting (see section below). The budgetary allocation of the four core functions provides a very different picture by suggesting that investment facilitation is a function that, in the case of Indonesia, seems to use far more human than financial resources (Figure 6.4 – Panel B). Investment generation produces the opposite effect, which could potentially be due to the fact that these activities are more cost-intensive (e.g. market intelligence, overseas missions and fairs).

BKPM noticeably dedicates a higher share of its resources (both staff and budget) to policy advocacy than its peers in other regions, which could be linked to its regulatory, co-ordinating and policy advisory functions. The agency's Deregulation Directorate, for example, is in charge of advising and consulting line ministries on policies and regulations that could affect FDI (e.g. business licences, restrictions to FDI, etc.).

Image building seems a marginal function in terms of staff allocation, but a very important one in terms of budget. Activities under this function often involve costly communication campaigns that are not necessarily personnel-intensive. For example, in the past years, BKPM had embarked in a large image building campaign called "Remarkable Indonesia". It involved communication activities aiming at reinforcing Indonesia's strengths in terms of market size and growth, and at promoting the country as a friendly destination to do business (Adam Smith International, 2014). BKPM's focus has since then increasingly shifted to more practical services designed to provide information to support actual investment decisions (i.e. investment generation) and support companies establish and operate (i.e. investment facilitation).

Moving away from large and costly communication campaigns for a country like Indonesia – which already enjoys a positive image as a large, stable, democratic and influential ASEAN and G20 member – is a reasonable idea. This becomes even more important in the context of the COVID-19 crisis, where sound and targeted investment facilitation and promotion measures are more efficient and relevant to support Indonesia's recovery, and should hence remain BKPM's core priority functions.

Figure 6.4. Estimated use of resources across the four core functions in BKPM and in the average IPAs of selected regions



Source*:* Based on OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

Facilitating investments – from both incoming and existing firms

Investment facilitation starts when an investor shows interest in a location. It includes the way enquiries are handled by the relevant authorities, notably the IPA, and measures to reduce potential obstacles faced by investors once they have decided to invest. But investment facilitation does not stop there: encouraging the expansion of existing investors and helping them overcome the challenges they face in operating their business is at least as important as facilitating new investments. Aftercare measures can be influential in companies' decisions to stay in the country and reinvest, and policy advocacy is a powerful instrument to bolster reforms and enhance the business environment by leveraging the private sector's feedback.

The government of Indonesia has placed the need to improve the business environment high on its agenda, recognising its contribution to sustainable and inclusive economic growth. Successive measures to facilitate the establishment of new companies have been implemented over the past years. After President Joko Widodo's re-election in 2019, there was an even bigger push for investment climate improvements, as the simplification of regulations and de-bureaucratisation have been placed among the top five priorities of the newly formed Cabinet.[1] Reforms to improve the business environment and measures to ensure that business regulations are transparent and predictable are particularly important in the context of the economic recovery from the pandemic.

The business licensing reform: ongoing efforts to facilitate new investments

The Online Single Submission: an attempt to improve the business environment

Making it easier for companies to establish has been a top priority for over a decade in Indonesia. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated a long-term licensing reform to facilitate investments. Efforts have been aiming at improving transparency and creating mechanisms to simplify and harmonise the business licensing process.

A multi-layer system of one-stop-shops was established in 2009 with the One-Stop Integrated Services Centre, or PTSP (standing for *Pelayanan Terpadu Satu Pintu*). A central office was created in BKPM's headquarters and dedicated decentralised offices in provinces and districts. Gradually equipped with an electronic information and licensing service system (SPIPISE), regional PTSP offices were tasked to receive and treat investors' applications. The role of the national government was to provide guidance and monitor performance of regional PTSPs while BKPM was providing them with technical and managerial assistance and training (Holzacker et al., 2015). As President Widodo placed the business environment among its top priority since the beginning of its first term in 2014, his government accelerated the licensing reform at all levels of government. In addition to reinforcing PTSP offices, it launched a 3-hour investment service at BKPM for large investments. The establishment of PTSPs was perceived as an investment climate improvement, which also allowed national, provincial and district governments to work together on their creation, functioning and monitoring (Kuswanto, 2019). The local dimension of investment facilitation measures and the implications of decentralisation on investment policy is further analysed in Chapter 7 of this *Review*.

By mid-2018, a new system to facilitate investments – the Online Single Submission (OSS) – was created to improve efficiency, transparency and further centralise business procedures and requirements. The new OSS has been an important step in the government's efforts to improve the country's business environment, although it has been suffering from implementation challenges. The system was launched jointly by the Coordinating Ministry for Economic Affairs and BKPM and is now fully managed by the latter. The Indonesian Corruption Eradication Commission, KPK, was also involved since the inception of the system to improve the transparency of the business licensing process. According to KPK, the number and complexity of licences in Indonesia had often been an avenue for corruption and the OSS, by standardising – if not centralising – business procedures in an online system, now helps in mitigating this problem.

The OSS issues three types of licences electronically: 1) the company identification number (NIB); 2) the business licence; and 3) the commercial/operating licence (if necessary). Until December 2019, other required licences and permits (e.g. land, construction, environmental permits, etc.) had to be obtained from other ministries or local authorities after the successive business licences had been received from the OSS.

Although the former system was recognised as an improvement in many respects, the new OSS brings an innovative approach to investment facilitation in Indonesia on different fronts:

- First, it consists in a fully integrated online system adopting modern technology for the registration of businesses. Although it is still at the first stage of operation, it aims to allow for data sharing on an electronic platform bringing together 22 relevant ministries and institutions as well as regional governments.
- Second, all licences issued by the OSS are centralised and thus supersede all other licensing authorities.[2] Ministries and local governments are thus no longer allowed to issues business licences within the sectors covered by the OSS (i.e. all sectors except mining, oil and gas, and finance).
- Third, the OSS now integrates the principle of "self-declaration" for investors applying for a licence, which is innovative in the way that the OSS issues the business licence upfront, before the investor fulfils the necessary related requirements. It is only after having obtained a licence that the investor must comply with obligations, without which his licence proves to be null and void.

The system is monitored by taskforces that are operating at the national, provincial and district (or city) levels. The main responsibilities of these taskforces are to monitor whether: 1) investors that have been granted the licences are fulfilling their commitments and complying with required standards, certification and other necessary registrations; and 2) other government bodies and local authorities are providing investors with their required licences once they obtained those delivered by the OSS. KPK is also involved in the monitoring process and provides advisory services to the taskforces. Monitoring and evaluation of licensing systems, through qualitative and quantitative indicators, can not only improve the registration programme itself but also assist in overall burden reduction policy and planning through enhanced data collection. For example, BizPaL, a Canadian one-stop shop, collected data that was used to create a 'burden index' to identify heavily burdened business sectors, both nationally and regionally (Box 6.2).

Box 6.2. Regulatory transformation opportunities as a result of BizPaL

When the Canadian one-stop shop BizPaL was launched, one aspect was to support Smart Regulations and Paper Burden Reduction initiatives by analysing opportunities for regulatory transformation. The purpose was to identify areas where regulatory burden could be reduced. The Strategic Policy Sector of Industry Canada used the data in the BizPaL database for the federal, provincial, and territorial Committee on Internal Trade. It researched the extent to which business licencing arrangements act as a barrier to inter-provincial trade in Canada.

Industry Canada concluded that the BizPaL database was the only viable source of reliable and comparable information across a wide range of industry sectors. The data was used to create a 'burden index' by sector, by jurisdiction. When the data was combined with business statistics, the report identified businesses sectors, both nationally and regionally, that were heavily burdened by licencing requirements.

Source: (Government of Canada, 2011).

An unfinished agenda

The licensing reform and the different, sometimes successive, measures to facilitate investment may take time to materialise and to bear fruit. The environment for starting and operating a business in Indonesia has often times been reported as challenging by the private sector and efforts must be consistent and persistent.

The authorities realised that the business environment needed more regulatory reforms and investment facilitation measures. Centralising only three types of licences through the OSS (as mentioned above) appeared not to be sufficient. In practice, many investors continued to have difficulties obtaining the remaining licences and permits from the line ministries and regional administrations, and investors were therefore unable to run their business. Consequently, by issuing Presidential Instruction 07/2019 on the Acceleration of Ease of Doing Business at the end of 2019, the government decided to standardise the licensing system one step further by providing BKPM with the authority to issue all additional business-related licences and permits. This new measure is marking an important step in the reform process, by seeking to make the OSS more autonomous and hence more functional. As mentioned below, the success of this measure will very much depend on the implementation of the Omnibus Law on Job Creation, which is meant to lay the legal background for such a recentralisation process.

It remains to be seen if this will always be smoothly implemented in practice. The pace of reforms has been rapid and the transfer from the PTSP system to the new OSS, particularly in many remote or less developed districts, has not always been well-understood or well-implemented. The implementation of the OSS has generated operational problems and is sometimes facing local resistance.

According to stakeholders, some local governments have invested significant resources in the implementation of well-functioning PTSPs and do not seem ready to abandon their efforts after such a short period of time. The same goes for the additional business-related licences recently transferred to BKPM (Presidential Instruction 07/2019): it is not clear to what extent local authorities will accept to yield their licensing authority on a voluntary basis. The decentralisation process initiated in 1998 have provided local governments with a high level of responsibility and the central government needs to work very closely with them to ensure that they do not challenge these reforms, keeping in mind that the ultimate goal is to make the process of starting a business more efficient (see Chapter 7 for a more complete picture of investment policy at subnational level).

The government needs to ensure that, while reforms are ongoing or in transition, the overlap of systems does not make things more costly and time-consuming for investors and officials. Capacity building should be delivered to local authorities for a smooth integration of the new OSS and more guidelines must be provided to investors on how to use the OSS. What businesses are seeking as a priority is transparency and predictability. As new regulations and licensing systems have been established over short periods of time in Indonesia, clear rules and guidelines need to be made available to investors as well as information services, so that firms can easily navigate into the new system and adapt to it. Forthcoming changes also need to be well-communicated in advance.

The OECD has prepared a set of best practice principles of citizen and business one-stop shops to offer general guidance on the establishment and maintenance of such tools based on the experience of different countries. Some of these principles are reflected in the Indonesian approach: including plans to develop an OSS within a broader administration strategy and showing high-level political commitment to the programme. The OSS also has a monitoring and evaluation system as well as a tailored governance to co-ordinate and facilitate co-operation between multiple sectors and regional levels of government. Greater review and clarification of considerations of human capital development of staff and management as well as public consultation with users in the creation and improvement of the OSS should however be considered (see Box 6.3 for more details).

Box 6.3. The OECD Best Practice Principles of citizen and business one-stop shops

Business and citizen interactions with governments are becoming increasingly complex – as interactions with government becomes more interconnected, both domestically and internationally. Governments can unnecessarily hamper growth opportunities where the interface with businesses and citizens is delinked or cumbersome. To address this issue, one-stop shops – a centralised platform for cross-government services – are introduced as a means of reducing transaction costs.

The OECD has prepared this list of principles to offer general guidance on the establishment and maintenance of one-stop shops based on the experience of different governments – utilising a series of country-specific case studies as well as previous general research and OECD work.

One-stop shops should be part of a broader administrative simplification strategy, as a means to improve service delivery, reduce transaction costs and improve societal welfare. Fundamentally, they should be user-centred and based on life events for citizens and businesses – thus deconstructing government silos and presenting information in formats that are of greater benefit to users. The following specific principles should also be considered:

- Political commitment, which has been unanimously highlighted in OECD country research as critical to the success of reforms such as one-stop shops. Continuous communication is important between the political and administrative levels.
- A legal framework that lays a foundation for effective co-operation and co-ordination across different sections and regional levels of government – fostering strong relationships and permanent communication channels.
- Governance of the one-stop shop can vary, but should still allow operative decisions to be taken by a single organism and ensure all agencies participate at an executive level.
- Leadership that carries out realistic planning that is flexible to changing circumstances. Sufficient resources need to be allocated to human capital in terms of appropriate, technical and interpersonal, skills and tailored training.
- Public consultation to ascertain, and pilot, whether one-stop shops are the best solution for the user and meet their needs. A phased approach can be taken to ensure lessons from previous phases are taken into the following.
- Communication and technological approaches, with a clear idea of one-stop shop's purpose, that are fit-for-purpose using a mix of approaches, be that a physical shop front or central website – taking into account the accessibility issues for certain users.
- Monitoring and evaluation to ensure that the programme continues to meet the expectations and needs of users as well as governments. Quantitative and qualitative indicators should be established to improve the programme and ensure that any changes are subject to public consultation and impact assessment.

Source: OECD (2020a).

An ever more ambitious reform to improve the business environment

The authorities realised that the OSS should not overshadow more ambitious policy and regulatory reforms aiming at improving the business environment, and that its success relies on these wider reforms. The modest results in the World Bank Ease of Doing Business indicators, although improving, reflect the fact that Indonesia has not yet reached the level of some of its peers in the region or elsewhere (Table 6.2).

Although it ranked at a slowly improving 73rd place out of 190 economies in 2020 on the overall indicator, its score in the Starting a Business category was significantly worse in 140th place. President Widodo has set as a target to improve Indonesia's ranking to 40th position. While the Doing Business indicators do not portray a comprehensive image of the business environment in Indonesia, they can illustrate both the efforts undertaken in the recent past and the necessity to address certain remaining shortcomings to ease the establishment of companies.

Table 6.2. Doing Business' scores in Indonesia and selected other countries, 2019-2020

		Indonesia	Brazil	Malaysia	Mexico	Philippines	Thailand	Turkey	Viet Nam
Ease of Doing Business (overall)	2019	**68.2**	58.6	81.3	72.3	60.9	79.5	75.3	68.6
	2020	**69.6**	59.1	81.5	72.4	62.8	80.1	76.8	69.8
Starting a Business	2019	**79.4**	80.3	82.8	85.9	69.3	92.3	88.2	84.8
	2020	**81.2**	81.3	83.3	86.1	71.3	92.4	88.8	85.1

Note: An economy's ease of doing business score is reflected on a scale from 0 to 100, where 0 represents the lowest and 100 represents the best performance
Source: World Bank.

In this context, the authorities realised that identifying and cutting redundant regulations and streamlining overly burdensome procedures and requirements for investors should remain the top priority. While BKPM was already tasked to identify cumbersome regulations and procedures to start and operate a business in Indonesia over the past years, it had little convening power to influence line ministries to amend or remove them. As mentioned previously, with the issuance of Presidential Instruction 07/2019, one of the new government's first decisions was to provide more power to BKPM in the streamlining process of existing business licences. Line ministries are requested to actively identify and assess regulations regarded as disruptive toward the ease of doing business and to report them to BKPM, which in turn has to provide recommendations for their revisions. The Presidential Instruction also provides that a secretariat is created by the ministries and government institutions to implement BKPM's recommendations.

More importantly, the new Cabinet embarked upon an ambitious reform process with the preparation of two new Omnibus laws, one on job creation, and the other on taxation. The Omnibus Law on Job Creation is a wide regulatory reform process, for which the government identified 76 laws and over 1000 articles that are either overlapping or need to be revised. It addresses 11 clusters:

1. Simplification of licensing endeavours
2. investment terms and requirements
3. labour reform
4. protection and empowerment of micro, small and medium enterprises
5. ease of doing business
6. research and innovation support
7. government administration
8. penalty (sanctions)
9. land acquisition
10. ease for government projects; and
11. special economic zones.

The law aims to establish a friendlier investment environment, notably by significantly reducing the existing restrictions on foreign investments (see Chapter 3 on Indonesia's FDI regime). It also seeks to harmonise and simplify the business licensing process by amending and superseding individual laws related to almost all economic sectors and by limiting the role of local governments' licensing authority. By further centralising the licensing authority within BKPM, the Omnibus Law on Job Creation is seeking to make the OSS fully functional.

The law, enacted in October 2020, has been facing resistance, notably on its labour and environment components. Indonesia has strong and well-established trade unions, which are concerned about adding more flexibility to the labour regime. By relaxing environmental standards, the law is also raising concerns on its potential impact on environmental protection (see also Chapter 5 on responsible business conduct). In order to implement successfully such a high-profile reform, the government needs to go through a wide-ranging and meaningful consultation and communication process to avoid fierce confrontation with part of the population and promote an environment of trust (see below).

While this reform bodes well in some aspects, the rapid pace of successive measures is putting pressure on government officials, not only at national level but also at provincial and district (or city) level. New regulations come with new rules, tighter deadlines, new technology, while local administrations have to adapt, often with the same resources. Remote and less developed districts do not necessarily have institutional capacities to properly implement national policies and regulations. At the same time, these attempts to re-centralise the business licensing processes from local authorities may not be well accepted nor allow investors to fully bypass local officials in practice. And while the Omnibus Law on Job Creation is an ambitious reform, its success will depend on its application throughout the national administration and in the regions. Continuous efforts should hence be put on strengthening the capacities of officials dealing with businesses, enhancing the transparency in decision-making and maintaining a constructive dialogue with all stakeholders involved.

Maintaining a constructive dialogue with stakeholders for an ever improving business climate

Consulting stakeholders and advocating for better policies

In their continuous efforts to provide a friendlier investment climate, governments should maintain a regular dialogue with the private sector as well as other stakeholders – including labour unions, civil society and academia – to ensure an environment of trust, encourage investment retentions or expansions, and involve stakeholders in policy design. Consultation mechanisms and aftercare services are also key to collect feedback on recurrent issues affecting business operations and conduct effective policy advocacy.

The private sector is often consulted on an ad hoc basis in Indonesia, particularly when new policies and regulations are in preparation, including through KADIN – the Indonesian Chamber of Commerce and Industry. KADIN is the umbrella organisation of the Indonesian business chambers and association, covering all sectors of the economy throughout the nation. Thanks to this large network, it is the government's privileged private sector counterpart.

The government, especially BKPM, also consults foreign chambers of commerce and embassies but less systematically. In order to properly monitor the investment climate, it is important that all segments of the business community are taken into consideration equally, no matter the size, nationality or sectors of the companies. The voice of civil society and that of workers and consumers should also be taken into consideration in the government's investment climate related decisions.

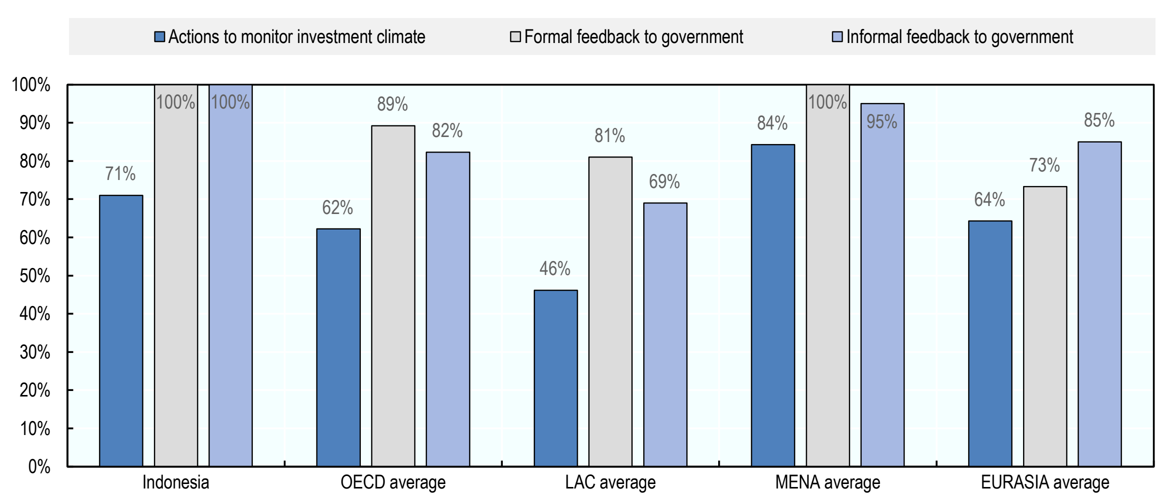
BKPM performs well its interface role between government and businesses, but there is no formal public-private dialogue platform in place allowing for systematic, comprehensive and open discussions on investment climate challenges and priorities. BKPM collects business' feedback through ad hoc meetings and workshops, as well as surveys of foreign investors, but the latter are mostly used to collect and disseminate data rather than to provide recommendations to policy designers.

BKPM uses the feedback collected from the private sector to formulate recommendations to other parts of the government in co-ordination meetings and position papers, and often advocates for friendlier investment policies and regulations. Policy advocacy is a natural function for a co-ordinating body involved in regulatory and facilitation activities like BKPM. IPAs involved in policy advocacy can decide to focus on specific activities over others, which are often grouped into three main categories: 1) performing actions to monitor the investment climate (e.g. tracking of rankings, meetings with the private sector, business surveys, consultation with embassies); 2) providing formal feedback to the government on how to improve the investment climate (e.g. meetings with government officials, production of position papers); and 3) providing informal feedback to the government on how to improve the investment climate (e.g. participation in periodic meetings, events, press articles).

Policy advocacy is conducted by a majority of IPAs around the world, but BKPM performs a wider range of related activities than its peers from the OECD, LAC and Eurasia areas (Figure 6.5). IPAs in OECD countries, for example, are often more focused on the implementing aspects of investment promotion and facilitation than on their policy and regulatory features, whereas their counterparts in the Middle-East and Southeast Asia tend to have broader policy mandates (see above). In the future, as the spread of the COVID-19 is prompting global uncertainty and declining FDI flows, IPAs will have an ever greater policy advocacy role to play to support sound business environments (OECD, 2020b). Working at the intersection of business and public service, IPAs are particularly well-placed to advocate for open, transparent and well-regulated markets. IPAs from OECD countries, such as Germany, Spain and the United Kingdom, are already planning to reinforce their policy advocacy roles to limit trade and investment barriers, improve the investment climate and ensure that policy instruments are non-discriminatory.

Figure 6.5. Comparative overview of BKPM's policy advocacy activities

As a percentage of all possible activities under this category



Source*: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).*

Effective co-ordination within government to channel pertinent policy and regulatory recommendations – and ensure their implementation – is as important as collecting relevant feedback from investors, but it can also be as challenging if not more (de Crombrugghe, 2019). The case of the Australian Trade and Investment Commission (Austrade) illustrates how building a strategic network of key relationships is critical to make policy advocacy effective and successful (Box 6.4). It shows that both getting relevant feedback from investors and nurturing constructive relationships with relevant public bodies are equally important.

Box 6.4. Austrade's Policy Influence Strategy: building on a strategic network of partners

Austrade works across government to advocate for investors in policy debates and decision-making processes. Its policy advocacy relies on its practitioners' knowledge of government policy agendas and decision-making processes. The agency often faces an asymmetric playing field, however, as other parts of government have more resources and direct policy responsibility. It thus needs to carefully pick its policy battles and thus developed a Policy Influence Strategy to maximise its policy resources.

