

## BUILDING A COMPETITIVE AND RESPONSIBLE INVESTMENT ENVIRONMENT IN INDONESIA TO SUPPORT A RESILIENT COVID-19 RECOVERY

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**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. Sustained and steady growth, sound macroeconomic policies, an increasingly accountable political system and progress in the social protection system have allowed the country to increase living standards and reduce poverty in both rural and urban areas. The COVID-19 pandemic has halted this progress and plunged Indonesia into a major crisis. Economic activity has contracted, foreign direct investment (FDI) has plummeted, and unemployment and income losses have risen sharply. Private investment, both foreign and domestic, can make an important contribution to a sustainable and inclusive recovery from the COVID-19 pandemic and resulting social and economic crisis. Reforms are needed to improve the investment climate in Indonesia and ensure investment contributions are maximised.**

The second *OECD Investment Policy Review of Indonesia* presents an assessment of the investment climate in Indonesia and provides recommendations to support the government in its ongoing reform efforts.<sup>1</sup> It identifies challenges and opportunities in selected policy areas and offers advice to increase competitiveness, support growth and ensure investment contributions are shared widely and are 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.

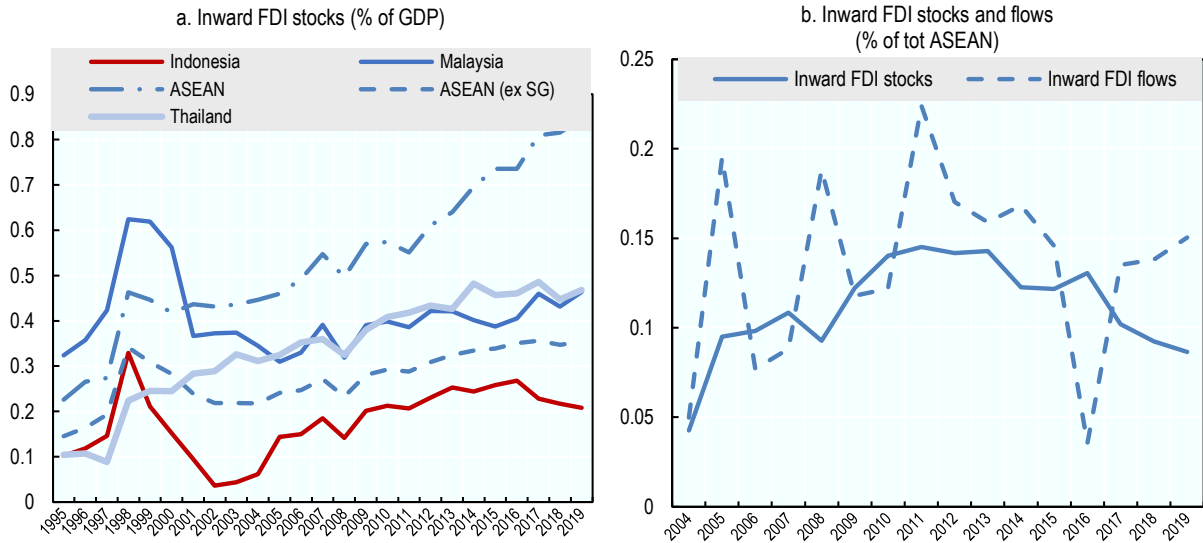
### **FDI has played an important role in Indonesia but can further contribute to sustainable development**

Indonesia has historically been an important FDI destination in ASEAN, especially due to the size of its market. Foreign investments during 2009-19 went mostly to manufacturing, although this share has been declining over the past few years. The primary sector, also attracting a large share of FDI, driven by the country's rich endowment of natural resources, experienced a similar trend. Conversely, the services and energy and construction sectors have received increasing FDI flows. Yet, already before the pandemic, FDI inflows had recently declined as a share of GDP and as a share of total inflows into ASEAN (Figure 1).

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<sup>1</sup> [www.oecd.org/investment/oecd-investment-policy-reviews-indonesia-2020-b56512da-en.htm](http://www.oecd.org/investment/oecd-investment-policy-reviews-indonesia-2020-b56512da-en.htm).

**Figure 1. FDI as a share of GDP and in total ASEAN**

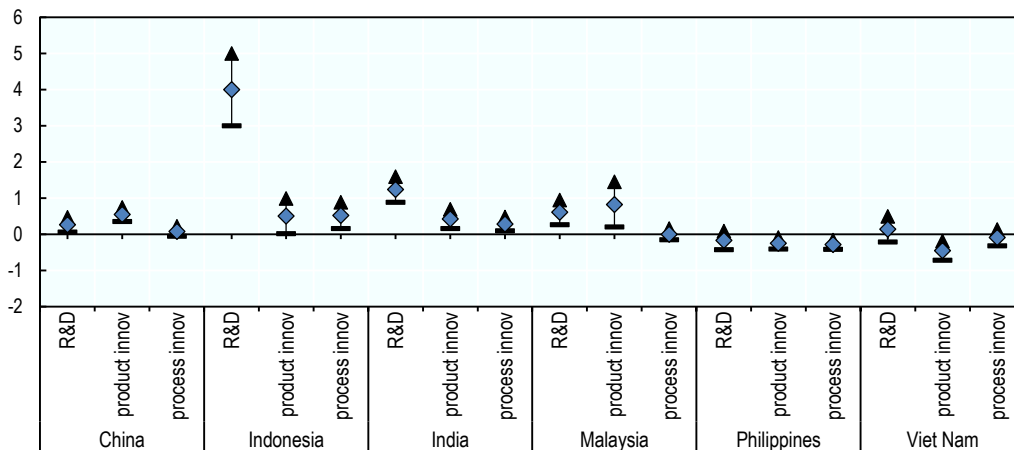


Source: OECD elaboration based on UNCTAD and the World Bank.