Against this background, Austrade recognises the need to develop and nurture the relationships in its policy ecosystem – both with government agencies and other stakeholders. Using those relationships to prosecute policy arguments at the highest levels within government and the policy ecosystem can help maximising the number of successful cases. The Australian IPA also seeks to use the right tools, including data to ground their policy arguments and commercial insights from the agency's client-facing teams and their policy networks. Austrade is the only Federal government agency that can provide commercial-level input into policy debates.

The agency is working on the best ways to routinely get insights from its client-facing teams, who are busy servicing clients. Building external relationships, particularly with large policy agencies, is also critical to be successful. Partnering with other like-minded agencies in policy processes helps amplify the voice and arguments of Austrade in their quest for investment climate improvements.

Source: Australian Trade and Investment Commission, July 2019 (based on de Crombrugghe, 2019)

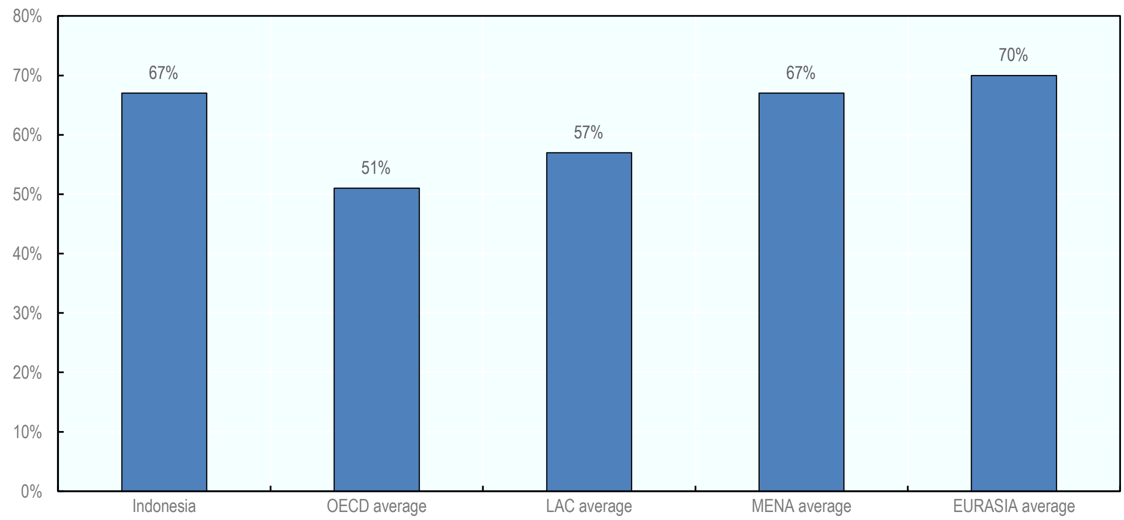
Aftercare as a channel to avoid disputes and promote business linkages

In addition to involving the private sector in policy design, working more closely with the private sector through aftercare can also help retain existing investors and encourage expansions. As the crisis is affecting businesses worldwide, IPAs have considerably scaled up their aftercare activities to help existing investors cope with the crisis and support their ongoing investments or operations (OECD, 2020b). Two areas where IPAs can make a difference are in avoiding potential disputes, on the one hand, and building business partnerships, on the other. While BKPM is using its leverage to prevent disputes involving investors, it is not yet involved in supporting business linkages between foreign affiliates and local companies.

IPAs can play an important role in preventing potential disputes involving investors, notably through structured trouble-shooting with individual investors, mitigation of conflicts (e.g. between investors and authorities, between investors and communities, etc.) and ombudsman intervention. BKPM provides the first two, which are also the most frequent dispute prevention mechanisms used by other IPAs, and compares relatively well vis-à-vis its international peers (Figure 6.6).

Figure 6.6. Comparative overview of BKPM's dispute prevention activities

As a percentage of all possible activities under the category



Source*:* OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

Structured trouble-shooting with individual investors, for example, is provided by at least 80% of IPAs in OECD, MENA, LAC and Eurasia countries. Ombudsman intervention is the least frequently available activity of the three across IPAs and is not performed by BKPM either. Korea was a forerunner in setting up a foreign investment ombudsman in its IPA in 1999. Its role is to solve complaints reported by foreign investors both by sending relevant experts to business sites and by taking pre-emptive measures to prevent future grievances by encouraging systemic improvements and legal amendments.

Aftercare can also support creating linkages between foreign investors and domestic firms, especially small and medium-sized enterprises (SMEs). MNEs do not necessarily engage in linkages with domestic suppliers automatically – even when local firms are competitive enough and technology-ready. Many MNEs are bound by international contracting arrangements that tie them to international suppliers, offsetting the effectiveness of public policies to promote linkages. In some other cases, MNEs rely on their usual overseas business partners for convenience or because of lack of information, and do not make the effort to look for local firms that can act as suppliers. In this case, the government can bridge information gaps with targeted measures to facilitate exchange of information. By interacting with MNEs on a daily basis, IPAs are often well placed to do so, especially through their aftercare activities.

As such, many IPAs around the world are involved in linkages programmes, most often through matchmaking services between foreign and domestic firms. BKPM, like many other IPAs, currently runs a business matchmaking programme between foreign investors and domestic firms (as mandated by the Presidential Regulation Number 44 of 2016). It could, however, benefit from further strengthening and better co-ordination with other existing MNE-SME linkage programmes across ministries and agencies, which would not only avoid that such initiatives are implemented in silos and overlap, but also help monitor the linkage programme. BKPM could also consider compiling a database of domestic firms and make it available to MNEs that are looking for suppliers in Indonesia. Co-ordination with similar initiatives across government is also important to establish a single database, which could help MNEs reduce their transaction costs while providing opportunities for local businesses. Suppliers' databases are often industry-specific and sometimes focus on priority sectors for FDI attraction. Some IPAs, often those that also integrate the mandate to promote domestic investment, have more sophisticated business support programmes (e.g. cluster programmes and capacity building) that can help domestic firms become suppliers of foreign affiliates.

Evidence shows also that long-lasting foreign investors, by knowing the local context better, are more inclined to use domestic suppliers instead of sourcing internationally (Farole and Winkler, 2014). Aftercare can thus support the double purpose of better anchoring foreign investors in the local economy and enhancing their positive spill-overs.

Through its aftercare activities, BKPM may also consider working with existing investors to promote responsible business conduct and encourage them to more systematically comply with laws, such as those on the respect for human rights, environmental protection, labour relations and financial accountability, as well as to embrace responsible and sustainable practices in their business operations (see Chapter 5 on policies to promote and enable responsible business conduct).

Investment promotion efforts

Prioritising FDI and designing a well-crafted investment promotion strategy

To attract FDI and fully benefit from it, measures to facilitate incoming investments and retain existing ones are not sufficient. A government needs to design a clear and well-defined investment promotion strategy to provide an overall direction to the IPA, with specific targets and means to achieve the set targets.

Investment promotion strategies are prepared to ensure that attraction efforts are well-targeted and contribute to the government's broader national development objectives. They need to draw on the country's economic development strategies but focus on what FDI can bring in addition to domestic investment and how MNEs can support national development objectives. These strategies revolve around the question of what to promote (i.e. sectors, countries, projects, investors) and how to implement this promotion in practice. Prioritising sectors, countries and projects should be conducted according to a set of well-defined criteria in line with the country's economic, social and environmental goals.

FDI prioritisation is a dominant practice across IPAs in the world, as virtually all IPAs target some investments over others. In OECD countries for example, 84% prioritise sectors, 59% prioritise countries and 78% prioritise projects (OECD, 2018a). Across MENA and Eurasia agencies, the majority prioritise sectors (80% and 70% respectively) and projects (70% each), while in LAC IPAs the majority prioritise countries (84%).

According to the IPA survey filled in by BKPM, Indonesia prioritises sectors, countries and projects. Its national investment promotion strategy is jointly designed by BKPM, the Coordinating Ministry for Economic Affairs, the Ministry of Foreign Affairs, the Executive Office of the President, the Ministry of Industry and the Ministry of National Development Planning. The collegial preparation of such a document is a good initiative given the horizontal nature of investment. The strategy draws on two main current strategic documents guiding the country's overall development objectives:

- The *Medium-Term National Development Plans 2015-2019 and 2020-2024*, prepared by the Ministry of National Development Planning, which are the third and fourth phases of implementation of the *Long-Term National Development Plan 2005-2025* that lays out the long-term vision. The five-year plans provide guidance to the entire cabinet, including on economic policy. They identified the following economic priorities: *i)* food sovereignty; *ii)* energy sovereignty; *iii)* maritime affairs; *iv)* tourism and manufacturing industry; and *v)* water security, infrastructure and connectivity.
- *Indonesia 4.0*, the country's latest industrial strategy, which is a roadmap designed to move from a traditional manufacturing-based economy to a high-tech mode of production with a stronger focus on R&D activities. It is led by the Ministry of Industry and has identified five sectors: *i)* food and beverage; *ii)* textile and apparel; *iii)* automotive; *iv)* chemicals; and *v)* electronics.

According to the information provided by BKPM, the sectors targeted for FDI attraction broadly reflect a combination of those included in both strategies, notably: *i)* infrastructure (electricity and transport); *ii)* tourism; *iii)* manufacturing (labour-intensive and export-oriented); *iv)* lifestyle industry & digital economy; *v)* maritime & fisheries; and *vi)* agriculture. The level of sector prioritisation is thus relatively low, as the wide range of industries for FDI promotion reflects the government's willingness to attract FDI to almost all sectors of the economy. The only sectors, for which BKPM does not conduct proactive promotion are financial services and upstream oil and gas.

Although the economic literature warns against a counter-productive "picking winner" approach by governments (Rodrik, 2004), empirical research also finds that countries obtain higher FDI levels in sectors targeted by their IPAs (Harding and Javorcik, 2011). BKPM should thus consider further focusing its promotional efforts on industries where a locational advantage can be developed rather than dispersing its attraction activities across a large scope of sectors. Working on a focused prioritisation strategy with more targeted objectives will make the work of BKPM more impactful and aligned with the country's sustainable development goals. It will also be easier for its staff to establish concrete targets, monitor progress and measure results.

BKPM also prioritises certain FDI projects, those they define as high quality investments, which is a way to be further focus its attraction efforts within each sector. The way Indonesia selects its criteria for prioritising investment projects reflects its willingness to maximise the development impact of FDI, including with criteria such as the impact of the potential investment projects on jobs, wages, exports, innovation, regional and sustainable development (Table 6.3). BKPM puts a stronger emphasis on these potential outcomes than on other upstream criteria to select projects, such as the country of origin, the mode of entry or the type of investor, which are being considered in other IPAs (e.g. Australia, Brazil, Korea, Turkey or the United Kingdom).

Table 6.3. Criteria used for prioritisation of FDI projects by BKPM and selected other IPAs

	Indonesia	Australia	Brazil	Korea	Myanmar	Turkey	UK
Priority Sector	√	√	√	√	√	√	√
Priority Country of Origin		√	√			√	√
Mode of Entry		√	√	√		√	√
Size of Investment	√	√		√		√	√
Investment Horizon / Duration	√	√					√
Type of Investor		√	√				√
Size of the Company	√					√	√
Nationality of Investor		√					√
Company's Engagement in FDI		√	√			√	√
Impact on Job Creation	√	√	√	√	√	√	√
Impact on Wages	√	√					
Impact on Exports	√	√	√	√	√	√	√
Impact on Innovation	√	√	√	√	√	√	√
Impact on Regional Development	√	√	√	√	√	√	√
Impact on Tax Revenue	√				√		
Impact on Country's Image	√	√	√		√	√	
Impact on Local Firms' Capacities	√	√	√		√	√	
Impact on Competition	√	√	√	√	√	√	
Sustainability	√	√	√	√	√	√	√

Source: Based on OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

While the intention is laudable to focus on development outcomes, it might also require a strong monitoring and evaluation system and well-targeted performance indicators to ensure that the agency's investment generation efforts are leading to the expected results. Making sure to work with manageable and meaningful indicators (i.e. that can help determine whether the IPA actions generate expected economic and social outcomes) would help evaluate BKPM's contribution to sustainable development and responsible business conduct.

Overall, BKPM could dedicate more efforts to its investment promotion and attraction activities, with more focused and prioritised investment generation efforts. Criteria to select those sectors should strike a balance between the government's desire to diversify the economy and the possibility of relying on strong domestic capacities. Focus could be given to emerging and sustainable sectors such as the digital industry, clean energy and eco-tourism. Drawing on Chapter 2 of this *Review* on trends and impacts of FDI in Indonesia, BKPM should also focus on projects in sectors where foreign investments' performance is higher than domestic ones, notably in terms of productivity and innovation (e.g. chemicals, food), wages and skills development (e.g. energy, transport services), and environmental performance and clean technologies (e.g. energy efficiency) as well as on sectors that are more likely to generate linkages with domestic firms (e.g. automotive and electronics). The chapter provides an in-depth analysis of foreign investments' contribution to sustainable development goals in Indonesia, which could guide BKPM's prioritisation efforts in attracting FDI.

Chapter 2 also highlights that FDI is highly concentrated in terms of origin, as the bulk of foreign investments originates in Singapore and Japan. While there is evidence that some OECD multinationals invest in Indonesia through their operations in Singapore, reliance on FDI from a small group of investors increases Indonesia's exposure to changes in macroeconomic conditions in those countries. BKPM could thus actively target firms from other countries and regions to reduce Indonesia's vulnerability to external shocks. The prioritisation of countries should go hand in hand with the prioritisation of sectors and projects addressed above.

The COVID-19 outbreak, and the risk of reduced FDI flows as a consequence, makes it even more important for the government to focus its investment promotion strategy on targeted projects with a high developmental impact and likely to support a sustainable recovery in Indonesia. Many IPAs in the OECD area and elsewhere are rapidly shifting their activities accordingly and adopting new strategies (Box 6.5).

Box 6.5. OECD IPAs' evolving strategies in light of the COVID-19 outbreak

IPAs' capacity to adapt to new situations makes them key actors in governments' responses to the COVID-19 crisis. By working closely with the private sector and on different policy areas, IPAs are often flexible and prone to adapt to new situations but need to rethink their strategic orientations to better respond to both public and private sector needs.

In the short term, the nature of services provided by IPAs in the OECD area has changed radically by shifting away from marketing to intense aftercare. While IPAs are immediately and significantly scaling down their marketing campaigns and activities, focus is now given to engaging and maintaining contact with existing investors. Informing them about government programmes, helping them to cope with the crisis and supporting their ongoing investments or operations are the IPAs' immediate priorities. Focus is given on hardest hit sectors, notably SMEs and export-oriented investors. IPAs have also activated their existing business networks, particularly in the health sector, to help the government fight the crisis.

In the medium to long-term, the COVID-19 response has drastically accelerated the trend towards greater digitisation of IPAs. While many IPAs have seen an immediate impact of the crisis on the way of doing business, digital means will allow them to continue servicing and identifying future clients, which requires access to different digital tools. For example, digital client prospecting, capable of correctly identifying potential leads, and virtual-reality solutions for site visits can gain in importance. IPAs are already planting the seeds of, or speeding up, this transformation. For example, CINDE Costa Rica has accelerated its digital plans, including artificial intelligence-based marketing, providing services and products online. IDA Ireland will include more digital solutions and services in its new strategy. Business Sweden provides investors with access to online interactive maps of different industrial clusters and proximity of key infrastructure, and plans to expand them.

IPAs are also rethinking their investment promotion strategies to increase the impact of inward FDI. Prior to the crisis, several IPAs had been developing tools to better identify and support FDI projects that can have the highest impact on the local economy and support sustainable and green growth. This trend is likely to be accentuated as the pressure on IPA budgets increases and the recovery requires a concerted effort to create and sustain jobs. For example, Business Sweden has used for years a qualitative evaluation system to identify "high-quality" projects and the UK Department for International Trade will continue to build on its work to maximise its economic impact through the use of economic analysis and intelligence driven prioritisation, ensuring FDI plays an effective role in economic recovery. Many other IPAs have expressed a strong interest in better prioritisation that is evidence-based and centred around sustainable development.

Source: OECD (2020b).

The role of zones-based policy in promoting FDI

Indonesia has a longstanding experience in relying on different types of economic zones to promote foreign and domestic investment. Since the beginning of President Widodo's first term in 2014, the development of industrial parks (or industrial estates) and special economic zones (SEZ) has been used extensively by the government to revamp the economy's industrialisation and promote labour-intensive investments (Octavia, 2016).

The development of industrial estates was initiated in the 1970s in certain cities (Jakarta, Surabaya, Cilacap, Medan, Makassar and Lampung) at the joint initiative of local and provincial governments to promote investments in the manufacturing sector (EIBN, 2017). Industrial estates provide land and facilities to manufacturing companies, which do not benefit from extra tax incentives. Presidential Decree 53/1989 opened up the possibility of developing industrial estates to private companies and set the related legal and technical standard requirements for their development and operation. The first guidelines were established in 1996, which were then successively revised in 2009 and 2015.

According to the Industrial Estates Association, there are 87 industrial estates in Indonesia, a majority of which are being located in Java (and close to Jakarta). They cover over 86 000 hectares with approximately 9 600 firms employing 4.5 million workers. Industrial estates are mostly used by manufacturing companies, both domestic and foreign, notably in the automotive, electronics and food industries. Industrial estates can be privately or publicly-owned. Local authorities are in charge of preparing a masterplan, which is then submitted to and approved by the Ministry of Industry. The business community tends to recommend the use of industrial estates, especially by SMEs, notably because of the ease in generates in terms of land procurement, permitting and infrastructure facilities.

The development of SEZs have also been an important part of the Indonesian economic development policy. One of the major differences with industrial estates is that SEZs, in addition to land and facilities, also provide tax incentives to investors (see section below). Successive programmes have been put in place, one of the most ambitious of which has been the Integrated Economic Development Zones (KAPET) created in 1996. While the stated objective of this programme was to promote development and inclusive growth in lagging regions, the programme seemed not to have achieved its intended outcome (Rothenburg et al., 2017). Districts benefitting from the KAPET programme experienced no better development outcomes than others. Although firms paid lower taxes, it did not promote business activities or led to development outcomes. Co-ordination challenges between local governments and the central government over administrative authority were partly behind the implementation issues that the KAPET programme faced (See Chapter 7 for more information).

Currently, SEZs are located in strategic locations, close to boundaries and often in regions endowed with natural resources. The objectives of SEZs are to attract investments outside of Java and to encourage mining and other natural resource companies to transform locally. There are currently 12 SEZs and the government intends to create 25 under the Mid-term National Development Plan. The regime for FDI applies differently in SEZs, as the Negative Investment List does not apply in SEZs. Only prohibited sectors and SMEs are restricted for FDI, like under the general regime.

The development and management of SEZs is the joint responsibility of the central government, regional governments and private promoters. At the central level, a multi-ministerial council supervises the SEZ programme and planning. It is chaired by the Coordinating Minister for Economic Affairs and includes the Ministry of Finance, the Ministry of National Development Planning, the Ministry of Transport, the Ministry of Land and BKPM. Each individual SEZ is governed by a regional council chaired by the Governor. While the intention to create zones to attract FDI in remote areas and promote industrial activity through local processing of natural processing are valuable objectives, the government should make sure not to replicate the failure of the KAPET programme. The authorities should also ensure that the efforts made to develop SEZs do not overshadow the more important objective of improving the business environment throughout the country.

The management and expansion of industrial estates and SEZs have important implications on local economic development, which is being further examined in Chapter 7 on investment policy and regional development in decentralised Indonesia.

An overview of corporate taxation in Indonesia

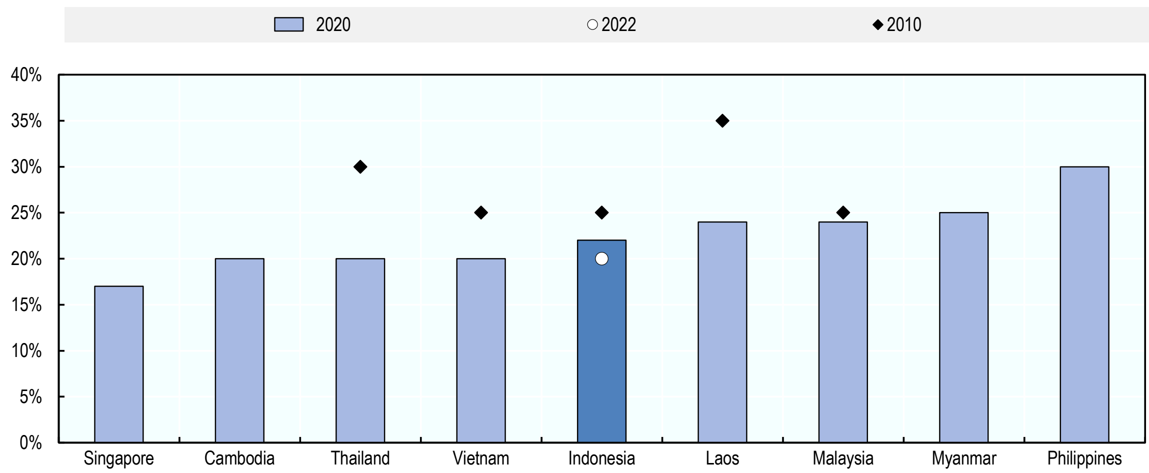
Corporate income tax rates are in line with the ASEAN average

Statutory corporate income tax (CIT) rates are the first reference point for foreign and domestic investors when evaluating the tax treatment of a jurisdiction and carry an important signalling role. With a further rate reduction planned in 2022, Indonesia's CIT rate (22%) is regionally competitive and in line with the ASEAN 22% average (Figure 6.7).[3] It is lower than the OECD average (23%) and than that of similar income level countries (25%).

The statutory CIT rate was lowered in 2020 as part of the policy response to the COVID-19 outbreak and its economic impacts. A rate reduction – already envisaged under the Omnibus bill on taxation proposed in 2019 – was anticipated to provide tax relief to businesses affected by the crisis (Box 6.6). The COVID-19 policy response accelerated other tax reform measures, such as the electronic transaction tax. Income tax applies on businesses registered in Indonesia. As of 2020, an electronic transaction tax applies on e-commerce income of foreign registered digital companies with a significant economic presence. The rate and definition *of significant economic presence* will be regulated in a future government regulation.

Figure 6.7. Statutory corporate income tax rates in Indonesia and ASEAN

Statutory corporate income tax rate (in %)



Source: OECD based on OECD Corporate Tax Statistics and EY (2019).

Box 6.6. Omnibus bill on taxation and COVID-19 tax response

Taxation regulations are spread out across many applicable laws and regulations in Indonesia. The Omnibus bill on taxation proposed to introduce several changes to multiple tax laws and regulations through a single new bill. Part of tax policy changes were anticipated as part of the policy response to the COVID-19 pandemic, including:

- Statutory CIT rate reduced to 22% in 2021-22 and 20% from 2023 onwards;
- Electronic transaction tax applies to foreign registered digital companies with a significant economic presence; and
- Value-added tax (VAT) applies on use of foreign intangible goods or services.

Other tax reforms planned under the bill but not yet introduced include:

- Unifying regional taxes and sanctioning regional administrations that impose by-laws deemed not in line with national policy;
- Extending taxation to long-stay expatriates in Indonesia (over 183 days per year);
- Reducing interest on late tax payments; and
- Removing withholding tax on dividends, as long as they are reinvested in Indonesia.

Source: PERPPU 1/2020 and Minister of Finance Regulation 23/2020.

Tax reform and COVID-19 policy response

Indonesia is implementing a comprehensive tax and tax administration reform that seeks to create a more open and attractive business climate for investors. Partially implemented, the tax reform seeks to unify, simplify and lower corporate taxation. The reform took a new dimension with the start of the COVID-19 health crisis. Indonesia decisively acted to provide temporary tax relief and financial support to its business sector as part of its national economic recovery strategy. Specific measures targeted the health sector and introduced income tax exemption in the provision of good and services to combat COVID-19, as well as tax deductions for acquisition of medical equipment.[4] Accelerated VAT refunds, tax deferral and financial subsidies for SMEs, and import tax reduction were extended to almost sector of the economy. Support to SMEs is of particular importance as they may be less able to withstand liquidity and solvency risks, as well as to highly impacted sectors (e.g. tourism industry).

Tax policy response plays an important role in limiting the adverse effects from containment and mitigation measures. Public deficit is expected to increase in short run and tax revenues are likely to be significantly reduced for a number of years, due to the direct effects of the crisis as well as to policy action during the crisis. Forgone tax revenue and additional spending is estimated to reach 2% of GDP in 2020 (IMF, 2020). Fiscal consolidation will be needed, but Indonesia advance carefully so as not remove its support to business too early and maintain the economy's ability to rebound.

A particular challenge to Indonesia stems from the country's historically low tax base. Indonesia has persistently had difficulty to increase its tax-to-GDP ratio, despite government efforts. In 2018, Indonesia's tax-to-GDP ratio was 11.3%, the lowest tax-to-GDP ratio among G20 countries and particularly low relative to other countries at a similar income level. The tax-to-GDP ratio of lower middle-income countries is on average 18.5%. In the same year, corporate income taxes in Indonesia accounted for 23% of the total tax revenue (2.6% of GDP). The lower CIT rate risks eroding Indonesia's tax base if not accompanied by base-widening measures in the medium-run. The 2 percentage-point CIT rate cut The Ministry of Finance estimated that the reduction of the CIT rate alone could lower tax revenue by up to IDR 86 trillion annually prior to the onset of the COVID-19 crisis (Akhlas, 2020). Lower tax revenues can constrain government spending on infrastructure and social services, which in turn can hamper progress toward improving the business environment in the long run.

The role of investment incentives in Indonesia

Tax incentives are a widely used tool to promote investment, particularly FDI. Tax incentives attempt to influence the size, location or industry of an investment project, reducing the cost or risk attached to the investment decision. Indonesia has a long history of use of tax incentives. In recent years, they have been extensively reviewed and expanded to attract investment, as well as being been extended to additional business segments and activities.

Tax incentives can take many different forms. Indonesia's tax incentive schemes include tax holidays, investment tax allowances, enhanced deductions, accelerated depreciation and special customs regimes for firms in SEZs.[5] Tax incentives mainly support the development of key industries (pioneer industries), activities with socio-economic spillovers (R&D and vocational training) and those that contribute to regional development through SEZs.

Tax incentives for investment in Indonesia target companies incorporated in the country and do not distinguish between domestic and foreign ownership. Incentives regulations adopt a number of measures that limit the administrative cost of processing the incentive applications. When applying for incentives (e.g. tax holidays or investment allowances), investors must opt for one incentive scheme and may not apply again if their application is rejected. If an investor receives one incentive, they may not receive any other main incentive.

Applications for most tax incentives are submitted through the OSS system and, if eligible, passed on to the Ministry of Finance, which has the sole authority to grant tax incentives. The OSS has been an important step in cutting the red tape that is involved in applying for tax incentives by streamlining the requests together with those to obtain business permits in Indonesia (see above). The central online system also facilitates keeping records of incentive requests and approvals, as well as streamlining the selection process.[6] The move to electronic services also strengthens monitoring and detection of non-compliance.

The gradual shift to cost-based incentives is a positive development

International organisations often argue that cost-based tax incentives should be preferred over profit-based ones, as they are generally more efficient (IMF-OECD-UN-World Bank, 2015; OECD, 2015a). Profit-based incentives – such as CIT holidays and reduced CIT rates – are determined on already secured profits, while cost-based incentives reduce the cost of capital (Box 6.7). Indonesia has traditionally relied more on profit-based incentives than on cost-based ones. Past OECD recommendations have suggested shifting from profit-based to cost-based tax incentives (OECD, 2018b; OECD, 2010).

Box 6.7. Profit-based and cost-based tax incentives

Profit-based incentives are determined as a percentage of the investment project's profit. As a result, they benefit investments that were already profitable before the incentive was granted, and which are more likely to have occurred independently of receiving the incentive. Profit-based incentives have the advantage to be simpler to implement and to require lower tax administration capacities.

Cost-based incentives are generally less biased towards firms that are already profitable. They allow investors to recover their investment faster through additional deductions from their taxable income (e.g. investment allowances) or directly from their payable taxes (e.g. tax credits), lowering the cost of capital. By lowering the cost of capital, cost-based incentives make more investment projects economically viable at the margin – that is, investments that would not have been profitable without the incentive. As a result, they generally have the potential to mobilise more investment per dollar of forgone tax revenue compared to profit-based incentives (Clark & Skrok, 2019). Cost-based incentives may have a higher likelihood of generating positive spillovers if well implemented. Incentives vary according to investors' spending and performance, which allows for targeting certain activities (e.g. SME linkages, skills development etc.). Cost-based incentives, therefore, can be important to support specific policy objectives and to generate longer-term impact on investment.

Source: OECD (2014).

Since 2018, Indonesia has been extensively reviewing its tax incentive schemes. Since 2019, all new CIT incentives have been cost-based, which marks a positive shift in the tax incentives' design. During the same period, existing profit-based incentives were also expanded to benefit additional sectors. Eligible business segments were increased from 145 to 179. The authorities could consider limiting profit-based incentives to high priority investments in the future and continue to shift toward cost-based incentives. Given their potential disadvantages, rigorous impact evaluations should be used to assess whether profit-based incentives are achieving their intended policy objectives.

Pioneer industries are eligible for generous tax holidays

New investors in so-called pioneer industries are eligible to receive tax holidays.[7] A tax holiday is a complete exemption from taxation of corporate income, usually over a defined period of time, starting at the beginning of the investment lifecycle. Companies can only apply for the tax holiday once within the first year of receiving their New Business Licence, which reduces the administrative burden of processing applications.

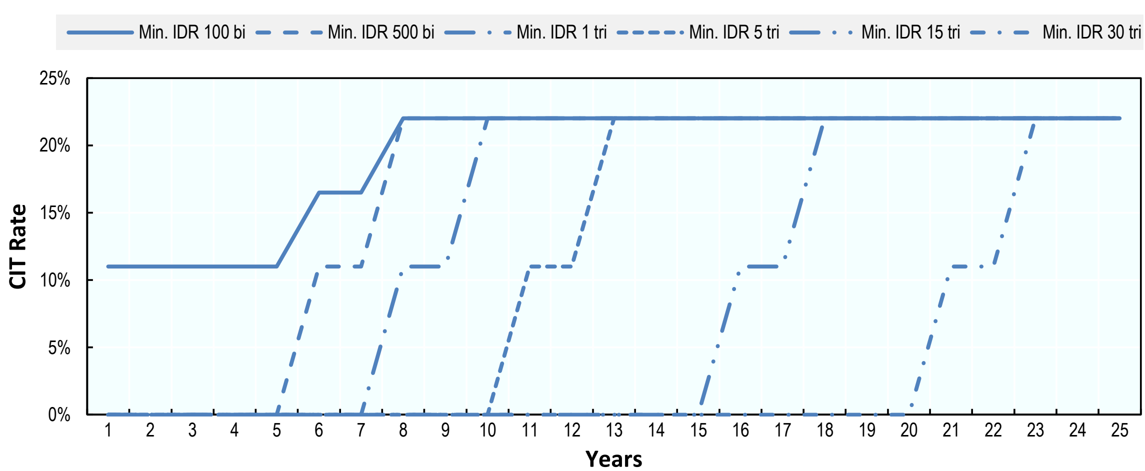
Pioneer industries refers to 18 broadly defined industries, selected based on their development potential and benefits to the economy. [8] In addition to belonging to one of these industries, investment projects must also produce extensive economic linkages, generate value-added and high positive externalities, and have strategic value for the national economy. Criteria used to determine the fulfilment of these conditions could be made more evident, in order to reduce discretionary decision-making when according incentives and to increase transparency. The list of pioneer industries has gradually expanded over time. For example, in 2018, an amendment to the regulation included economic infrastructure and the digital economy as pioneer industries.

The tax holiday's length varies according to the initial investment and ranges from 5 to 20 years (Figure 6.8). Investment projects of IDR 30 trillion or more receive 20-year tax holidays, the longest among ASEAN countries (OECD, 2018b). A reduced CIT rate applies for two years after the holiday period ends. Mini tax holidays are available for investment projects of at least IDR 100 billion and offer a 50% reduced CIT rate for five years combined with a 25% reduced CIT rate for two years after the holiday period ends.

The larger the project, the more generous the incentive and the higher the tax revenue forgone. Therefore, it is important for policy makers to evaluate the cost and benefits of each incentive. For certain investments, the authorities could consider coupling incentives with contractual obligations to undertake subsequent investments to deter footloose investments and encourage companies to develop long-term investment strategies (OECD, 2003).

Figure 6.8. CIT holidays and reduced rates for investments in pioneer industries

Year of reduced CIT rate according to investment project size



Note: Company must be incorporated in Indonesia, Debt Equity Ratio for income tax purposes must be below value stipulated on MoF Regulation No. 105/2018. Tax holiday and mini tax holiday introduced by MoF Regulation No. 150 of 2018.
Source: OECD elaboration based on national legislation.

Investment allowances were expanded to more investors

Indonesia offers several cost-based tax incentives to investors that apply under different conditions (Box 6.8 and Table 6.5). Two investment allowances are available: the first allows investors to deduct an additional 30% of the investment cost in "certain industries" and the second allows them to deduct an additional 60% of the investment cost.

Box 6.8. Definitions: cost-based tax incentives

- **Investment allowances** give the taxpayer the right to deduct a percentage of the cost of the investment beyond the regular tax depreciation that applies. For example, if an investor spends USD 100 and the investment allowance is 30%, the investor will be able to deduct an additional USD 30 from its taxable profits in the first year or years of the investment.
- **Accelerated depreciation** allows for depreciation at a faster schedule than is available for the rest of the economy. It reduces the cost of capital by allowing the investors to recover the investment cost faster. If the asset costs USD 200 and the standard depreciation period is 10 years, the investor can deduct USD 20 from its taxable income each year for 10 years. A 200% accelerated depreciation rate would allow the investor to deduct the cost of the investment twice as fast and deduct USD 40 each year for five years. This means the project will pay less tax in the first five years and therefore recover its costs more quickly, even if the final deducted value is the same.
- **Enhanced deductions.** Some countries, allow investors to deduct more than 100% of certain categories of expenses such as approved training programmes and R&D. This allows for decreasing the tax base amount that is taxed by deducting a certain expense at a higher rate than actual costs. An enhanced allowance of 200% allows a certain expense to be deducted twice as cost: its actual cost and a second time, for taxation purpose.
- **Loss carry-forward**. The general tax code usually allows operating losses to be carried forward to offset taxable income in a future year, with a limit on the loss carry-forward period. This reduces tax revenues where losses that would have otherwise expired can continue to be carried forward to reduce taxable income in future years.

Source: OECD and IGF (2018).

Policy objective of the 30% investment allowance is less clear

The 30% investment allowance – originally introduced through the 2008 income tax law[9] (Table 6.4) – was significantly expanded in 2019: (i) eligible industries increased from 145 to 183; (ii) geographic location requirements were removed, except for 17 industries; and (iii) the incentive was expanded to apply to any new investment project, while under the previous regulation it was only available to newly registered firms.

When possible, authorities should apply incentives in a uniform and consistent way across all investments or clearly target specific investments to achieve intended policy objectives. Industries targeted by the investment allowance are very broad, especially since the removal of the geographic location and of the newly registered firm requirements. The broad investment tax allowance creates an unequal playing field among investors, reducing the effectiveness and efficiency of the investment allowance. Indonesia could consider more clearly defining the policy objective of its “certain industry” incentive to avoid creating an uneven playing field.

The second investment allowance of 60% is targeted to develop labour-intensive industries and is well aligned with Indonesia’s broader policy to boost job creation in these industries. Under more restrictive conditions, the incentive is limited: (i) to 45 labour-intensive business segments; (ii) investors with a new business licence; and (iii) new projects that will employ at least 300 workers and investors. While the policy does not require any minimum investment (as the tax holiday policy does), it targets new medium and large investment projects by adding a minimum number of employed workers for the project to qualify.

Accelerated depreciation rates allow investors to recover their investment more quickly and apply under the same expanded conditions offered under the 30% allowance. Whether investor are more likely to opt for one or the other incentive is likely to vary according to the type of the investment project. The accelerated depreciation incentives apply to both tangible and intangible assets, while investment allowances apply to only tangible ones. This difference between the two incentives could be more clearly communicated to investors, as it is relevant for high-tech and digital industries.

Table 6.4 Description of cost-based tax incentive schemes in Indonesia

Incentive	Qualified Expenses	Deduction	Conditions
Investment Allowance ("Super deduction")	Capital Investment in tangible fixed assets, including land	60% of capital expense (10% per year, over 6 years)	Labour intensive industries (45 business fields) At least 300 employees New business licence
Investment Allowance	Capital Investment in tangible fixed assets, including land	30% of capital expense (5% per year, over 6 years)	Certain business fields (183 fields) Investment has a high investment value, is export-oriented, employs a large workforce or has high local content in its production. New investment project
Accelerated Depreciation	Capital Investment in tangible or intangible fixed assets	200% of tax code rate	*Certain area* business fields (183 fields) Investment has a high investment value, is export oriented, employs a large workforce, has high local content New investment project
Loss carry-forward extension	No applicable	5-10 extension (beyond 5 years specified in investment law)	*Certain area* business fields (183 fields) Investment has a high investment value, is export oriented, employs a large workforce, has high local content New investment project
Skill Development Enhanced Allowance	Costs from work practice, apprenticeship, and/or learning activities Building, physical facilities for trainings	200% of expense Applies to current expenses or asset lifetime for buildings	Internship or vocational training program in certain competencies to upskill human resources as part of the investment and fulfilment of workforce demand Limited to manufacturing (automotive, furniture, shipping, textile and garments) and industrial logistics
R&D Enhanced Allowance	Research and development spending*	300% of expense Applies to current expenses or for 5 following years when intellectual property is produced	Activities that produce new invention and innovation, master a new technology, or transfer of technology.

Note: The table only include cost-based CIT incentives. * Expenses not eligible for enhanced deduction include cost of quality control, seasonal design changes, routine equipment design, construction engineering/ relocation/ start up facilities, market research, etc.
Source: OECD elaboration based on national legislation (Government Regulation (PP) No. 45/2019, MoF Regulation No. 128/2019, Government Regulation No. 78/ 2019, Government Regulation No. 45/2019, MoF Regulation No. 128/2019, MoF Regulation No. 16/2020).

Enhanced deductions target skill development and innovation

Indonesia introduced enhanced deductions to support R&D activities and skills development. Spending on R&D and vocational training receives respectively a 200% and 300% enhanced tax deduction (Table 6.4). Investment in R&D is a key driver of innovation and has the potential to produce positive externalities. As private returns are lower than social returns, governments can incentivise R&D investment to bring it up to the social optimum. As a result, R&D is the focus tax incentive policy in many countries including OECD economies.

For R&D enhanced deductions, the regulation includes a number of good practice measures, such as clearly limiting eligible expenses to only those closely related to R&D (e.g. contracts with university and research labs, hiring of researchers and technicians, external consulting and training activities). Clearly defining targeted expenses is central to ensuring the policy benefits the activities with potential positive externalities. While the legal basis for the enhanced tax deduction for R&D spending was introduced in mid-2019 (Government Regulation No. 45), the implementing regulations have still not operationalised the incentive. Indonesia could consider limiting the delay between the introduction and operationalisation of new incentives, so as to reduce investor uncertainty.

Tax deductions linked to skills development can contribute to human capital development and firm competiveness under the right conditions. Tax incentives for vocational training are expected to benefit both newly entering investors and already established ones in Indonesia. New investors – particularly foreign ones – need to develop their pool of skilled labour to start production and the incentive can reduce this initial cost. Established businesses who already undertake regular training of their workers may have an additional incentive to expand worker training, which could help increase production efficiency.

Tax incentives – such as those for R&D and skills development – can enhance FDI spillovers on the domestic economy under the right conditions. SME-FDI linkages are another important channel for spillovers from FDI. Tax and other incentives that foster linkages with SMEs and upgrade their skills have proven effective in several countries in establishing linkages and boosting SME productivity (Perera, 2012; UNCTAD , 2011; Christiansen & Thomsen, 2005). In Indonesia, business linkages between foreign and domestic firms are already significant, suggesting that the potential for productivity spillovers is high (see above and Chapter 2 for more information of business linkages).

Box 6.9. Fostering FDI-SME linkages through tax incentives: Malaysia and Singapore

Malaysia and Singapore offer two examples of ASEAN countries that support FDI-SME linkages through tax incentives. In Malaysia, under the Industrial Linkage Programme, investors can claim tax deductions for costs involved in providing support to local suppliers, including training, product development and testing, and factory auditing to ensure the quality of local suppliers. A Global Supplier Programme also offers financial and organisational support to multinational enterprises, if specialists from their foreign affiliates are seconded to local firms (for up to two years).

Singapore's Local Industry Upgrading Programme had a similar design, but it has now been replaced by the Pioneer Certificate Incentive and the Development and Expansion Incentive. These two tax incentives offer corporate tax exemption or a reduced concessionary tax rate on eligible income if the multinational enterprise sets up locally upstream and downstream activities previously conducted internally. The aim of the programme is to foster technology transfers and the scale-up of local businesses.

Source: OECD (2019).

Linkage-development tax incentives, if integrated into a broader linkage development programme, could further encourage integration with the domestic economy, enhancing spillovers and promoting upgrading of local suppliers.[10] One option involves tax breaks for foreign investors who invest in the upgrading of local suppliers through training, mentoring or staff secondment programmes (OECD, 2018c). In the ASEAN region, Malaysia and Singapore have already used this policy with generally positive results (Box 6.9). Given Indonesia's recent expansion of tax incentives, any linkage incentive should replace another incentive – representing a design improvement – rather than the introduction of a new incentive.

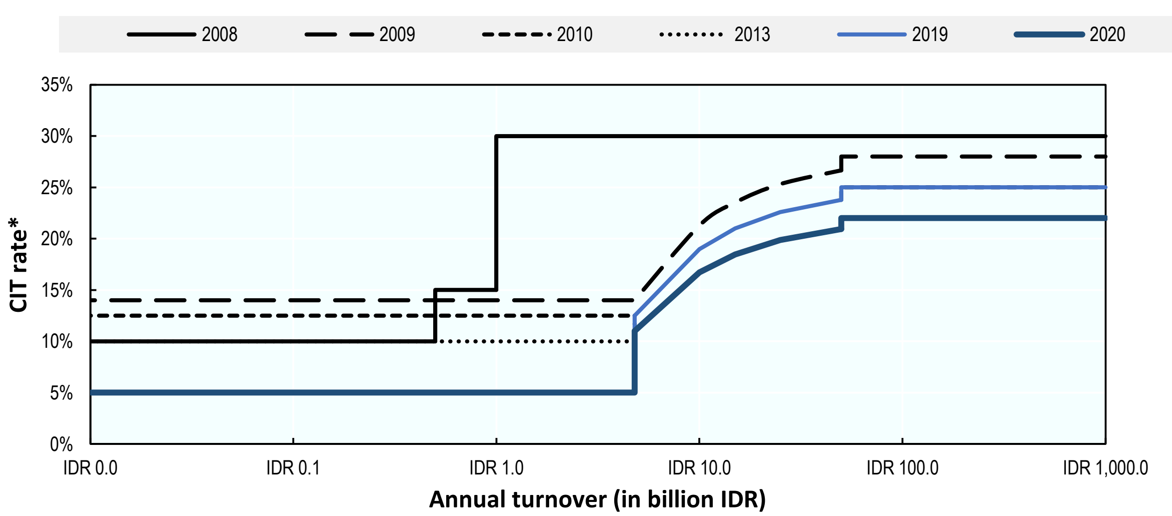
Preferential rates apply to newly listed companies and SMEs

Preferential CIT rates – rates lower than the statutory rate – apply to certain businesses. Newly publicly listed companies receive a 3-percentage point reduction on CIT payment (19% CIT rate), limited to a period of five years after listing. Indonesian SMEs also receive preferential tax treatment. Companies with a gross annual turnover of up to IDR 50 billion receive a 50% CIT rate reduction (11% CIT rate) on part of their income, while businesses with an annual turnover less than IDR 4.8 billion (small enterprises) may opt for a unified rate of 0.5% on their monthly turnover.

The preferential tax policy for SMEs seeks to promote small business formalisation. By mid-2018, it succeeded in encouraging 1.5 million small companies to formalise (OECD, 2018c).[11] Special tax regimes for SMEs are common among OECD and G20 countries, where the difference between the statutory and preferential CIT rate is on average 4 percentage points (OECD, 2015b). In Indonesia, the difference between the two rates is much higher (Figure 6.9). Support to SMEs will continue to be important as Indonesia moves toward economic recovery, but raising the upper limit of companies benefitting from the special tax regime for SMEs could serve as a source of new revenue in the medium-run.

Figure 6.9 CIT rates for SMEs have progressively been reduced over the past decade

Corporate income tax (in %) applied according to enterprise annual turnover (in IDR billion)



Note: CIT rate* refers to the relevant CIT rate or the CIT-equivalent rate under the assumption of a 10% profit rate on turnover. The unified tax as a share of revenue for SMEs (2013 and 2018) is calculated as CIT-equivalent and profit-based tax brackets (2008) are presented as turnover-equivalent.
Source: OECD elaboration based on national legislation.

Indonesia's Fiscal Policy Agency (*Banden Kebijakan Fiskal,* BKF), under the Ministry of Finance, does not consider the preferential taxation of SMEs as a tax incentive, but rather as part of the benchmark tax system – a characteristic of the general tax treatment (BKF, 2019). It may nevertheless still have significant implications for tax revenues even as part of the benchmark system. VAT exemptions for small enterprises alone represented 40% of forgone tax revenues from incentives for businesses in 2018 (BKF, 2019). CIT revenue implications could be larger. Furthermore, policy costs will continue to increase as SME formalisation grows. Given its relevance, the SME tax regime could be systematically evaluated to ensure it continues to achieve its intended policy objective.

Tax incentives in Special Economic Zones

Indonesia has introduced changes to its major tax incentives in recent years, including tax incentives in SEZs. In early 2020, Government Regulation 12/2020 on "Facilities in the Special Economic Zones" revoked the previous regulation on tax incentives in SEZs (GR 96/2015). The regulation introduces a similar basis for CIT facilities. The implementing regulation detailing the amount, duration, submission process of the incentives have not yet been published.[12]

The regulation provides details on the governance of tax incentives in zones, including a number of good practice measures relating to the use of CIT incentives. Tax incentives are limited to incomes resulting from the enterprise's main activity, capital goods eligible to receive incentives are clearly specified and the policy includes a clawback measure on incentives given in the case of non-fulfilment of requirements.

In addition to CIT incentives, incentives applying on other taxes are also available to investors in Indonesia within economic zones. VAT on inputs, excise tax, luxury goods sales tax (PPnBM) and custom duties exemptions apply on imports of certain goods within Special Economic Zones (KEKs), Integrated Economic Development Zones (KAPETs) and Bounded Zones. Import duty postponement on capital good and equipment and material for processing is available for investment in KEKs and KAPETs.[13] In addition, all machinery and equipment acquired by taxable entrepreneurs (PKP) and to be used for production in Indonesia is VAT exempt.[14]

Creating bonded areas with high-quality infrastructure, human resources and administration is an important policy tool to promote economic development, considering that Indonesia is geographically too large to improve infrastructure across the whole country in a short period of time. Place-based policies have the potential to generate positive local spillovers and serve as a tool to promote local economic development. Chapter 7 discusses the relevance of SEZs for regional development in Indonesia in further detail.

Consolidating incentives in tax laws increases transparency

To create an attractive business environment, transparency, simplicity and clarity in the provision of the legal and regulatory framework are important. In Indonesia, tax incentives are regulated through a combination of laws, decrees and implementing regulations (Table 6.5). The complexity of multiple regulations and of eligibility criteria creates additional costs to investors (e.g. requiring specialised tax advice) and deters investors from applying for the regime, which risks reducing its effectiveness and efficiency.

Indonesia could consider consolidating all the tax incentives provided, along with their eligibility requirements, to increase transparency and legal certainty.[15] The OECD *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries* (OECD, 2013) recommends that tax incentives and their eligibility criteria be consolidated and published in the tax law. Corporate tax incentives (such as the investment allowance) would best be provided through the Income Tax Law, whereas exemptions from VAT and customs should figure in the VAT and Customs law respectively.

BKPM's website provides a good overview of the main tax incentives offered to inward investors, but access to original regulations could be enhanced and official translations more systematically provided. A detailed overview of eligibility criteria, including easy access to a business segments list, could also be expanded.

Multiple tax incentives co-exist in Indonesia. Investors – under certain conditions – may be eligible to apply to more than one incentive scheme. The actual tax benefit received under each scheme may vary substantially and create an incentive for tax planning, creating an uneven playing field across investors. Identifying cases where overlapping incentives may occur can support the understanding to what degree the tax incentive framework is fragmented and where unequal treatment of investors occurs.

Table 6.5 Relevant laws and regulations regulating tax incentives in Indonesia

Incentive	Relevant laws and regulations
Tax incentives (legal basis)	Law No. 25 of 2007 on Capital Investment (Article 18) Law No. 36 of 2008 on Income Tax Law No. 39 of 2009 on Special Economic Zones Law No. 42 of 2009 on Value Added Tax
Tax Holiday	Government Regulation No. 24 of 2018 Minister of Finance Regulation No. 150 of 2018 (introduction of mini tax holiday) Minister of Finance Regulation No. 105 of 2018 (debt-to-equity ratio) Minister of Finance Regulation No. 35 of 2018 (pioneer industry broad business segments) BKPM Regulation No. 1 of 2019 (pioneer industry detailed business segments)
Investment allowances	Government Regulation No. 78 of 2019 Government Regulation No. 45 of 2019 Minister of Finance Regulation No. 11 of 2020 (new investment tax allowance) Minister of Finance Regulation No. 16 of 2020 (labour-intensive investment allowance)
Enhanced tax reductions	Government Regulation No. 45 of 2019 Minister of Finance Regulation No. 128 of 2019 (vocational and R&D)
SEZs	Government Regulation No. 96 of 2015
Import duty facilities	Minister of Finance Regulation No. 76 of 2012 Minister of Finance Regulation No. 110 of 2005 BKPM Regulation No. 16 of 2015
Reduced CIT rate for public companies	Government Regulation No. 29 of 2020

Source: OECD elaboration based on national legislation.

Regular review of tax incentives enhances policy efficiency

Promote regular reviews of benefited sectors and activities

Indonesia's main tax incentives are sector-specific and could benefit from a regular review of the list of sectors that qualify for incentives. This would ensure that policies are up-to-date, reflect wider changes in the government strategy and can quickly reflect new priorities. This is particularly relevant in the context of the COVID-19 crisis, which has led countries to prioritise investments in health industries. For example, Thailand has already introduced health industry sub-sectors in its sector-specific tax incentives, following the outbreak of the pandemic (OECD, 2020d). Regular review of benefiting sectors also encourages incorporating new medium-term priorities, such as sectors contributing to a green transition and building resilient infrastructure.

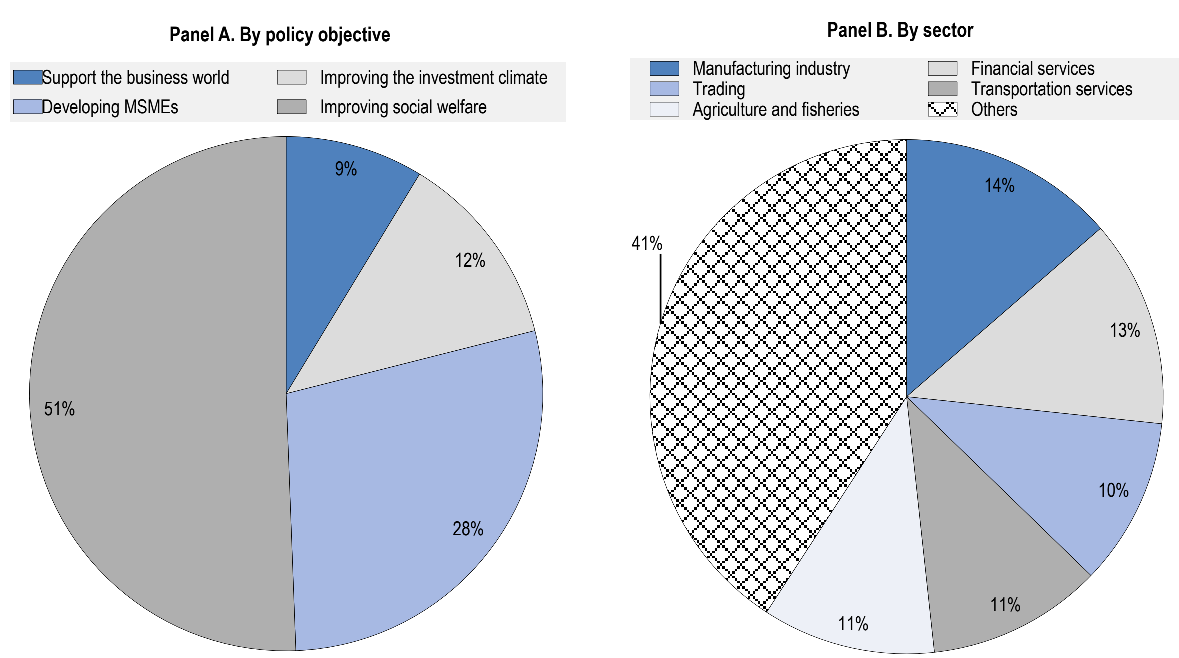
Well-designed and implemented sunset clauses can enhance the effectiveness of tax incentives by creating a natural break for periodic evaluation of incentives. While sunset-clauses can increase investor uncertainty and tax system complexity, they can also improve alignment with the intended policy objective. Regular and detailed review of policies can help identify new sector priorities, as well as incentives that are no longer needed. Indonesia could consider introducing sunset clauses for the most generous sector-based incentives.

Continue annual tax expenditure reporting and expand cost-benefit analysis

Tax incentives contribute to improving a country's socio-economic welfare, so long as the societal benefits generated exceed the associated costs. Careful and regular monitoring of tax expenditures (forgone tax revenues from tax incentives) is key to ensure that policy benefits outweigh costs. Reporting creates accountability over the use of public funds and provides inputs for policy makers to evaluate effectiveness and efficiency of tax incentives. Close monitoring of tax expenditures is of particular importance, as the COVID-19 crisis will deeply affect economic growth. As tax revenues are expected to drop by 10% in 2020, there is a need to carefully use public resources in the recovery process to maximise societal benefits through effective policies (Akhlas, 2020).

BKF published tax expenditure reports for the 2016-18 period.[16] Tax expenditures represented 1.5% of GDP in 2018, almost half of which was allocated to supporting businesses, improving the investment climate and fostering SME development (Figure 6.10, Panel A).[17] The manufacturing sector is benefiting the most from tax incentives (Figure 6.10, Panel B).

Figure 6.10 Tax expenditure in Indonesia, 2018



Note: CIT forgone tax revenues are estimated using static micro-simulation models. Static models do not take into account behavioural changes, economic impacts and policy reactions.
Source: BKF(2019).

Only a limited number of emerging economies publish tax expenditure reports (Redonda & Neubig, 2018). Indonesia's report is a welcome first step. It introduces several good practice elements in tax expenditure reporting, including identifying intended policy goals and legal references of each tax incentive (IMF-OECD-UN-World Bank, 2015). The most recent tax expenditure report introduced several extensions compared to the previous report, expanding regulations and sectors covered in forgone tax revenue estimates. Future reports may benefit from further details and the inclusion of additional tax incentives. Estimating forgone tax revenues of incentives in SEZs should also be prioritised.

A second area of interest could be to expand the analysis of the benefits of tax incentives, as the current tax expenditure report focuses on the costs. For the moment, the inclusion of possible benefits varies according to the estimation method used for each incentive. Finally, tax expenditure reports could provide additional details on the major differences of the multiple methods of tax expenditure evaluation used to increase transparency and interpretability of results.[18]

Increasing regional dialogue on use of tax incentives

International organisations and other entities have often advised countries to avoid an overreliance on tax incentives or at least to improve their design, transparency and administration (IMF-OECD-UN-World Bank, 2015). Unilaterally removing tax incentives may be politically difficult due to vested interests of policy beneficiaries and tax competition among countries. ASEAN economies extensively rely on tax incentives, resulting in heavy tax competition in the region (OECD, 2019). Countries may end up in a race-to-the-bottom competition, where tax incentives become increasingly generous and less effective at the same time.[19] Regional investment competition can result in further tax base erosion that may hamper improving countries' business climates in the long-run.

Since incentives in one country may affect others, international co-operation can be beneficial. Co-ordinating granting of tax incentives at the regional level would help address potentially harmful tax competition. Regional initiatives promote a better understanding of tax standards and practices of neighbours and contribute to this purpose (ESCAP, 2016).

The Study Group on Asian Tax Administration and Research is an important regional platform promoting co-operation in Asia-Pacific. The forum – in which Indonesia has participated actively since 1970 – seeks to share best practices among member countries and promotes bilateral or multilateral co-operation in taxpayer compliance. The ASEAN Forum on Taxation provides since 2011 a platform for dialogue on taxation in support of the ASEAN Economic Community. Sub-forum 2 on Enhancing Exchange of Views and Dialogue shares experiences on best practices in taxation systems, developing strategies for co-operation, and providing capacity building and training for tax administrations.

Regional dialogue and tax co-operation will be even more important in the COVID-19 context, to avoid that tax disputes harm economic recovery (OECD, 2020e). Indonesia should continue to actively engage in regional and international forums and exchange best practices in the current unprecedented environment.

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Notes

[1] The five national development priorities set by the President are the following: 1) infrastructure; 2) human capital; 3) simplification of regulations; 4) de-bureaucratisation; and 5) economic transformations.

[2] Government Regulation No. 24 of 2018.

[3] Regulated in Article 5 PERPPU I of 2020 and ratified into Law Number 2 of 2020.

[4] Government Regulation No. 29 of 2020, Ministry of Finance Regulations No. 23 and No. 83 of 2020.

[5] Government Regulations No. 45 and No. 78 of 2019.

[6] For incentives, the decision time should be of up to eight working days, which represents a quick decision process.

[7] Tax incentives for pioneer industries were introduced by MoF Regulation No.159/PMK.010/2015. Regulation was amended by MOF Regulation No.103/PMK.010/2016, by MOF Regulation

No.35/PMK.010/2018 and by MOF Regulation No.150/PMK.010/2018. Investment allowance introduced through (Government Regulation No. 78/2019.

[8] Introduced under the current regulation No.35/PMK.010/2018. A BKPM regulation matches the broadly defined industries to an Indonesian Standard Industrial Classification code (KBLI). Assigning KBLI codes to pioneer industries increases the policy's transparency. A complete list of the 179 business segments can be found in: https://oss.go.id/portal/insentif/content/tax_holiday

[9] Law No. 36/2008 on Income Tax, Article 31A

[10] See OECD (2018c) for additional information on SME and Entrepreneurship Policy in Indonesia.

[11] A progressive rate applied on revenue between IDR 4.8-50 billion that increases the effective tax rate gradually for firms. See the OECD report on SME and Entrepreneurship Policy in Indonesia 2018 for a detailed discussion: http://www.oecd.org/publications/sme-and-entrepreneurship-policy-in-indonesia-2018-9789264306264-en.htm

[12] Ministry of Finance Regulation No. 104/PMK.010/2016 on the "Treatment of Taxation and Customs at Special Economic Zones" has not been revoked as of late March 2020.

[13] Ministry of Finance Regulation 131 of 2018.

[14] Government Regulation No. 81 of 2015.

[15] Under the planned New Tax Law, the legal and regulatory frameworks for Indonesia's various incentives will be consolidated into one part of the law.

[16] Publication of the 2019 report is planned for late 2020.

[17] Forgone revenues from referential CIT rates and turnover tax are not included.

[18] Current report combines micro-simulation, input-output, CGE and mixed methods. When possible, align estimation methods to increase comparability of results across tax incentive measure.

[19] A KPMG (2014) study also warned that the paucity of coordination and harmonisation on tax matters in the ASEAN region, especially in light of the AEC, could result in continued tax competition that will have adverse effects on tax bases in the region

7 Investment policy and regional development in decentralised Indonesia

This chapter examines investment trends and policies in Indonesia at the subnational level. It analyses how Indonesia's decentralisation reforms have been shaping the investment policymaking landscape. The chapter reviews regional development policies related to investment attractiveness and the responsibilities of subnational governments in improving the business climate, particularly the business licensing process, and in conducting investment promotion activities. It also provides an overview of zone-based policies in Indonesia, with a focus on the Special Economic Zone programme.

Summary and policy recommendations

Indonesia has embarked on ambitious decentralisation reforms since 1998, which have shaped regional development and the geography of investment across the country. Decentralisation was seen as a vital complement to the democratisation process and a reaction to the inherently centralised approach of the previous government in a country with over 17 000 islands and strong cultural and linguistic diversity, as well as stark regional inequalities. Local governments were handed large responsibilities for providing public services and shaping economic policy, including investment policy, along with extensive fiscal transfers.

Two decades later, decentralisation is still an unfinished policy agenda. After the massive transfer of authority in the 2000s, Indonesia has been struggling to find the right balance in the sharing of investment and regional development policies responsibilities across different tiers of government. To simplify an overly complex investment environment and reduce legal and regulatory uncertainties, the central government has enacted successive policy measures modifying the responsibilities devolved to subnational governments. In this quest, the central government has adjusted the legal framework for local governance several times, through back and forth movements of decentralisation and recentralisation.

Hastened devolution of responsibilities has led local governments to manage their regions without the required accompanying skills, technical capacities, resources and oversight (OECD, 2016a). As a result, decentralisation has not led to significant reductions in regional inequalities, which continue to be high across the country. Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia's economy and, to some extent, more than in other emerging countries. Improvements in some policy areas have been made, but the capacity of subnational governments to produce public goods, generate inclusive growth and boost productivity has not always increased, even with rising transfers from the central to subnational governments. The COVID-19 outbreak, and the resulting crisis, may further exacerbate existing regional disparities.

Regional disparities in the levels of education, infrastructure, health and governance (e.g. less corruption) narrowed but they are still high and weigh on the ability of less developed regions to attract investment other than for commodity extraction. After decades of concentration on the island of Java, the observed catching-up in the level of investment by the other islands is partly driven by foreign exploitation of natural resources. Furthermore, the catching-up has not reached all regions, including urban areas with relatively high human capital and entrepreneurial activity. Resource-scarce and least developed regions, which are often at the periphery, have continued to attract little investment since being granted regional autonomy.

Regional governments have the authority to develop and implement their own investment-related regulations, in accordance with higher-level national regulations. The establishment of regional one stop integrated services centres, PTSPs, and, later on, the introduction of the online single submission (OSS) system were steps in the right direction to improve the business licensing process throughout the country. But regulatory, technical and governance challenges continue to hamper the efficacy of these initiatives, creating room for regulatory capture by local government. Not all local bodies in charge of delivering permits related to environmental standards or land use co-operate with the PTSP, arguing that the foreign investment projects are imposed by the central government. They may also lack the capacity to properly deliver such permits and can be more prone to corruption.

Overlapping regulations, if not contradictory investment policies, are another challenge behind the unclear division of authority between the central and subnational governments. For instance, some regions set their own regulations to restrict foreign investment in specific activities. Over the past two years, there has been a strong push for business climate improvements through a recentralisation of investment policymaking. The Omnibus Law on Job Creation, which was adopted in October 2020, seeks to harmonise central and regional regulations and ease the investment process. If the law is to reduce the level of legal uncertainty by withdrawing regulatory power from the regions – it allows the central administration to take over environment-related licences from regional governments, the central government should ensure that implementation at the subnational level takes place, as the proposed reduction in powers may create ground for a constitutional challenge. To avoid that outcome, it is critical to have solid consultation mechanisms ex ante to ensure that subnational government views are taken on board.

The rationale for recentralising investment policymaking and business licensing is, in part, because less developed regions do not always have sufficient institutional and technical capacities. This recentralisation, however, should not come at the expense of much needed labour and environmental protection safeguarding a more inclusive and sustainable local development pathway (see Chapter 5 on responsible business conduct). Local bodies may be better placed to assess business opportunities and sustainability risks, and at the very least should have a clear role in this process, even if ultimately the decision-making process is re-centralised. Building gradually their capacity can be a more sustainable approach in the longer term, while also promoting shared responsibilities across tiers of government rather than top-down governance. At the same time, higher levels of government lack the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors and to avoid a possible race to the bottom in environmental or other sustainability standards across regions.

One priority for the central and regional government is to strengthen their efforts in order to create a predictable investment environment that supports a resilient, sustainable and inclusive economic recovery from the COVID-19 pandemic. These efforts are more than ever needed in less developed and poorer regions of the archipelago, where higher levels of uncertainty may delay much-needed investments in infrastructure and human capital development. The pandemic has revealed that after-care services can be crucial in times of high uncertainty and subnational investment agencies are well-placed to deliver specific and targeted support to established investors. On the regulatory front, uncertainty on the content of the negative investment list (DNI) and the related restrictions on foreign investment in sectors like maritime transport may delay or prevent new foreign projects in infrastructure.

Another priority for all levels of government is to boost regional development by attracting more diversified, sophisticated and sustainable investment. Regional investment agencies should upgrade their investment promotion tools, in co-ordination with the national investment promotion agency, BKPM, and its international investment promotion centre overseas offices (IIPC). Previous zone-based policies to attract productivity-enhancing foreign firms into lagging regions had no conclusive impact. The Special Economic Zone programme aspires to overcome previous shortcomings by involving subnational governments in the decision-making process and granting non-tax incentives. Fiscal incentives consist of both tax holidays and investment tax allowances. The latter are preferable to preserve fair competition between firms inside and outside of zones.

Main policy recommendations

- The central government could further clarify investment policy responsibilities assigned to different government levels to reduce duplication and overlaps. Responsibilities should be balanced across levels of government, sufficiently funded, explicit, mutually understood and clear for all actors. Clarifying responsibilities is particularly important when they are shared, such as in the case of investment policy. The implementation of the Omnibus Law on Job Creation could be an opportunity to clarify responsibilities. Higher levels of government should ensure that subnational government views are taken on board through inclusive consultation.
- Higher levels of government should continue building the capacity of investment and investment-related institutions, particularly of PTSPs and technical agencies delivering operational permits. They should assess capacity challenges in regions on a regular basis and prioritise those with the most pressing needs (e.g. poor and remote areas). The central government should ensure that PTSPs can operate effectively the OSS and that they can issue most, if not all, investment permits.

- The recent recentralisation should go hand in hand with building the capacity of local bodies and sharing responsibilities across levels of government. Ongoing recentralisation reforms should provide higher levels of government with legal levers to limit regulatory capture and asymmetries in information between local administrations and investors, and ensure that national environmental norms, labour standards and other sustainability aspects are well-respected across regions.
- Regional investment agencies could seek to upgrade their core investment functions, in close co-ordination with BKPM. Regional agencies could take a more pro-active role in promoting foreign investment and tailor their promotion tools to focus on relevant investments for their region, in co-operation with BKPM overseas offices. Collecting comparative information on foreign competitor regions can be useful in refining local investment promotion tools such as investment generation activities. To reduce uncertainty generated by COVID-19, regional agencies could also strengthen their after-care services to respond to requests of existing investors.
- Regional investment agencies could reinforce their co-operation with other local bodies such as business development services to better align the production of local suppliers with the needs of foreign firms. Central and regional government could also help to build local firms' absorptive capacity by raising awareness about business development services and easing procedures to get the adequate support.
- Incorporate the investment aims of zone-based policies into investment promotion and regional development strategies. Cost-based incentives such as tax allowances should be favoured over tax holidays. To streamline wider zone-based policy, phase-out zone types that have not achieved their goals. Otherwise, convert them to special economic zones (SEZs). Monitor impact of regulatory incentives in SEZs, and if effective and do not lead to lower norms or standards extend them to the rest of the country.
- Promote regional development policies that reduce disparities in education, infrastructure and the quality of local governance:
  - The impact of the recently introduced firm-level incentives on skills development should be monitored to assess impacts.
  - In light of the high relevance of maritime transport for the connectivity of the archipelago, the central government could explore whether easing restrictions in this sector could help to attract foreign projects which support inter-island connectivity.
  - Increase the presence of the Corruption Eradication Commission, KPK, in provinces, especially in those with business sectors at high risk of corruption.
- The central government could develop investment environment indicators to benchmark provinces, provide them with technical assistance where needed and monitor impacts of reforms. Performance-monitoring systems of decentralised investment environments need to be simple, with a reasonable number of standardised indicators. Higher-levels of government should be able to monitor subnational performance of governments below them.

Indonesia's decentralisation process: an unfinished reform agenda

Decentralisation in Indonesia began in 1998, a period during which the country went through a democratic transition, an era known as *Reformasi*. The initial goal behind decentralisation was to moderate political and social tensions over the use of natural resources. It was also to reduce the distance between elected officials and their voters with the goal of placing regions on track for better monitoring and governance. With regional autonomy, the objective of economic development was handed to subnational policymakers, the rationale being better accountability and service delivery through increased responsiveness to local needs (OECD, 2016). This path is not unique to Indonesia – the global trend has been towards more decentralisation. Besides the quest for democracy, greater efficiency and accountability, mega-trends like digitalisation and globalisation also contribute to the stronger role played by subnational governments (OECD, 2019a).

Decentralisation has resulted in a significant rise in the number of subnational governments in Indonesia. The government consists of five levels of administration: central, provinces, regencies and cities, districts, and villages (Table 7.1). Villages are the only level with no dedicated investment policy responsibilities. Before 2000, there were 27 provinces and 297 regencies/cities. This number has increased to 34 provinces and 514 regencies/cities as of early 2020. To get an order of magnitude of the geographical size associated with each level, a province has a median land area of 41 000 square kilometres – approximately the size of Switzerland. A district has a median land area of 1886 square kilometres, which is slightly larger than a US county (Rothenberg et al., 2017).

Table 7.1. The levels of government and investment policymaking in Indonesia

Type	Number	Head of administration	Investment policy
Central	1	President (elected)	✓
Provincial	34	Governor (elected)	✓
Regency/City	514	Regent & mayor (elected)	✓
District	7160	Head of district (appointed by regency/city)	✓
Village	83184	Chief	x

Source: OECD (2017) and Statistics Indonesia.

This ambitious course of decentralisation has transformed the way the Indonesian government conducts investment policy and has shaped the archipelago's regional development objectives. Within an overarching strategy to improve the business climate, decentralisation can be a channel to improve investment promotion and facilitation. In decentralised countries, subnational levels of government are, to varying degrees, bound to legislative, operational and other constraints set at the national level. At the same time, decentralisation creates new opportunities for local innovation and progress by making the political process more efficient. Subnational governments can push reform to improve their investment regime to the greatest extent possible, while avoiding duplication of activities or conflicts with investment laws and policies of the central government (OECD, 2010).

The first wave of sweeping decentralisation reforms in 1999 devolved authority from the central government to subnational levels in all policy domains, except national security, defence, religious affairs, foreign affairs, monetary policy, and justice.[1] Local administrations became autonomous in managing economic development and providing public services. On investment, regional governments started issuing foreign and domestic investment and business licences while the central government continued to issue licences for foreign projects in high technology and high-risk sectors.[2] For instance, provinces established regional investment boards to advise the governor on local investment policy, issue licences and monitor implementation.

The abrupt and massive transfer of responsibilities to the subnational government, with no clear co-ordination mechanisms and little local capacities, led to a worsening of the business climate. In response, the government transferred two million civil servants to the provinces and adjusted the law on local governance twice, in 2004 and 2014.[3] With the second wave of reforms, the central government recentralised the authority to deliver investment licences for foreign projects and ran the licensing procedure through the Indonesian Coordinating Investment Board (BKPM).[4] The third wave in 2014 further delegated the issuing of permits to lower tiers of government, entitling them to grant operational permits like environmental and land use permits.[5] At the same time, the law gave back to provinces the authority that districts had in issuing licences for natural resource exploitation (e.g. mining and forest cultivation).

Box 7.1. Ten guidelines for effective decentralisation conducive to regional development

1. *Clarify the responsibilities assigned to different government levels*. Responsibilities should be balanced across levels of governments, explicit, mutually understood and clear for all actors. Equally important is clarity in the functions that are assigned within policy areas – financing, regulating, implementing or monitoring. Policy areas shared across different government levels need greater clarity to reduce duplication and overlaps.
2. *Ensure that all responsibilities are sufficiently funded.* Access to finance should be consistent with functional responsibilities. Division of financing responsibilities should ensure that there are no unfunded or underfunded assignments or mandates.
3. *Strengthen subnational fiscal autonomy to enhance accountability*. Subnational governments should have a certain degree of autonomy in the design and delivery of their public services within the limits set by regulations, such as minimum service standards. They need own-source revenues beyond grants and shared tax revenues.
4. *Support subnational capacity building.* Central government should assess capacity challenges in regions on a regular basis. Policies to strengthen capacities should be adapted to regions' specific needs. Governments should build capacity of institutions in a systemic approach, rather than adopting a narrow focus on technical assistance. Specialised agencies accessible to multiple jurisdictions should be encouraged.
5. *Build adequate co-ordination mechanisms across levels of government*. Tools for vertical co-ordination include dialogue platforms, fiscal councils, standing commissions and intergovernmental consultation boards, and contractual arrangements.
6. *Support cross-jurisdictional co-operation*. Carry out horizontal co-ordination using specific matching grants, and by promoting inter-municipal/interregional co-operation as well as metropolitan governance. Promote rural-urban partnerships as a form of cross-jurisdiction collaboration to enhance inclusive growth and address co-ordination failures.
7. *Strengthen innovative and experimental governance, and promote citizens' engagement*. Citizens should be empowered through access to information. Ensure that elected local councils have the ownership and control of citizen participation and engagement initiatives. Participatory budgeting can strengthen inclusive governance.
8. *Allow and make the most of asymmetric decentralisation arrangements.* Asymmetric decentralisation should be supported by effective co-ordination mechanisms and needs to go hand in hand with an effective equalisation system. Whenever possible, participation in such arrangements should be voluntary.
9. *Improve transparency, enhance data collection and strengthen monitoring*. Performance-monitoring systems of decentralisation and regional development policies need to be simple with a reasonable number of standardised indicators. Higher-level governments need to monitor subnational performance in critical service areas and inter-local performance in service delivery. Subnational governments need to be subject to higher-level fiscal rules to ensure fiscal discipline.
10. *Strengthen regional development policies and equalisation systems and reduce territorial disparities*. The equalisation programme must not be looked at in isolation from the broader fiscal system. Pro-active regional development policies should offset potential negative incentives of such equalisation systems.

Source: OECD (2019).

Decentralisation in Indonesia is an unfinished agenda and further adjustments to the reform process are happening both on the regulatory and operational fronts. Other countries are also conducting reforms to make the most out of decentralisation, particularly in the context of heightened regional inequalities within countries. Indonesia could rely on OECD's guidelines for implementing effective decentralisation conducive to regional development (Box 7.1). Despite progress, the division of responsibilities across levels of government continues to be imprecise and jurisdictional regulatory overlaps remain (OECD, 2016). The Omnibus Law on Job Creation aims at harmonising a still overly complex regulatory framework by, inter alia, recentralising some prerogatives that were devolved to regional governments in 2014. Meanwhile, regional governments still need very much to build their capacity to support regional development, including through effective and co-ordinated regional development policies.

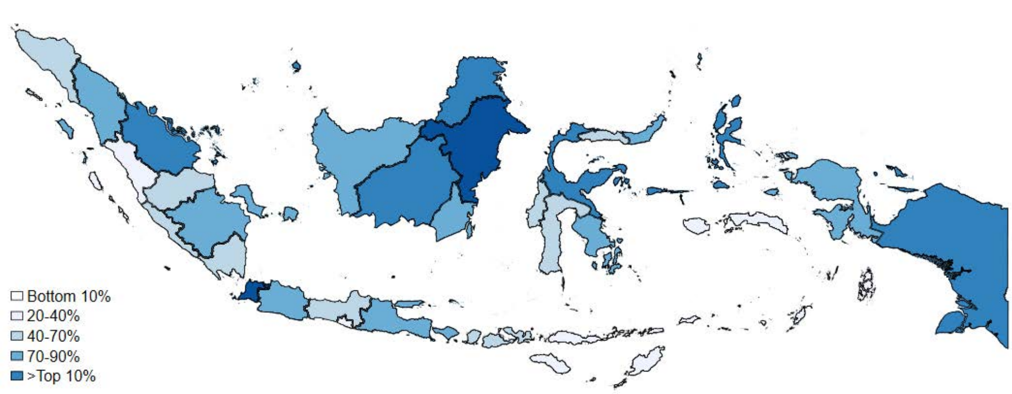
The geography of investment in decentralised Indonesia

Indonesia's noteworthy geographical and cultural diversity creates challenges but also formidable opportunities for attracting investment and enabling inclusive regional development. The country is the largest archipelago in the world, made up of over 17 000 islands, of which about 6000 are inhabited, spanning three different time zones. The population is unevenly distributed, with 62% on the island of Java with only 7% of the nation's land mass. Linguistic, cultural and religious diversity are remarkable, with over 300 distinct ethnic groups and, while Bahasa Indonesia is the national language, there are around 34 other languages spoken by at least half a million people. This section provides insights on the local context for investment policy following the process of decentralisation and examines regional variations in foreign and domestic investment.

The variety of policy settings created by regional autonomy, together with differences in economic performance across regions, have shaped the geography of investment in Indonesia. The sum of foreign and domestic investment per capita is highest in the Jakarta metropolitan area, which spreads over the provinces of Jakarta, Banten and West Java (Figure 7.1). The area is the most populous region in Indonesia and the second largest urban area in the world after Tokyo. Resource-rich regions like East Kalimantan (oil) and, to a lesser extent, Riau (oil, gas and palm oil) and Papua (copper and gold) are also home to large investment per capita. Provinces with lower investment per capita are often remote islands that lack natural resources like Maluku or East Nusa Tenggara but also areas in Java and Sumatra Islands like Yogyakarta and Aceh, the westernmost province of Indonesia.

Figure 7.1. Investment per capita across Indonesian provinces

Realised foreign and domestic investment per capita between 1990 and 2019, percentile distribution



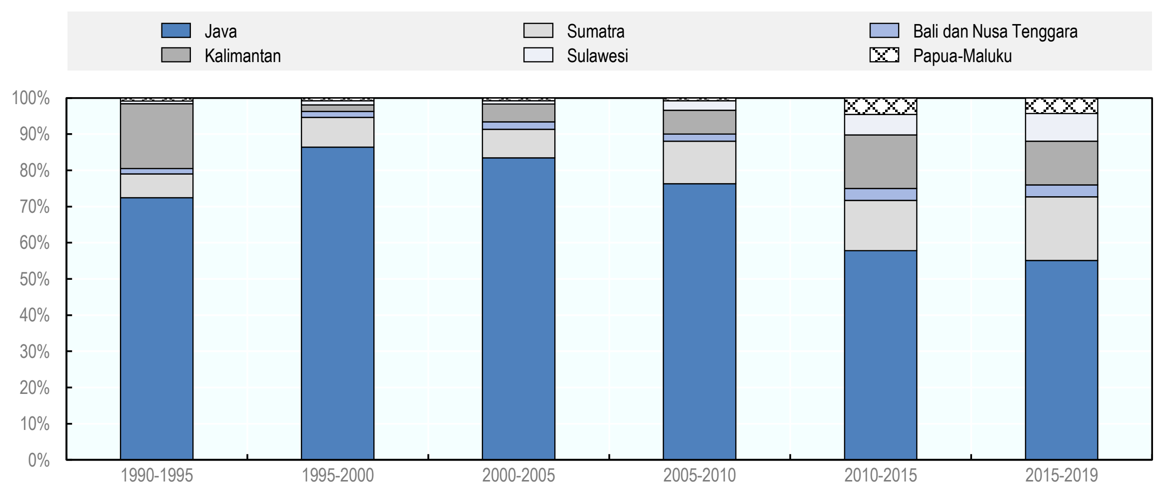
Source: OECD based on BKPM and Statistics Indonesia 2015 "Intercensal Population Census".

Decentralisation coincided with a decline in investment disparities across regions

Twenty years after decentralisation started, there are signs of convergence in the level of investment across Indonesian regions, although raw material exploitation is partly behind the catching-up. The adjustment in the geography of investment started to be visible from the early 2000s but mostly accelerated after 2010 (Figure 7.2). Industrial hubs in Jakarta, Banten, East and West Java continue to be the top investment recipients but they have gradually lost ground in favour of resource-rich and less densely populated regions outside of Java like Central Kalimantan, North Maluku, Papua, and Sulawesi. Convergence did not spread to all regions, however, including areas like Yogyakarta, an urban hub with high human capital and strong entrepreneurial activity (Box 7.2). Less wealthy provinces like Gorontalo and Maluku continued receiving little investment after regional autonomy.

Figure 7.2. Investment across Indonesia's main Islands before and after decentralisation

Share of realised investment by island



Source: OECD based on BKPM.

Box 7.2. SME and entrepreneurship activity across Indonesia's provinces

Investment is one indicator of regional economic performance among many others. Measures of small and medium-sized enterprise (SME) and entrepreneurship activity corroborate the regional patterns for investment only to some extent. For instance, small businesses density in Aceh, Maluku, Yogyakarta, and West Nusa Tenggara is high relative to other provinces while investment per capita in these areas is the lowest. Resource-rich regions such as Riau and East Kalimantan have the opposite patterns. Local factors like natural resources (large investments dominate the exploitation of natural resources) and urbanisation can explain differences between SME and investment activity across Indonesia's regions.

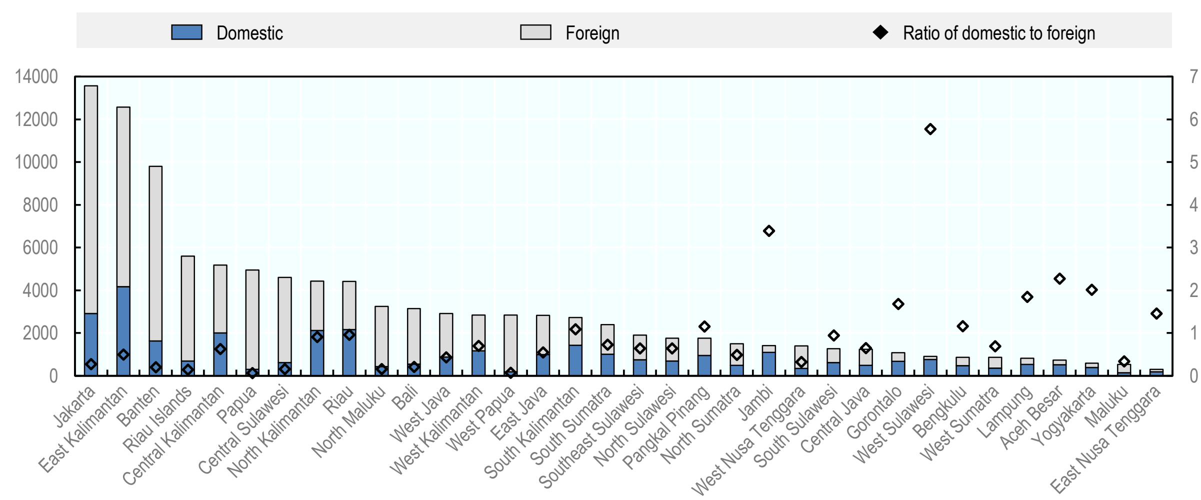
Source: OECD (2018a)

Foreign investment is geographically more concentrated than domestic investment

The activity of foreign firms has largely shaped the geography of investment in Indonesia. Between 1990 and 2019, two-thirds of investment going through BKPM was foreign but its prevalence relative to domestic investment varies strongly across the 34 provinces (Figure 7.3). Regions with larger markets, better infrastructure and more natural resources have attracted more foreign investors (Sodik et al, 2019). This is the case of industrial and tourism hubs in Java and Bali and of the region of Papua, which hosts the world's largest gold mine. National restrictions on foreign ownership in some sectors or specific regional policies could be further affecting the geographic differences between the two groups of investors. For instance, regions endowed with gas and oil such as Kalimantan and Riau have a more balanced share of foreign and domestic investors. Domestic projects prevail in regions with low foreign investment such as in Aceh Besar, Jambi and West Sulawesi.

Figure 7.3. Foreign and domestic investment per capita across Indonesian provinces

Realised foreign and domestic investment per capita between 1990 and 2019, in USD

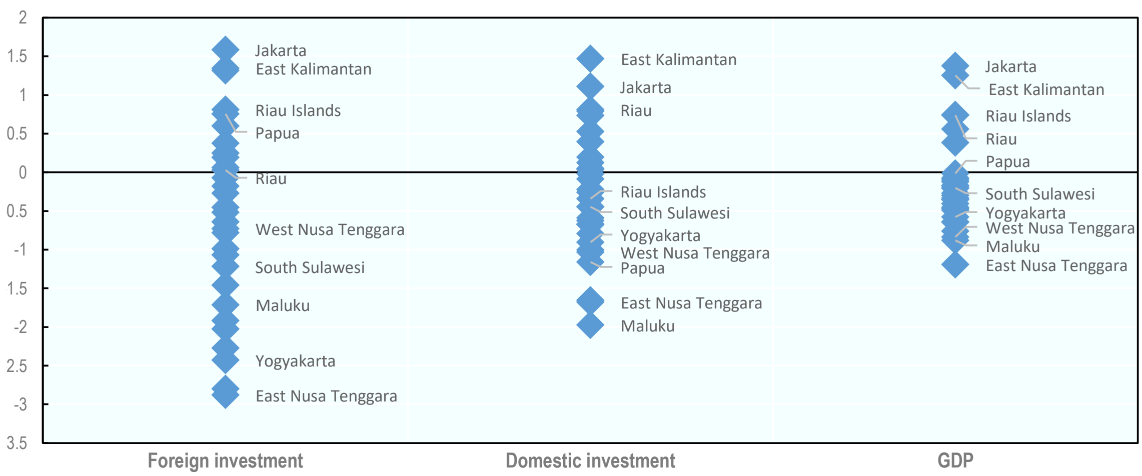


Note: Provinces' population is based on 2015 figures.
Source: OECD based on BKPM and Statistics Indonesia 2015 "Inter-censal Population Census".

Foreign businesses' unequal distribution and impacts across regions may hinder the wider process of regional convergence and, if excessive, such inequalities can feed a geography of discontent. Foreign investment in Indonesia is more concentrated in the most dynamic regions of the archipelago than are regional domestic investment and gross domestic product (GDP) (Figure 7.4). For instance, Jakarta's foreign investment is four times higher than the national average while only three times higher for domestic investment. Less developed provinces have much lower foreign investment per capita than the national average, which drives the geographical disparities in foreign investment.

Figure 7.4. Distribution of investment and GDP per capita across Indonesian provinces

Log of ratio of per capita regional foreign and domestic investment and GDP to national averages



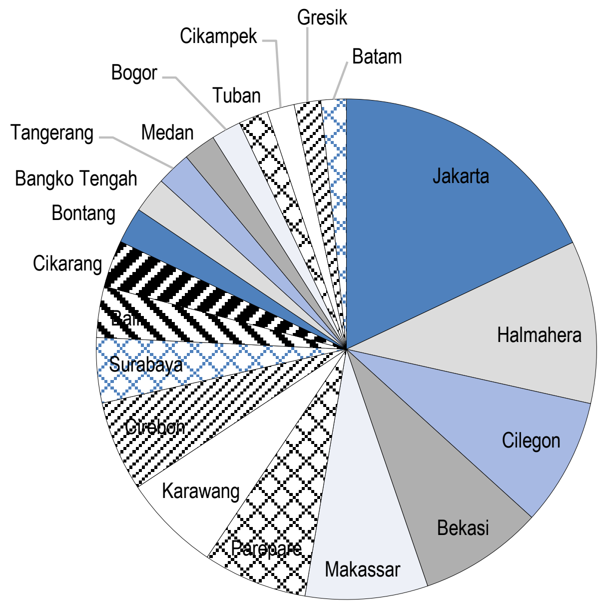
Note: Investment: realised investment between 1990 and 2019; Regional GDP: 2015. Values above (below) zero indicate that the province regional outcome is higher (lower) than the national average.
Source: OECD based on BKPM and Statistics Indonesia BPS Gross Regional Domestic Products Series.

The concentration of foreign investment in specific regions is not unique to Indonesia and is observable in other countries as well. Although there are no cross-country comparable data on foreign direct investment (FDI) geographical concentration, available statistics on GDP per capita reveal that regional disparities are larger within Indonesia than in other emerging countries (OECD, 2016). Foreign multinational activity tends to be less widespread than domestic activity, either concentrated in the industrial sector or economic hubs within the tertiary sector of host countries (Lejaragga and Ragoussis, 2019). This is partly driven by the behaviour of larger firms, whether foreign or domestic. More specific to Indonesia is the concentration of large-scale foreign projects in remote regions with natural resources such as Papua.

Along with natural resources, the presence of urban hubs also shapes the variations in FDI flows across Indonesia. Some provinces are home to nine cities (e.g. East Java) while others host two (e.g. Jambi). Among 90 cities with greenfield FDI projects between 2003 and 2019, the 20 cities with the largest amount of FDI accounted nearly for 40% of the total (Figure 7.5). The metropolis of Jakarta, the largest recipient, ranks 29th in the world as a recipient of FDI, ahead of Manila but behind Shanghai and Ho Chi Minh City (Wall, 2019). Major cities like Surabaya and Bekasi in Java and Makassar in South Suwalesi are also top recipients. Despite their smaller population, Halmahera and Cilegon account for large shares of greenfield investment. Halmahera in the province of North Maluku had a boom in mining activity in the 2000s – the provincial government issued at least 34 mining licences at that time. Cilegon is a major coastal industrial city in the province of Banten and one of the largest steel production centres in Southeast Asia. The city hosts industrial estates that are home to factories of large multinational companies.

Figure 7.5. Greenfield foreign investment across top 20 Indonesian cities, 2003 to 2019

Announced greenfield foreign investment by city, in percent



Source: OECD based Financial Times fDi Markets.

The economic crisis generated by the COVID-19 pandemic can affect the geography of FDI in Indonesia and may even slow down the observed convergence in the distribution of investment across regions. Although Jakarta is hit hardest, the shock is likely to be more transitory than in other regions of the archipelago. Provinces relying on investment in tourism (e.g. Bali) and oil production (e.g. Riau) will be temporarily affected too. More problematic for regional convergence is the rising level of uncertainty that may push investors to cancel projects in riskier sectors and regions such as infrastructure investments in remote areas with poor institutional and socio-economic conditions.

Regional disparities affect the geography of FDI and its development impact

Regional specificities, and related policies, shape the location choice of foreign investors in Indonesia and their motives, which in turn can amplify or reduce spatial development inequalities (Box 7.3). Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia's economy. In the 1980s, the per capita gross regional GDP of Central Jakarta, the richest district, was over 23 times that of South Bengkulu in Southeast Sumatra, the poorest district (Rothenberg et al., 2017). Decentralisation to promote regional development and reduce disparities has had mixed outcomes (OECD, 2016). The difference in per capita GDP across Indonesian provinces continues to be high relative to other emerging countries like Brazil, China and Mexico.

This section reviews regional development challenges and policies that are most relevant for attracting investment. Aside from market size, investors in Indonesia are attracted to provinces with both hard (transport, electricity, etc.) and soft (ICT) quality infrastructure, a skilled labour force, competitive wages, and a larger pool of exporters (Sodik et al., 2019). Indonesia has made progress in some areas but the capacity of local governments to produce public goods and boost productivity has not always increased, despite an increase in transfers from the central to subnational governments (OECD, 2016a). Despite the advances, regional disparities in education, infrastructure, governance, continue to be large.

Box 7.3. Reconciling global investment with regional development policies

Globalisation has led to a stronger role of subnational governments (OECD, 2019a). Free movement of capital means that subnational governments can compete for global investment, a task once monopolised by central governments. On the other hand, globalisation has exacerbated within-country inequalities. The disparity, which has fuelled a geography of discontent, questions the achievements of traditional liberalisation policies and the view that location advantages reflect only national policies and not regional features (Iammarino, 2018). In this context of a backlash against globalisation, the role of subnational governments became a way to better echo citizens' demands and needs.

Regions' specificities shape the location choice of FDI. Regional development policy includes business climate policies related to education and infrastructure, support to local firms, and skills development. By improving human capital and modernising infrastructure, a region not only becomes more attractive but can also benefit more from FDI through higher spillover mechanisms and absorptive capacities. A well-informed subnational strategy for improving the investment climate must target specific reform areas where local governments' room for manoeuvre is greatest, and where other challenges could be addressed at central level through effective policy advocacy.

Other policies influence directly the location choice of firms. These include fiscal incentives, the creation of special economic zones and the establishment of local bodies in charge of investment policy. Non-fiscal policies striving at informing investors about the investment potential of regions and improving the local business climate, for example by removing burdensome regulations, can be effective. For instance, FDI responds particularly well to the activity of subnational investment promotion agencies, especially in regions with malfunctioning institutions and inadequate information diffusion mechanisms (Crescenzi et al., 2019).

Regional variations in the ease of doing business persist despite improvements

Contrary to expectations, the investment climate in Indonesia did not significantly improve following regional autonomy (OECD, 2010). The cost of starting a business in Indonesia continues to be high and varies widely across regions, and procedures for obtaining a business permit can remain lengthy and complex despite recent improvements (see Chapter 6 for an analysis of the investment environment at the national level). A number of surveys identify variations in the ease of doing business across Indonesian provinces or cities, although the surveys are often outdated, except for an annual comparison of Jakarta and Surabaya in the World Bank Doing Business indicators.[6] Available surveys also examine few aspects of the business climate, or cover only a small number of provinces or cities.[7]

Since 2017, UKM Indonesia, a web portal developed by UKM University, tracks all licensing regulations at the subnational level. In a pilot project covering eight cities, the initiative has collected, analysed and published in a user-friendly format more than 130 national regulations and 371 regional regulations so that users can access information that is relevant to their business context. The project identifies whether a one stop integrated services office (PTSP) or a specific technical agency (SKPD) issues the licences. The results have shown that the number of licences is broadly similar across cities – between 100 and 130 licences, but the capacity of the PTSP to be the authority responsible of issuing them can strongly differ (Table 7.2). In most of the surveyed cities, PTSPs issue up to two thirds of the licences. In the city of Pajakumbuh, the PTSP issues 107 out of the 115 licences while Bandung's office issues less than 30 out the 130 licences inventoried by the project.

The initiative by UKM Indonesia is useful in providing an online inventory of all existing licensing regulations at the subnational level. But there continues to be a dearth of complete, comparable and up-to-date information on the quality of the business climate in Indonesian regions. The central and regional governments could work with UKM Indonesia to further extend the inventory of regulations to cover other cities, particularly in the eastern islands of Indonesia, where information about the business climate is less available. Policymakers could leverage this inventory as an evidence-based tool to streamline the business registration process and monitoring progress.

Table 7.2. Number of licensing regulations at the city level, 2017

City	All Licences	One Stop Integrated Service Office (PTSP)	Specific technical Agency (SKPD)
Bandung (West Java)	130	28	102
Bekasi (West Java)	107	47	60
Bogor (West Java)	131	72	59
Denpasar (Bali)	130	80	50
Depok (West Java)	112	59	53
Payakumbuh (West Sumatra)	115	108	7
Sukabumi (West Java)	58	41	17
Surabaya (East Java)	137	76	61

Source: UKM Indonesia and World Bank, see http://www.ukmindonesia.id.

As a complement to the initiative by UKM Indonesia, which only lists permits, the central government, together with regional actors like KPPOD, could develop and publish online regional indicators on de facto barriers to private sector development. This would help to benchmark provinces, identify those most in need of support and monitor progress over time. Transparency could push regional governments to undertake reforms that improve the business climate. For instance, the provincial competitiveness index in Viet Nam, released every year, has been used by Vietnamese provincial authorities to learn from one another and conduct reforms (OECD, 2018c). As in Indonesia, provinces in Viet Nam have the authority to issue investment certificates and business registration certificates (Box 7.4)

Box 7.4. Tracking improvements in provinces' business climates: The example of Viet Nam

In Viet Nam, the Investment Law of 2005 (since superseded by the Investment Law of 2014) transferred the authority to issue investment certificates and business registration certificates, among other things, to the provinces. Following these reforms, provincial authorities were formally empowered to improve their own investment climate. Teams were charged with facilitating FDI in each province and many provinces were able make significant changes in the rules and regulations governing business activities.

Following the 2005 reforms, peer learning and benchmarking among Vietnamese provinces helped boosting regulatory reform at local level. This is illustrated by the Provincial Competitiveness Index, which assesses and ranks the economic governance quality of provincial authorities. The index is based on annual business surveys of the local business environment and data from official sources regarding local conditions. The business survey data can be disaggregated by firm age, legal type and sector.

The Provincial Competitiveness Index is divided into ten sub-indices: (i) entry costs for business start-up; (ii) access to land and security of business premises; (iii) transparency of the business environment and equitable business information; (iv) existence of informal charges; (v) time required for bureaucratic procedures and inspections; (vi) crowding out of private activity from policy biases toward state, foreign, or connected firms; (vii) proactivity and creativity of provincial leadership in solving problems for businesses; (viii) existence and quality of business support services; (ix) existence and quality of training policies; and (x) fairness and effectiveness of legal procedures for dispute resolution.

Source: OECD (2018c).

Spatial inequalities in infrastructure continue to be a challenge for connectivity

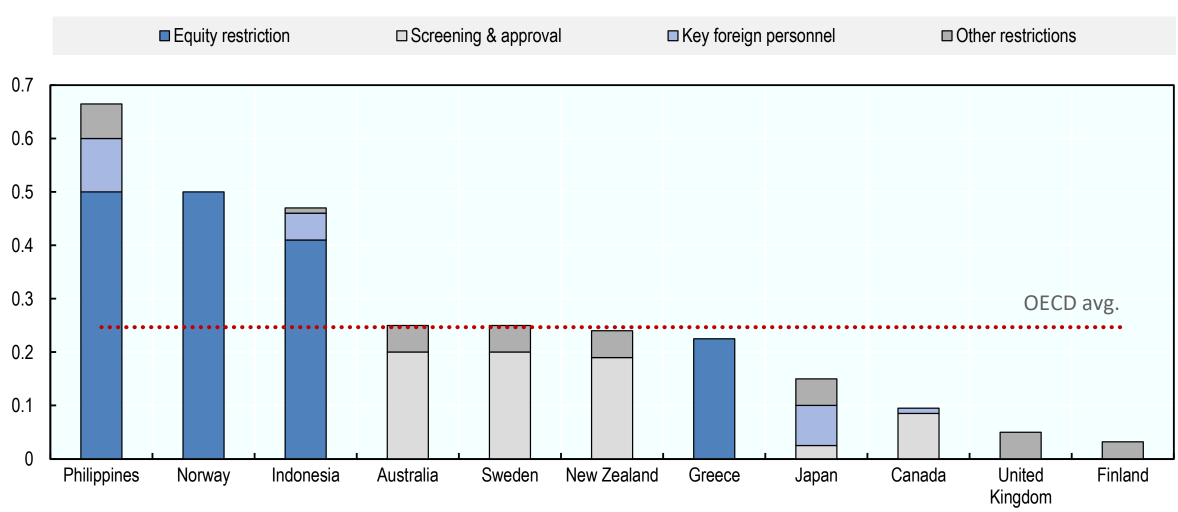
Improvements in infrastructure have occurred in the last few years, and private investment has been on the rise in the sector, but regional disparities remain a big challenge (OECD, 2018b). The decentralisation process transferred both decision-making and financial resources for the provision of transport infrastructure to local governments. The process was slowed down by the lack of co- ordination among key stakeholders and still needs to be improved (OECD, 2013).

Despite being an activity that needs involvement of different jurisdictions, in practice, shared responsibilities across levels of government in developing physical infrastructure is limited in comparison with other countries, including other unitary states like Indonesia – more than one government level is involved in only 30% of the decisions related to transport policy (OECD, 2019a). Local administrations do not necessarily have the capacity to design and implement their assigned infrastructure projects effectively. Central government needs to intervene to build local capacity, by increasing resources, training local government staff, and improving e-government tools.

Insufficient in quantity and inadequate in quality, transport infrastructure is a serious bottleneck in developing regions of Indonesia (Vujanovic, 2017). The disparities across regions, and between urban and rural infrastructure, pose further challenges (OECD, 2013). The expansion of air transport infrastructure to new regions of the country has been visible over the past years and, among other things, has facilitated the rapid growth of tourism. Investment is still needed to improve existing airports and build new ones, however. Environmental infrastructure such as waste, water, sanitation and sewerage facilities is also spread unequally across regions. Soft infrastructure is equally essential for connecting islands with each other and beyond national borders. Better reach and reliability of 4G technology and broader internet availability would help local firm creation and growth and reduce the gap between urban and rural Internet users (OECD, 2018b).

Figure 7.6. Maritime transport: restrictions on FDI in top countries with islands

OECD FDI Regulatory Restrictiveness Index (open=0; closed=1), 2018



Note: The OECD FDI Regulatory Restrictiveness Index covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other important aspects of an investment climate (e.g. the implementation of regulations and state monopolies, preferential treatment for export-oriented investors and SEZ regimes among other) are not considered. Data reflect regulatory restrictions as of end-December. Please refer to Kalinova et al. (2010) for further information on the methodology.
Source: OECD FDI Regulatory Restrictiveness Index, www.oecd.org/investment/fdiindex.htm.

Given the government's revenue constraints, public and private investment in infrastructure, particularly in transport, should be encouraged. In order to increase regional access to infrastructure financing sources, the government has made several efforts such as relaxing the rules related to regional loans in 2018.[8] This included an expansion of the types of projects that can financed by regional bonds but also a clarification of the division of tasks between the Ministry of Finance and the Ministry of Home Affairs in the loan approval process.

Foreign investors can also help plug the investment gaps that hamper infrastructure development, particularly outside of Java. Easing restrictions in the transport and tourism sectors, notably by reducing foreign equity limitations and restrictions on foreign personnel, could facilitate foreign investment (see Chapter 3 on the FDI regime).[9] If restrictions in maritime transport are common across countries, they are often low in those with many islands, particularly foreign equity limitations, reflecting their larger investment needs in this sector (Figure 7.6). Outside of special economic zones, foreign land ownership restrictions also limit the development of hotels and restaurants although a right to build can be issued to foreign companies for 30 years.

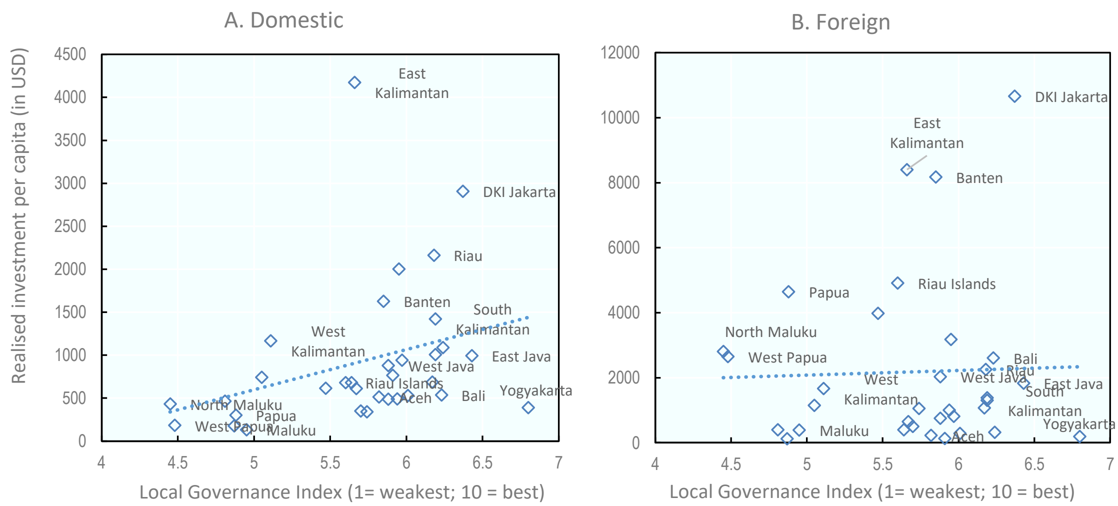
Better local governance can unlock investment in non-resource activities

The quality of local governance is a strong factor of foreign investment attractiveness. In China and Russia, for instance, regions with higher levels of government efficiency and active anti-corruption campaigns attract more FDI (Cole et al., 2009; Zakharov, 2019). In Indonesia, anti-corruption reforms have enjoyed some success. But decentralisation has, in effect, shifted corruption to the local level (Transparency International, 2018). Strong variations exist in the quality of local governance across Indonesian provinces. The Indonesia Governance Index shows that the quality of local government is best in Yogyakarta and Jakarta and worst in North Maluku and West Papua, suggesting that it is linked, among other things, to local levels of income (OECD, 2016a).

Agencies such as the Corruption Eradication Commission (KPK) play crucial roles in improving local governance, notably in reducing losses due to bribery and corruption and in providing capacity building to local bodies. KPK's resources and institutional capacities are largely concentrated at the national level, however, leaving the fight against local corruption primarily in the hands of local governments (Tomsa, 2015). Reforms must further target corruption in local government, notably by increasing KPK's local presence in provinces, especially in those with business sectors at high risk of corruption or conducting infrastructure procurements (OECD, 2016b). Recent reforms in local governments to increase e-procurement and strengthen internal budgeting and controls go in the right direction (OECD, 2018b).

Better local governance would help resource-rich regions diversify away from FDI in commodity extraction, where large-scale investors may be offered specific guarantees by the government, and strengthen investment impacts on the local economy. Figure 7.7, panel a, shows that the quality of local governance relates positively to domestic investment per capita – provinces with better governance attract more investment. The poor performance of Yogyakarta is puzzling in light of the province's better governance and higher skilled workforce. The relationship between local governance and foreign investment is altered by resource-rich areas, like Papua and North Maluka, which attract relatively high amounts of foreign investment, despite weaker governance (Figure 7.7, panel b).[10]

Figure 7.7. The quality of governance and investment per capita across Indonesia's provinces



Note: Realised investment per capita corresponds to foreign and domestic investment between 1990 and 2019.
Source: OECD based on Indonesia Governance Index (2012) and BKPM.

The impact of foreign investment on jobs and other development outcomes in resource-rich regions is probably limited, as companies are capital-intensive. Fiscal revenues from large mining companies, to the extent they are retained locally, could contribute to improving development outcomes indirectly as they could be used to develop infrastructure and improve the level of skills of the workforce. Taxation is relatively centralised, however, and funding for public services continues to be through central government transfers and, to a lesser extent, equalisation funds that share revenues from natural resources across governments (OECD, 2018b). At the same time, fiscal decentralisation with limited local capacity and low accountability may favour corruption cases in local governments.

Upgrading SME capabilities in less developed regions will improve FDI impacts

Foreign investment in Indonesia can create significant business linkages with domestic companies (see Chapter 2). Nonetheless, investment outside of Java has not necessarily generated the expected spillovers on the local economy as it has often been confined to resource-rich projects that forge few business linkages in an environment with weak rule of law. Furthermore, the performance gap between foreign and domestic firms in Indonesia also points to gaps in domestic SME capabilities, which may reduce chances for linkages with foreign firms and limit spillovers, especially in less developed regions with a larger knowledge gap between foreign and domestic firms.

Strengthening domestic firms' capabilities requires policy efforts in different areas, including improving human capital, boosting innovation, and promoting responsible business conduct (see Chapter 5 on responsible business conduct). Indonesia, as other countries, provides recourse to business development services (BDS) to enhance the productivity and competitiveness of SMEs through the upgrading of managerial and technical skills, access to markets, new or improved technologies, and appropriate financing mechanisms. The use of BDS varies strongly across Indonesian provinces, ranging from 1.5% in the eastern province of Maluku to 14% in the Special Region of Papua in 2015. Lack of awareness about BDS has been the main reason across all provinces for small businesses not using them, followed by procedural difficulties. Indonesia could seek to remedy this through awareness-raising campaigns on existing BDS programmes and through ensuring that these services are available in all provinces (OECD, 2018a).

Beyond strengthening SME capabilities, Indonesia's subnational governments have an incentive to maximise their own FDI attraction efforts, building on the competitive advantages of their local economies to attract investments that have the potential to amplify productivity diffusion. Indonesia's restrictive regulations on foreign businesses such as local content requirements, performance standard requirements and divestment requirements can be barriers to attract foreign investment with productivity spillover potential in non-resources activities (see Chapter 3 for more details). Proactive measures incentivising foreign firms to forge business linkages with local SMEs may prove to be more effective. But there are only a few tools at the disposal of local governments to forge linkages between foreign and domestic firms, to facilitate technology spillover, or to reduce the gap of technical capacity between domestic and foreign firms (Kuswanto, 2019).

Investing in skills is a priority to reduce development gaps across regions

Indonesia has achieved substantial progress in improving education and skills outcomes across regions but considerable challenges remain to ensure that regions have relevant and high levels of skills. Rural and remote provinces, especially those located in the east of the country, are characterised by poorer skills outcomes as seen by the difference in the OECD PISA scores between villages and large cities. For example, more than one in four people in Papua are illiterate, making it the province with the lowest literacy in the country. Disparities in educational attainment among the different provinces show that Jakarta has the best qualified human resources with 13% of the population reaching higher education. The picture contrasts with the mostly rural provinces of Papua, West and East Nusa Tenggara, West and South Sulawesi, and West Kalimantan, where between 13% and 38% of the population have never attended school (OECD, 2020 forthcoming).

Providing the right incentives to invest in skills is essential to help regions reduce skill mismatch with investors' needs. Most Indonesian workers do not have access to training and substantial differences exist between rural and urban workers. Out of the 13% of the working population who receives training, less than one third works in rural areas (OECD, 2020 forthcoming). Differences are also high across provinces, mostly reflecting the presence of large firms, which often have more capacity to train their workers. According to the 2015 World Bank Enterprise Survey of Indonesia, 21% of businesses in Jakarta Special Capital Region (DKI) provided training to their workers while the national average was 8%. The recent tax deductions granted to firms that invest in human resources development activities could help smaller businesses build the skills of their workers but also improve the wider quality of apprenticeships and vocational training (see also Chapter 6 on investment promotion).

Regional policy has shaped Indonesia's investment climate but policy coherence is limited

Decentralisation granted regional governments in Indonesia the responsibility to develop and implement their own investment policies and investment-related regulations. These must be aligned with national investment policies as presidential regulations supersede regional regulations.[11] Rather than a clear-cut separation of responsibilities, most duties are shared among levels of government – the trend toward shared responsibilities has increased over the past decades in other countries too. The need to share responsibilities may arise for practical reasons – as is common between different tiers of government around issues of transport and infrastructure, environment and economic development (OECD, 2019a).

Table 7.3 shows the respective responsibilities of the central and regional government in investment policy, based on Law No. 23 of 2014 on Regional Governance. Both national and regional governments run public institutions with the mandate to regulate the business climate, including foreign investors' entry and operations, and to develop and implement investment promotion strategies, including the provision of incentives. Duties across different levels of government are not identical, however, and higher tiers hold more responsibilities, including the supervision of the lower tiers. The division of tasks will likely evolve with the implementation of the Omnibus Law on Job Creation.

Table 7.3. Investment policymaking across different levels of government

Function		Central government	Subnational government
Business climate regulations	Investment effects on society and environment	National regulations to protect domestic firms National land use planning policies National environment policies	Regulations on local wages Local land use planning policies Local environment policies
	Investment facilitation	Stipulate investment licence Stipulate business licence (operational)	Stipulate permits as part of business licence: location permit, environment permit and land use permit
Investment promotion	Strategic planning to attract FDI/investment promotion	Develop general investment plan at national level International investment promotion	Develop general investment plan at local level International and national investment promotion
	Investment incentives	Provide national financial and non-financial incentives	Provide local financial and non-financial incentives

Note: Provinces and districts have similar mandates except that districts only provide non-financial incentives.
Source: OECD based on Law No. 23 of 2014 on Regional Governance and Kuswanto (2019).

Subnational institutions in charge of investment policymaking have similar mandates to the national investment promotion agency (IPA), BKPM, although they are not subsidiaries of BKPM and their exact institutional configuration within regional administrations can vary between and within different tiers of government (provinces, regencies/cities, and districts). All provinces have established regional co-ordinating investment agencies (DPMPTSP), with both investment promotion and facilitation responsibilities. Governments in regencies or cities and districts often have an investment unit located within the administration. The next sub-sections describe subnational investment-related regulations and examine how these are co-ordinated with national policies.

Investment facilitation through the lens of subnational governments

Indonesia has enacted successive measures to facilitate the establishment of new companies, thereby regularly modifying the responsibilities devolved to subnational governments in that area. After the rushed and massive transfer of authority to subnational governments in the 2000s, the country has been struggling to find the right balance in the level of responsibilities devolved to different tiers of government. In this quest, the central government has adjusted the legal framework for investment facilitation, through back and forth movements of decentralisation and recentralisation. Since 2019, there was a push for investment climate improvements, with a steep trend towards recentralising business licensing responsibilities.

With regional autonomy, subnational governments that proactively sought to attract investment obtained the policymaking space to do so, in particular as concerns business facilitation measures. Those that have been successful in improving their area's business climate have focused on investment facilitation measures, in particular on simplifying procedures to obtain a business permit (OECD, 2010). Subnational governments have also contributed to wider investment facilitation efforts by the central government and more specifically to improving the licensing process – even if they also are criticised for hindering the process. Following decentralisation, several districts unilaterally established one-stop integrated services offices, or PTSP, with the objectives of auto-regulating themselves and simplifying procedures (Kuswanto, 2019). The innovation spread to other districts and became a benchmark. It ultimately led to the creation of an informal PTSP forum to share good practices and build capacity of local officials (Priyono et al., 2015). During that period, the central government helped set standards and provided guidance.

With the growing number of locally-established PTSPs, the central government made it mandatory to run such agencies for all tiers of government in 2009, along with the operation of an electronic information and licensing service system (SPIPISE). This collaborative, bottom-up, approach to generalise the creation of

PTSPs to the whole country was praised for its success (Kuswanto et al., 2015). Districts granted the authority to issue the licences to their PTSP. Three institutions were involved: BKPM (assistance in investment procedures), the Ministry of Bureaucratic Reform (assistance in human resources) and the Ministry of Home Affairs (monitoring the operations of the PTSPs).

Despite the success in establishing PTSPs in most regions of Indonesia, there are challenges in implementation, particularly in the less developed and remote regions of the country. Limited human and operational capacity strongly affected the quality of operations of PTSPs. Some district-level offices are not equipped with electronic systems and thus are not connected to the provincial and national governments. One reason behind this implementation failure in services delivery is the uniform treatment of heterogeneous subnational units in policy design and implementation and the inadequate financial resourcing of provinces and districts (World Bank, 2014). Even if there is a well-functioning PTSP, the lack of co-ordination between and within tiers of government obstructs the licensing process. There is no guarantee that the technical local agencies (SKPD) are willing to delegate their licensing authority to the regional PTSP (Kuswanto, 2019). For instance, in eight cities, PTSP offices could only issue up to two thirds of the licences (Table 6.2). Firms still have to go to the SKPDs to obtain the remaining permits.

Reforms to harmonise the licensing process across tiers of government procedures have accelerated in the past years. The Online Single Submission (OSS), launched in 2018, connects the centralised licensing service system (central PTSP) in BKPM with regional PTSPs. Investors can access online regional licensing data without going to the concerned offices. The Ministry of Home Affairs pushed regional governments to accelerate the implementation of OSS by simplifying the types of licensing and non-licensing services and setting up the adequate facilities. To accelerate the process, the central government has set strict rules with financial sanctions for local governments that do not implement the new system. It also created district/city level task forces to ensure transparency in the licensing process and that it does not harm the state or investors.

Despite the technological improvement, the OSS system could not solve the issues of the large number of licences and the multiplicity of local agencies (and related line ministries) providing these licences. Investors still have to obtain some licences from ministries, government institutions or regional administrations (e.g. OPD *or Organisasi Perangkat Daerah*). Co-ordination and harmonisation of regulations between line ministries and regional governments is challenging because of the variety of regional governments, both across and within administrative levels (provinces, regencies/cities and districts). Implementation of the OSS tool will take time due to different capacities and resources across provinces and districts.

The transfer of greater business licensing authority to BKPM in 2019 marked a new step in the centralisation of the licensing process around the national IPA (see Chapter 6 on investment promotion and facilitation policies).[12] It is not clear, however, whether the Presidential instruction is addressed to central government ministries only or also to subnational governments. Notwithstanding the vagueness of the instruction, there is more than ever a need for more effective co-ordination across tiers of government. Regional investment agencies complain that licensing requests sent through the OSS system to other regional agencies, with each possibly reporting to specific line ministries at the central level, often stall (Kuswanto, 2019). Strong buy-in from all regional players is crucial to integrate the countrywide OSS system into PTSPs' electronic system (SPIPISE). The use of hierarchical governance should be limited to cases where co-operation and sharing responsibilities across different levels of government is not effective or not possible.

Besides licensing services, Indonesian subnational investment agencies also have a mandate to provide non-licensing services. Local agencies should strengthen this component of their mandate, as they are well-placed to deliver specific and targeted after-care support to investors. The crisis generated by the COVID-19 pandemic has revealed that after-care services can be crucial in times of high uncertainty. During the crisis, IPAs worldwide temporarily shifted their activities towards after-care and retention services (OECD, 2020a). Regional IPAs in Indonesia should be ready to provide support in such circumstances and help with unexpected requests.

Regional policies relating investment to societal and environmental outcomes

Subnational governments set minimum wages, develop land use planning and define environmental policy, as per Law No. 23 of 2014 on Regional Governance. The law also delegated the issuing of permits to lower tiers of governments, entitling them to grant location permits, environmental permits, land use permits, and building permits. This is part of the government's wider objective of better mitigating adverse effects of foreign businesses on society (e.g. rising income inequality) and the environment, although evidence suggests that FDI impacts on these outcomes can also be positive. Chapter 2 has shown that while foreign investment goes to more polluting sectors of the Indonesian economy, foreign firms are more energy-efficient that domestic firms. They also hire more people, pay higher salaries and are more gender-inclusive than domestic firms. The Omnibus Law on Job Creation – enacted in October 2020 despite strong opposition by labour unions and civil society – amends the law on regional governance and weakens the regional government role in policymaking, particularly with respect to environmental protection.

Statutory minimum wages should continue reflecting the cost of living in regions

Despite the preconceived idea that regions with lower minimum wages attract more foreign investments, there is no strong evidence that this is the case for either Indonesia or other emerging countries (Sodik et al., 2019; Haepp and Lin, 2017). Overall, the minimum wage in Indonesia is higher than in other emerging countries such as Brazil, Mexico and China (OECD, forthcoming). DKI Jakarta had the highest provincial minimum wage (USD 298), a rate that is more than twice higher the rate in East Java (USD 125), owing to cost of living variations. Differences within provinces are substantial too. For instance, the regency of Karawang sets a rate that is as high as in DKI Jakarta, although the regency is located in East Java.[13]

The statutory minimum wage, regulated by Government Regulation 78 of 2015, consists of a fixed basic wage set by the governor or head of the province or regency/district as a safety net. The minimum wage in a regency/district cannot be lower than the minimum wage set at the province. The Omnibus Law on Job Creation includes new stipulations about minimum wage setting. While minimum wages are still set at a provincial and regency level, the minimum wage will now depend on a formula to be set out in a later government regulation, which will take into account the level of economic growth, inflation and productivity in provinces. Furthermore, the law abolishes sectoral minimum wages, but only when these were lower than the minimum wage fixed by the regency. More problematic, the law removes specific protections afforded to workers when employers underpay the minimum wage.

The One Map project should improve land use planning in less developed regions

Local land use planning (RDTR) is one prerogative of subnational governments that has a considerable impact both on the investment environment and on sustainable development. Local agencies deliver land use permits based on subnational government land use planning. Subnational bodies define which parcels of land are for development and which business activities are permitted. As such, they can use the plan to protect the environment from potentially harmful activities. Land use planning is predominantly a local task in other countries too, even though several countries use land use plans prepared at the inter-municipal or regional levels (OECD, 2019a). National and regional governments both focus primarily on strategic planning and the provision of policy guidelines – they often prepare land use plans only for areas of particular importance.

Getting a land use permit can be a challenge for foreign firms in Indonesia, and their conflicts with the local community are often over land issues. Ambiguity in the national legislation together with the decentralised property registers widens the scope for corruption in allocating property rights (OECD, 2018b). This increases businesses' operating costs, with compensation sometimes needed to be paid to local communities or NGOs, due to unresolved conflicts, that are not always based on transparent and predetermined criteria (Kuswanto, 2019). The Indonesian government launched in 2018 a unified map of land use, One Map, in an effort to resolve overlapping claims that have led to conflict, human rights abuses and environmental damage. One Map establishes a single database for all government maps to eliminate disparities between the various maps in use by different agencies. Finalising the remaining elements of the One Map will help to improve the land use permitting system (OECD, 2019b).

Some regional governments may divert environmental regulation from its initial objective

Subnational governments have the authority to manage their natural resources. The ministry of environment and forestry oversees compliance monitoring and enforcement activities of subnational administrations. Provincial and district governments set up bodies to conduct environmental audits of companies, as per the environment law. They also implement environmental impact assessments (AMDAL) and, if projects do not require an AMDAL, the firm must submit an Environmental Management and Monitoring Program (EMMP) document. AMDAL or EMMP approval results in the issuance of an environmental permit. The quality of the assessments conducted by local bodies has improved due to stricter regulations and better guidance from the central government, although capacity building continues to be necessary. Better guidance on the content of environmental permits is another pressing priority. Permits rarely fix limits on polluting activities, are valid indefinitely and are not subject to periodic review (OECD, 2019b).

Subnational administrations use sometimes the issuance of land use or environmental permits as de facto regulatory tools to screen foreign projects, as the business licensing procedure is centralised at BKPM. This has led foreign investors to report cases of arbitrary treatment on the part of local governments in terms of getting operational permits (USAID, 2013). This is particularly the case of district governments with little or no involvement in the negotiations between central (or provincial) governments and investors. Foreign businesses usually have obtained their investment licences from BKPM and have determined with the help of the national IPA the location for their establishment (Kuswanto, 2019). They enter in contact with the subnational administration only to apply for the operational permits needed for the business licence. By rejecting or delaying investors' requests, local governments exercise their influence but can obstruct the registration process. They are also open to capture by local elites and by foreign investors, which can multiply the opportunities for corruption and raise the possibility that environmental and social standards are not properly enforced.

The recently enacted Omnibus Law on Job Creation weakens regional government role in environmental policy. The law amends Law 32/2009 on environmental protection and management to allow the central government to take over environment-related licences from regional governments, including AMDAL. The objective is to simplify administrative procedures for investors by adopting a risk-based approach to licensing – the Omnibus law on Job Creation stipulates that only "high-risk" projects will require a licence. This, however, should not come at the expense of much needed environmental protection safeguarding a more inclusive and sustainable local development pathway (see Chapter 5 on responsible business conduct).

Overlapping and conflicting central and regional investment policies persist

The country's decentralisation "big-bang" has complicated policy and regulatory certainty for investors (OECD, 2010). The variable capacity of regional governments to formulate, implement and enforce policies has led to a multiplication of overlapping and conflicting central and local government regulations. The inability to raise taxes at the local level partly led to a proliferation of regulations on local levies on business activities, which has generated challenges with regard to the investment environment. In some cases, local authorities request foreign investors to pay levies without a clear legal basis, in addition to paying taxes to the central government (USAID, 2013).

Some local governments have enacted laws discriminating, sometimes indirectly, against foreign investment projects, in conflict with the principle of equal treatment between foreign and domestic investors as per the 2007 Investment Law. This undermines the ability of the DNI to provide clarity to investors as the single legal resource of investment restrictions (World Bank, 2017). For instance, Malang regency recently stopped the licensing process for a foreign investment in the business of modern shopping centres, stipulating that the investment goes against a regional regulation on the zoning allocation for shopping centres and the protection of traditional markets.[14]

The emergence of overlapping regulations, if not contradictory policies, is one of the main challenges behind the unclear division of authority between the central and local governments, including those related to investment. The central government tries to use hierarchical governance in order to harmonise regulations across different levels of government (Kuswanto, 2019). Firstly, the national government creates guidance for local governments in enacting local regulations, and the draft of local regulation must get approval from the central government. A second mechanism is that the central government revokes local regulations that contradict national law, public interest and moral norms. Law No. 23 of 2014 on local governance gives the Ministry of Home Affairs the power to revoke such regulations through the Ministry of Home Affairs Regulation No. 80 of 2015 on the enactment of local regulation.

Through hierarchical governance, the central government has revoked some local regulations conflicting with higher-level laws, but the approach has not been successful enough and the ease of obtaining business licences from local authorities still varies greatly across the country. According to the Ministry of Home Affairs, there were 3143 local regulations in 2016 that contradicted national laws and the public interest. In 2017, a review of 1084 local regulations related to business licensing revealed that 61% of the subnational regulations contradict central government regulations (Pangestu, 2020). During the first mandate of President Jokowi (2014-19), the government attempted, through a ministerial decree based on regulation No. 80 of 2015 on the enactment of local regulation, to cut 3000 regional regulations considered to be in conflict with central government rules, but the nation’s highest court ruled that the move was unconstitutional.

Ongoing reforms aspire to harmonise regulations but recentralise policymaking

The Omnibus Law on Job Creation seeks to harmonise government regulations and regional bylaws to ease the investment process and reduce corruption risk. The law amends Article 25 of the Investment Law to place all relevant licensing authority in the hands of BKPM, including operational licences such as environmental permits. Furthermore, the law amends the regional governance law of 2014 to give the central government the power, through presidential decree, to revoke regional regulations in contravention of “higher statutory provisions”, including as regards investment licensing. To bypass the possibility that the constitution rejects central government requests for revoking regional laws, as in 2016, the Omnibus law plans to scrap provisions allowing regional governments to appeal against revocations.

From a legal perspective, the implementation of the Omnibus law may prove challenging. The constitution expressly states that the division of authority between central and regional government is to be determined by national law but it also provides that the division of authority in the field of public services must be "just and appropriate". According to consultations with stakeholders, this may create enough ground for a constitutional challenge to the proposed reduction in the powers of regional government licensing authority. If the Omnibus law intends to reduce the current level of legal uncertainty, the government should ensure that implementation at the subnational level takes place. The reform may be counterproductive without solid consultation mechanisms on the implementing regulations to ensure that subnational government views are taken on board.

The Omnibus Law on Job Creation transfers regulatory power to the central government, represented by BKPM, rather than individual line ministries. This may be a step in the right direction for regional investment agencies, as it could address the longstanding problems of silos across ministries, and across their respective reporting regional agencies. The law also establishes that regions must set up a one-stop integrated service unit providing licensing services in compliance with regulatory requirements. Business licensing services must use the electronic system managed by the central government, in that case BKPM. District/city governments who do not provide services business licensing through the electronically integrated system are subject to sanctions, including the possibility that the governor, as a representative of the central authority, grants the licence.

The implementation plan of the Omnibus Law on Job Creation should be realistic in light of the major changes it intends to bring to the regulatory framework. Remote and less developed districts do not necessarily have the institutional capacities for effective implementation of the law. For instance, the law transfers the authority over land use (RDTR) and environmental impact assessments (AMDAL) from local bodies to the central government in case the latter does not have the necessary tools and resources. According to the regional autonomy implementation monitoring committee, KPPOD, fewer than 100 regencies and cities (out of 514) have a RDTR, which means that the central government will handle the approval for the more than 400 remaining entities.

Under the right conditions, local bodies may be better placed to assess land use and environmental risks. Building gradually their capacity and equipping them with, inter alia, a RDTR is a more sustainable option in the longer-term, an option that would promote co-operation across tiers of government. At the same time, higher levels of government should have the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors, and a possible race to the bottom in environmental or other sustainability standards. Moving forward, the authority of provinces may have to be strengthened to streamline governance across the archipelago. Recently, governors emerged as effective intermediaries in the COVID-19 crisis by synchronising district responses and forcing the central government hand when necessary (Jaffrey, 2020).

Regional investment promotion: place-based strategies and attraction tools

The Indonesian government has been relentlessly trying to attract FDI to specific regions to support regional development objectives. These attempts have entailed mostly national investment policies disregarding that each city or province is unique in the way it competes in national, regional and global trade and investment networks. Decentralisation gave subnational governments the autonomy to promote investment, along with promotion activities by the central government. Provinces, cities and districts could exploit further this opportunity, which in other countries is often limited or non-existent because of centralised investment policy.

Decentralised investment promotion

Besides operating a PTSP, each subnational IPA in Indonesia, sometimes called DPMPTSP (or BKPMD), is in charge of elaborating an investment strategy at the subnational level (e.g. selecting priority sectors for investment attraction), in line with the region’s wider economic development plan. They operate independently from, but in co-operation with, the national IPA, BKPM, which is in charge of developing the overall strategy of the country with respect to investment promotion (see Chapter 6). Subnational IPAs develop investment promotion strategies with objectives, target indicators and corresponding policies and strategies to achieve them. For instance, the Aceh Investment and One Stop Integrated Services Agency (DPMPTSP Aceh) has based investment priorities on the Midterm Development Plan of Aceh, which focuses on agro-industry, infrastructure and energy and tourism.

Both the national and subnational IPAs undertake investment promotion activities to attract foreign and domestic investment. BKPM co-ordinates the wider investment promotion activities and co-operates with subnational IPAs. It focuses on promoting foreign investment, through the Investment Promotion Centre (IIPC) overseas offices, and domestic investment projects with scope covering multiple provinces. Subnational IPAs promote both foreign and domestic investment. With respect to domestic investment, for many decentralised entities, attracting companies from the same country can be as important an objective as attracting foreign investors – local companies from the same country may not have access to full information on investment opportunities in other regions of the country (MCI and VCC, 2009; OECD, 2018c).

Indonesia's central and regional governments promote regional investment through different mechanisms. At the subnational level (provinces, regencies and cities and districts), IPAs conduct their own investment promotion activities. Each IPA performs various functions pertaining to investment attraction, such as marketing their location as an investment destination, conducting promotional missions and organising meetings with businesses and embassies of potential investing countries, organising site visits for prospective investors, and arranging matchmaking between domestic businesses and foreign affiliates.

Subnational IPAs can also provide tax incentives, financial grants, and facilities for investment that are tailored to the development priorities of their regions. The provision of incentives is regulated by a central government regulation but regional governments must issue a specific regional regulation to elaborate further on the criteria and on the procedure for obtaining them.[15] The mechanism is voluntary instead of mandatory, which means subnational governments have the option to develop those policies. For instance, the district of Banyuwangi provides incentives for multinational enterprises (MNEs) that purchase products from local SMEs (Box 7.5). To incentivise regional governments to use this policy, the central government commits to give "awards" to regional governments that have been outstanding in providing incentives or facilities to investors in accordance with the provisions of the regulation.

Box 7.5. Investment promotion at the local level: Learning from the district of Banyuwangi

Banyuwangi is the administrative capital of Banyuwangi Regency at the far eastern end of the island of Java. The capital is the largest district both in the Eastern Java Province and on Java itself with 5 800 square kilometres in total. Socio-economic conditions are better than the national average: The district enjoys economic growth of 7% per annum, unemployment of 4.7% and a poverty rate of less than 10%.

The district of Banyuwangi provides financial and non-financial incentives for MNEs if they purchase goods and services from domestic enterprises, especially SMEs. The district also starts the matchmaking process from the investment promotion phase. During this phase, the district government facilitates meetings between potential foreign investors and local enterprises. After the business is established, the MNE is required to train domestic managers and employees, so they learn the technology used by the MNE.

Source*:* Kuswanto, K. (2019).

At the central government level, BKPM, notably through the IIPC, seeks potential (foreign) investors by organising promotional events in Indonesia and abroad and inviting subnational IPAs to participate. It also organises networking sessions between the IIPC overseas offices and representatives from the subnational IPAs. Thirdly, BKPM co-ordinates with subnational IPAs the provision of information on potential investment projects in the regions. BKPM disseminates the online material on business opportunities and regions' business potential.

Decentralisation of investment promotion can provide an incentive for subnational authorities to become more efficient in their efforts to promote investment. Even if the priority of these IPAs is with the licensing process, developing more sophisticated and innovative investment promotion tools is equally relevant.

Subnational IPAs can convey critical information about the attractiveness of their regions to potential investors. Evidence from the European Union's regions shows that FDI responds better to the activity of subnational IPAs operating in closer proximity to investors' operations (Crescenzi et al., 2019). Stronger and better co-ordination between BKPM's IIPC and subnational IPAs can help to channel more effectively information about investment prospects in regions.

Mechanisms for tailoring national investment promotion to local conditions

Two elements characterise the governance of investment promotion at the subnational level. On the one hand, the central government alone cannot foster economic attractiveness, suggesting the importance of a multilevel arrangement. On the other hand, the ideas of flexibility and a single point of entry for foreign companies and investors have gained awareness and interest. Subnational IPAs are encouraged to think beyond their administrative borders (Pasquinelli and Vuignier, 2020). Thus, investment promotion should strike a balance between a reasonably centralised strategic decision-making and enough room for manoeuvre for subnational governments.

The multiplicity of investment promotion activities at the subnational level does not necessarily have to generate a race to the bottom. While the risk of exacerbated competition between Indonesian regions (or cities) is real, competitors can often be regions outside the national borders. Foreign competitors can be very different from one region to another and depend, inter alia, on regions' distinct positions in global supply chains (Box 7.6). Some regions compete with each other while others, like Batam, have rivals in ASEAN, and a minority, including perhaps the metropolis of Jakarta, compete worldwide. This underlines the importance for IPAs involved in investment promotion, either BKPM or local agencies, to know whom their rivals are and for which economic activity they are competing.

Box 7.6. Identifying cities' rivalry over FDI: Casablanca versus Cairo

FDI geographical networks provide unique insights on competing destinations by decrypting greenfield foreign investment project flows from source to destination city. The analysis of these networks shows that some cities compete with peers within the same country, while others compete more regionally (e.g. ASEAN, Europe, Latin America, MENA, etc.), and only a few cities, most often metropolises, have rivals at the global scale. Network analysis also reveals that neighbouring cities, including within the same national borders, are not necessarily rivals as they may attract FDI in distinct economic activities or in different segments of the global supply chain.

The OECD applied such network analysis to shed light on the geography of FDI in MENA cities. For instance, Casablanca and Cairo do not compete over foreign investment, despite their countries' geographic and cultural proximity. Casablanca's rivals are port-cities spread over different continents and include Panama City, Danang and Valencia. Cairo's competitors are mostly neighbouring cities like Algiers, Riyadh and Tunis. One reason Casablanca has global rivals is likely because the city is well anchored in global value chains and has access to maritime networks through Casablanca port. Casablanca and its rivals compete over efficiency-seeking investment automotive, business services and transport. In Cairo, the world's 16th largest metropolis, foreign investors are more interested in serving domestic consumers and in using the capital as an entry gate to markets in Africa or in the Middle East. This is visible in the city geography of FDI networks as Cairo, and its city rivals, compete over FDI in services like real estate, energy and financial services.

This comparative information can help IPAs, with their subnational branches, or subnational agencies craft investment promotion strategies tailored to the competitive strengths and potentials of each territory. It can also help developing policy tools that connect foreign investors with local suppliers. For instance, smaller cities may deploy massive efforts to attract large, top-end, companies (e.g. by offering generous tax incentives) instead of focussing their promotion strategies on smaller investors that they can realistically attract. Investment promotion policies to attract such second-tier firms might prove useful as these may forge stronger linkages with local companies than large top-firms because of lower absorptive capacity gaps and higher labour mobility.

Source: Wall (2019).

Co-operation between BKPM and subnational agencies brings a number of challenges, as interests are not necessarily aligned. Subnational agencies often attempt to steer foreign investors to their respective regions by seeking the attention of BKPM, rather than by their own means. Because of such inter-region competition, a national IPA can become an arbitrator (i.e. which province should they direct a foreign investor to) and face difficult decisions or, on the contrary, can be deliberately excluded from locally identified opportunities (OECD, 2018d). Some regions may also resist the establishment of a foreign investor that was directed to the region by the central or provincial agency.

Co-ordination tools help partly to overcome these challenges. In Sweden, a code of conduct agreement among the national IPA and the regions was established to better communicate opportunities and encourage exchange of information. The IPA also uses software that allows information sharing with external partners. The French IPA has a formal information-sharing process to increase the efficiency of the collaboration with France's subnational IPAs (Box 7.7). The agency created a "marketplace" of investment projects and shares information weekly with its regional partners (OECD, 2018d).

Box 7.7. Business France's co-operation agreement with regional agencies

Business France has a formal agreement with the 13 regional agencies of the country that provides a clear framework for co-operation. The co-operation agreement entails prospection and promotion activities, as well as support for project implementation. Shared trainings are organised in its framework. An annual performance survey monitors the results of the co-operation. This framework also guarantees the impartiality and neutrality of Business France vis-à-vis all the regions (not favouring one over the other when bringing new projects). This is essential to establish trusted partnerships.

As part of the co-operation, Business France has also developed a dedicated information-sharing process for investment projects. It consist of a "market platform" where Business France and its regional partners can enter information about new foreign investment projects identified, and requests made at the regional level. Thanks to this platform, partners can co-ordinate their responses and identify areas for joint action. In 2016, this system allowed to provide to investors 650 regional setting offers, and organise 220 business visits.

Source*:* OECD (2020b) based on Business France, presentation at the OECD seminar in Paris in October 2017, http://www.oecd.org/mena/competitiveness/REPORT-Regional-EU-OECD-IPA-Workshop-Paris-201710.pdf

Zone-based policies to attract foreign firms with high productivity gains

Indonesia has attempted to use zone-based policy to attract FDI, increase exports, create jobs, and support the country's development but, so far, these policies have not had a strong record of demonstrated success. The government established the first zones in 1970 and the country has since seen a proliferation of these areas (Table 7.4). Most zones are governed by specific laws, overseen by different levels of government, operate under distinct regulatory and institutional frameworks, provide different incentives to investors and often have overlapping goals, most often to boost exports. Zones in Indonesia can fall into five types: free trade zones

(FTZ), bonded or export processing zones (kawasan berikat), industrial estates (kawasan industri), integrated economic development zones (KAPET), and special economic zones (KEK). The multiplicity of zones and related types can create institutional bottlenecks and generate confusion for private investors.

Table 7.4. Overview of zone-based policies in Indonesia

Zone	Year	Number	Main objectives	Main incentives
Free trade Zone	1970	1	Develop tradeable sector and improve exports	- Import income tax exemption - Import duty exemption
Bonded Zone	1986	1350	Encourage high-value exports with focus on manufacturing	- Import income tax exemption - Import duty temporary exemption
Industrial Estate	1989	87	Improve growth and industrial competitiveness aimed at export and domestic demand	- Depends on the location of the industrial estate.
Integrated economic development zone (KAPET)	1996	13	Create new centres of economic development and promote inclusive growth	- Investment allowance on CIT - Import income tax exemption - import duty temporary exemption
Special Economic Zone (KEK)	2009	15	Combine objectives of all previous zones	- Tax holidays on CIT - Import income tax exemption - Import duty exemption - Foreign ownership of property

Note: Among the 15 KEK, 11 are operational as of February 2020. OECD (1999) counts seven bonded zones but this number strongly varied in 2000 and beyond. Batam is both an SEZ and a FTZ.
Source: OECD based on Wicaksono et al. (2019); Rothenberg and Temenggung (2019); OECD (1999); the National Council for Special Economic Zones.

Zone objectives have changed over time with the evolving place-based policy

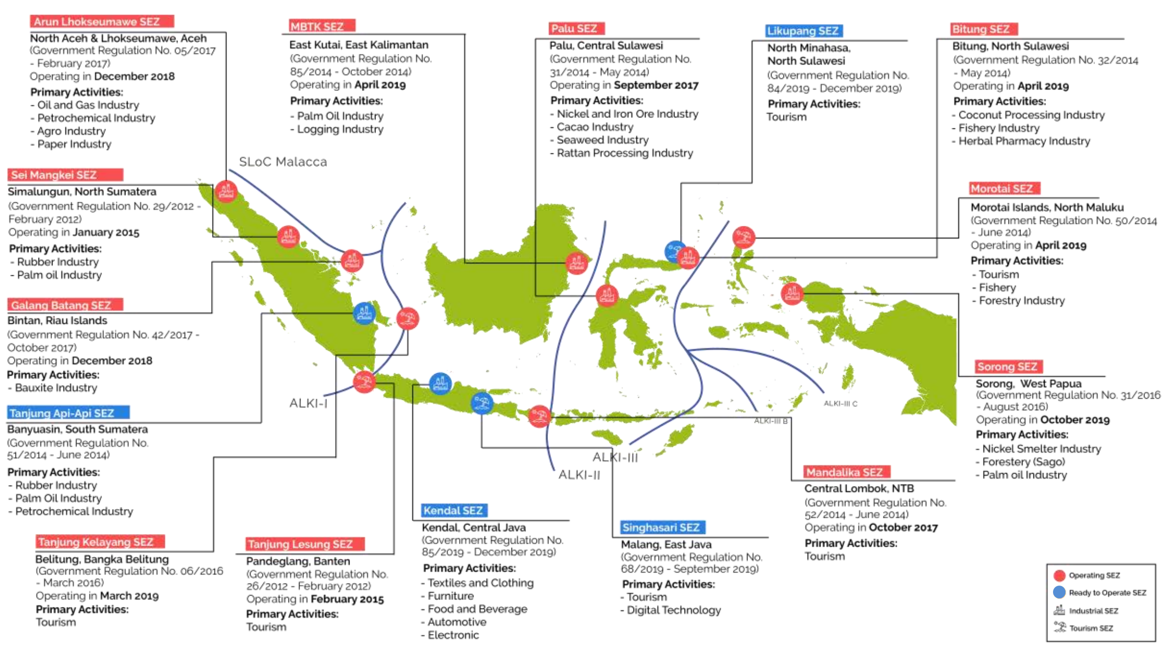
Indonesia established the five zone types at distinct time intervals and in different regions and districts. The legal status of some zones changed over time to adapt to the evolving place-based policy of the government. FTZs and bonded zones, established in the 1970s and 1980s, proliferated until the early 2000s, before stagnating or receiving the status of a newer type of zone. They promote imports and exports by granting import duty and value-added tax exemptions. There are around 1500 foreign and domestic firms with licences to operate in bonded zones but the majority are located on Java. In the late 1980s, the government introduced industrial estates, which grant non-fiscal incentives. For instance, in Batam, a FTZ (and since 2020 also a SEZ), foreign ownership restrictions were relaxed in industrial estates to attract nearby firms from Singapore, notably in the electronics sector (OECD, 1999). The private sector developed the majority of industrial estates, which it also operates. Most of the successful estates are located in West Java (ASEAN, 2017).

The success of liberalisation reforms in the 1980s created export-oriented industrial hubs in Java and Sumatra while the eastern islands continued lagging behind (Wicaksono et al., 2019). As in other developing countries, liberalisation led the government to move away from confined free trade and manufacturing bonded zones, cut off from the local economy, to large-scale hubs with regional development goals. Accordingly, the government's place-based policy expanded from granting trade-related exemptions to wider incentives, including corporate income tax (CIT) holidays. It introduced the KAPET programme in 1996, a few years before the decentralisation “big bang”, to create growth centres in the Eastern districts of the country. On top of various tax breaks, KAPET grants specific incentives to foreign firms. The policy shift culminated with the launch of the SEZ programme (KEK) in 2009, although it started operating in 2015. SEZs combine export-oriented goals of bonded zones with regional development objectives of KAPET.

SEZs are the government's new policy to attract investment outside of Java

The SEZ programme is one of the latest place-based tools to develop regions outside Java. It spreads over all of the Indonesian territory, unlike KAPET zones, and SEZs often cover the entire locality where they are situated, and each could contain several industrial estates. As of early 2020, they were 11 operating SEZs, and four were in the development phase (Figure 7.8) - the government plan is to have 25 under the Mid-term National Development Plan. SEZs cover a broad range of activities, as per Law No. 39 of 2009 on SEZs, ranging from the mineral industry to food processing (e.g. fishing industry). Five SEZs are touristic destinations that are part of the government's wider tourism development strategy, which prioritised 10 destinations for tourism infrastructure development.[16]

Figure 7.8. Indonesia's SEZ distribution map as of February 2020



Source: National Council for Special Economic Zones.

One difference between the SEZ programme and other zone-based policies, all launched before decentralisation, is the active role played by regional governments in the institutional framework surrounding SEZs' establishment and supervision. The central government, through a National SEZ Council, takes the decision to establish a zone, but proposals to establish zones come from local governments. The council reports directly to the president and is chaired by the Coordinating Minister for Economic Affairs. BKPM is a member of the council, along with several other government bodies.

The bottom-up approach in SEZ establishment should ensure buy-in from regional governments in developing and managing zones. This inclusive approach is missing in KAPET zones, where the lack of co-ordination between the central and local government is one the main reasons for their limited success (Rothenberg and Temenggung, 2019). Despite a stronger role by local governments, they are not sufficiently involved, for instance in the planning of SEZs that are part of the national tourism strategy. Greater co-ordination would ensure that tourism serves regional development needs (OECD, 2018b).

SEZs grant CIT holidays and many other tax and non-tax incentives, including softer regulations on foreign ownership of property, simplified foreign worker arrangements and simplified licensing procedures. Regulation 12/2020 on Facilities and Ease in Special Economic Zones, which revoked a previous regulation issued in 2015, clarified the provisions with regard to the incentives granted by SEZs and extended further these incentives.[17] According to an evaluation by the government, the performance of SEZs has not been optimal in terms of realised investment, especially foreign investment, because the 2015 regulation was not clear, generating uncertainty for investors, and incentives granted, including facilitation measures, were not as attractive as in other countries' zones like in Chinese SEZs.

SEZ policy should gradually shift from relying on tax incentives to facilitating a more conducive business environment

SEZ policy should focus on promoting a friendlier business regulatory environment. This could also help improve the wider business environment. The government could experiment with different non-tax incentives in SEZs to extend proven good practices to the whole economy (OECD, 2018b). Given the recent creation of SEZs, no studies have evaluated their impact on regional development goals. Previous zone-based policy has helped to attract FDI and create jobs in regions with attractive geographical locations and good endowments in terms of infrastructure and skills (e.g. West Java). But they have had little impact on attracting FDI to other, less attractive, regions as well as in generating sufficient productivity spillovers to improve national welfare (Rothenberg et al. 2017; Rothenberg and Temenggung, 2019; Wicaksono et al., 2019).

Previous zones were not entirely successful in attracting significant investment or generating significant employment, due to their remote locations, a shortage of infrastructure and lack of jurisdictional clarity (OECD, 2016). Bonded zones did not lead to a significant increase, either in existing firms' exports or in the number of new firms exporting, although there is some evidence that they created jobs (Wicaksono et al., 2019). Similarly, KAPET zones reduced production costs, thanks to the incentives, but had little impact on productivity, investment and employment (OECD, 2016; Rothenberg et al. 2017). Evaluations of these programmes call for caution from policymakers in spending resources to subsidise development in lagging regions. There is a potential for such policies to be tax giveaways to firms that would have located in the targeted regions in the absence of such incentives.

The FTZ of Batam is another example of the partial success of zone-based policy in Indonesia. The island is an important manufacturing hub in the region and has attracted more than USD 20 billion in investments, of which half are foreign. Most foreign investors established their subsidiaries primarily because of the island's proximity with Singapore where labour costs are much higher (a setting that is it difficult to replicate in other regions with less favourable locations). Since decentralisation, the performance of the FTZ stagnated because of, inter alia, rampant legal uncertainty over zone management between the central government-appointed FTZ authority and the regional government (OECD, 2016). Investment in the FTZ also did not led to growth extending beyond the immediate vicinity of the zone (Rothenberg and Temenggung, 2019). This prompted a presidential decision in 2019 to change the status of Batam from a FTZ to a SEZ, although the government already announced a similar plan in 2015. As of today, this has not yet been completed. Instead, the government launched in 2020 two SEZs in Batam but outside of the borders of the FTZ.

Zone-based policies impose a certain cost on government revenues, as the incentives granted to firms can reduce the fiscal base. More problematic, zones in Indonesia may be impeding fair competition between firms inside and outside of zones. This can be particularly the case for the SEZ programme, as it provides CIT holidays, a type of incentive that raises two concerns. The first is the limited efficiency of CIT holidays in attracting investors, in comparison with other incentives such as investment tax allowances (see Chapter 6 for more details). A second concern, which directly relates to zones' impacts on regional development, is the possibility for SEZ firms to sell into the domestic market while they enjoy a competitive advantage over peers outside of zones, owing to tax relief.

To foster business linkages between SEZ firms and suppliers nearby, goods exiting from the SEZs to the domestic market are not subject to customs duty if they fulfil a minimum local content requirement of 40%. This policy, which also exists in other countries like Brazil, intends to generate local economic development in areas nearby SEZs. The possibility for SEZ-based firms to sell their goods on the domestic market may have adverse impacts on countrywide productivity, however, as firms can avoid export markets and related competitiveness pressures to be profitable at international prices. When poorly designed, zone-based policy could have adverse impacts on the wider economy (Box 7.8).

Box 7.8. Zone-based firms' sales on the domestic market: international evidence

Governments have opted for various policies regarding zone-based investors' sales on the domestic market. In Thailand, as in most other countries, sales on the domestic market are treated as any imported good and thus zone-based firms pay the related customs duties. Countries like Bangladesh and Egypt have a similar practice but impose a ceiling on domestic market sales, the rest of the production being for export only. Other countries permit a fixed percentage of production to be sold on the domestic market without facing customs duties, using duty-free domestic access as an incentive to attract FDI to the zones. This is the case of Mauritius, where firms are allowed to sell up to 20% of their production duty free on the domestic market, thus offering them preferential, albeit limited, access. In Brazil, the FTZ of Manaus grants tariff incentives conditional on the local value-added created in total production, a similar policy to Indonesia's SEZs.

Notwithstanding the policy choice, all countries, in one way or in another, let zone-based companies sell their products on the domestic market, even if the primary objective of such areas is to boost exports (some zones face important trade deficits). Sales to the domestic market can adversely affect firms outside zones by exposing them to unfair competition. Preferential treatment given to firms in zones, in particular corporate income tax holidays, along with import facilitation measures, may offset the cost of customs duties they may have pay to sell on the domestic market. This preferential treatment gives market-seeking businesses in zones a comparative advantage over firms outside zones. Countrywide productivity growth may be adversely affected by zone-based firms' sales on the domestic market, as they can avoid export markets and related competitiveness pressures to be profitable at international prices while benefiting from tax incentives.

The design of zone-based policy should consider the potential adverse impacts of zones on the wider economy. It should shift from relying on fiscal incentives to facilitating a more effective business environment that promotes competition, integrates targeted sectors with the rest of the economy, and adequately protects the environment. Governments should opt for policy reforms that align the country's import tariffs, import procedures and corporate income tax incentives with those in zones to cut the detrimental comparative advantage gap between firms inside and outside of zones. Levelling the playing field between zones and the rest of the country is an even more pressing priority in light of many governments' strategy, including Indonesia, to expand the number of zones.

Some countries have successfully managed to address challenges inherited from their zone-based policies. Poland established zones in the 1980s for a temporary period of 20 years (setting a temporary lifespan for zones is in itself a good practice). Zones in Poland contributed to productivity growth but were not without some adverse consequences. The criteria discriminated against SMEs based outside zones. Furthermore, neighbouring countries started offering tax incentives regardless of investors' location. As a remedy, Poland introduced in 2018 a law to expand zones incentives to the entire territory and shifted criteria from geographical and investment scale to sustainability and innovation.

Source*:* OECD (2020c), OECD Investment Policy Reviews: Egypt 2020, OECD Publishing, Paris.

The phenomenon of zone-based firms selling on the domestic market is observable in bonded zones. In these areas, the gap between output and exported output is substantial, suggesting that not all firms export their products.[18] This is a concern amongst policymakers, some of whom call for removing bonded-zones, as some firms enjoy incentives without exporting (Wicaksono et al., 2019). More problematic, the proportion of exported output amongst bonded-zone businesses is lower than amongst non-bonded exporting firms, particularly in the food and textile industries. Thus, not only do bonded-zones not contribute to raise exports of firms, they also host businesses that take advantage of the zone incentive and use it as a platform to produce and sell to the domestic market.

There is little evidence of zone-based productivity spillovers to nearby Indonesian regions. In other countries, too, the results are often mixed, illustrating both the benefits and limitations of zone-based policies. In Brazil, Manaus FTZ was successful in reducing local poverty through higher incomes in the zone but spillovers to neighbouring areas were limited (Castilho et al., 2019). In India, place-based policy attracted large and productive firms but there were no tangible spillovers (Chaurey, 2017). The Chinese SEZ programme, which inspired the latest SEZ regulation in Indonesia, has had a positive effect on investment, employment, productivity and wages, mostly driven by the entry of new firms rather than incumbents. Because of the CIT incentives, capital-intensive industries benefit more than labour-intensive ones from the programme (Lu et al., 2019).

Zone-based policy in Indonesia should gradually shift from relying on fiscal incentives to facilitating a more effective business environment that promotes competition, integrates targeted sectors with the rest of the economy, and adequately protects the environment. The government could opt for reforms that align the country's import tariffs, import procedures and corporate income tax incentives with those in zones to cut the detrimental comparative advantage gap between firms inside and outside of zones. Levelling the playing field between zones and the rest of the country is an even more pressing priority in light of the government's strategy to expand the number of SEZs.

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Notes

[1] Law No. 22 of 1999 on Local Governance.

[2] Presidential Decree No. 117 of 1999; Government Regulation No. 25 of 2000.

[3] About half of the civil servants were already in the regions but paid by the central government.

[4] Law 32 of 2004 on Local Governance; Head of BKPM Decree No 57&58/SK/2004.

[5] Law No. 23 of 2014 on Local Governance; Head of BKPM Decree No. 14 the Year of 2015.

[6] The World Bank Doing Business surveys in 2010 and 2012 benchmarked 14 Indonesian cities and found large differences in the ease of doing business. For example, the cost of dealing with construction permits ranged from 132% of per capita income in Makassar to 32% in Jambi, while the cost of opening a business in relation to income per capita was nearly twice as high in Manado as in Pontianak.

[7] In 2014 and 2017 the ADB and KPPOD conducted a joint survey on the ease of doing business in five Indonesian cities: Jakarta, Surabaya, Medan, Balikpapan, and Dan Makassar. The results of the surveys could not be retrieved online. The translation of online press articles in Bahasa indicates that the top three impediments to doing business across the five cities were the ease of starting a business, the ease of getting construction permits, and registration of land and building rights.

[8] Government regulation No. 30 of 2011 on regional loans became regulation No. 56 of 2018.

[9] Foreign investment in passenger and cargo sea transport is limited to 49% of equity interest and in some sea transport auxiliary services to 67% (OECD FDI Regulatory Restrictiveness Database).

[10] The Indonesia Governance Index measures the quality of local governance in four areas: government, bureaucracy, civil society and economic society.

[11] Law No. 12 of 2011 on the hierarchy of laws and legislations in Indonesia.

[12] Presidential Instruction No. 7 of 2019 on the acceleration of ease of doing business.

[13] Unlike most provinces, East Java has not established a provincial level minimum wage, and instead sets wages at the district and regency level.

[14] Malang Regency Regulation No. 3 of 2012 on Protection and Empowerment of Traditional Markets and Structuring and Control of Shopping Centres and Modern Stores, article 10 paragraph (2) letter (a). See also: https://nusadaily.com/en/headlines/breaking-through-complex-permits-jokowi-issues-presidential-instruction-7-of-2019.html.

[15] Government Regulation No. 24, 2019.

[16] The four SEZs are in Mandalika, Tanjung Lesung, Tanjung Kelayan and Morotai.

[17] The provisions of the tax holiday for SEZs are listed in Regulation Number 104/PMK010/2016, where investors could get a reduction in corporate income tax by 20% to 100%.

[18] A bonded zone is required to export at least 25% of total zone output. Thus, a firm in a bonded zone does not need to export if total exports in the zone account for more than 25% of total output.

OECD Investment Policy Reviews

INDONESIA

Building on the achievements since the first *OECD Investment Policy Review of Indonesia* a decade ago, this *2nd Review* presents an assessment of the investment climate in Indonesia to support the government in its ongoing reform efforts. It identifies challenges and opportunities in selected policy areas and provides recommendations to increase competitiveness, support growth and ensure investment contributions are shared widely and environmentally sustainable. The review places great emphasis on measures to build a sound, transparent and responsible investment environment to support a resilient economic recovery from the COVID-19 pandemic.

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