These declining trends are a cause of concern, as FDI can make an important contribution to the economic recovery and to achieve Indonesia’s sustainable development objectives. Foreign firms in Indonesia already generate important multiplier effects on the domestic economy. For example they are more likely to invest in research and innovation (R&D), across most sectors, or to introduce a new product or process innovation relative to domestic firms. The difference with other Asian economies is particularly striking for R&D (Figure 2).

**Figure 2. 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 figure shows a type 1 FDI qualities indicator and its respective 95% confidence interval. See the complete Review for a description of the methodology. Data for Indonesia refers to 2015.

Source: OECD elaboration based on World Bank Enterprise Survey.

FDI in Indonesia is also concentrated in sectors with relatively higher wages (mining, energy, transport services). In most sectors, foreign firms pay higher salaries than domestic firms. 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. 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<sub>2</sub> emissions, but they are more energy-efficient than domestic firms. While the share of FDI in renewable energy is still comparatively low, inflows into clean energy infrastructure are increasing rapidly.

Conversely, Indonesia is less integrated in global value chains (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 compared to other countries in the region. This can be explained by the types of FDI that Indonesia attracts, which are in their majority resource-based and market-seeking, as opposed to export-oriented, FDI.

Through profound, sustained and well-designed investment policy reforms, foreign investment can play an even greater role in Indonesia's sustainable development.

## **Investment climate reforms are necessary to achieve a sustainable and inclusive recovery from the COVID-19 crisis**

Recognising the important role of the private sector, including foreign investment, in sustainable economic development, measures to improve the business environment have been high on the government's agenda. Policymakers, however, have yet to demonstrate the intention to establish a clear role for FDI in Indonesia's economic, social and environmental development ambitions, and make Indonesia an attractive destination for investors in the aftermath of the pandemic.

Divergent forces are influencing 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 state-owned enterprises continue playing an important role in economic development. 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 comes with opportunities but also makes it challenging to conduct consistent and efficient investment policymaking.

The Omnibus Law on Job Creation enacted in October 2020 is a major reform package seeking to address many of these challenges, by repealing 76 laws and over 1000 articles considered to be hampering investments and job creation. It aims to lift restrictions and conditions placed on FDI, significantly reform Indonesia's labour market, and 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. The law was passed despite strong opposition, including by labour unions, regional administrations and civil society. The concerns expressed relate to risks to the protection of workers and the environment, the recentralisation of

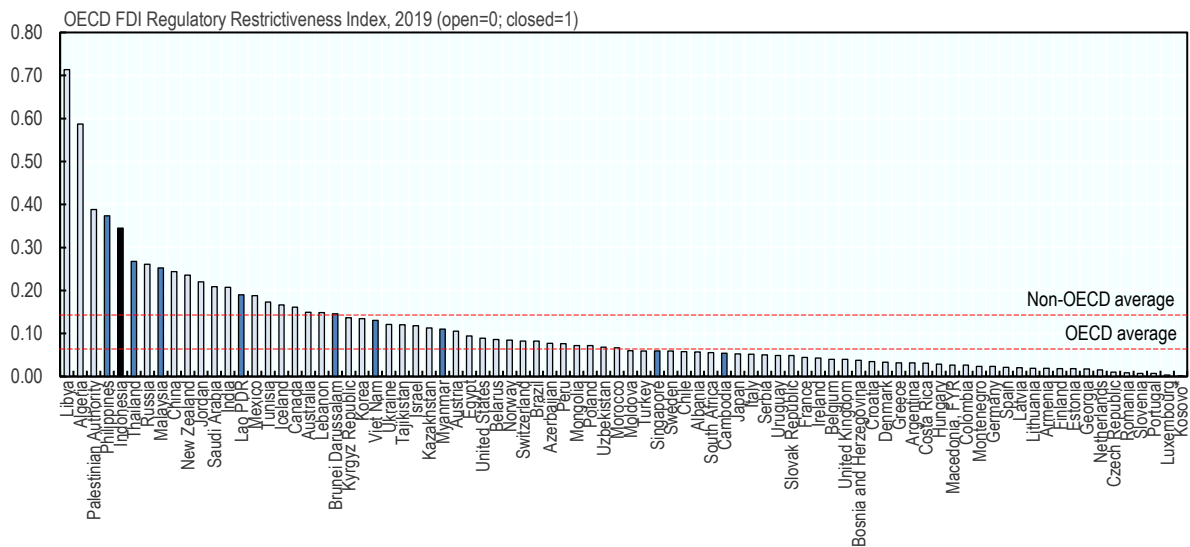
administrative power in the hands of the executive and the lack of public hearings, among other things.

Based on an updated version of the *Policy Framework for Investment* and building on selected OECD tools, the second *OECD Investment Policy Review of Indonesia* proposes policy options for the Indonesian government to consider as it reforms its investment climate. These recommendations, summarised below, relate to the country's openness to FDI, the legal framework for investment protection and dispute settlement, policies to promote and enable responsible business conduct, efforts to promote and facilitate investment, and investment measures to support regional development without jeopardising harmonised and efficient policymaking at national level.

## 1. Indonesia's approach to FDI needs to be more open

Despite significant efforts to liberalise its foreign investment regime, Indonesia is still one of the most restrictive countries to FDI as measured by the OECD *FDI Regulatory Restrictiveness Index* (Figure 3), 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.

**Figure 3. Indonesia's score under the OECD FDI Regulatory Restrictiveness Index, 2019**

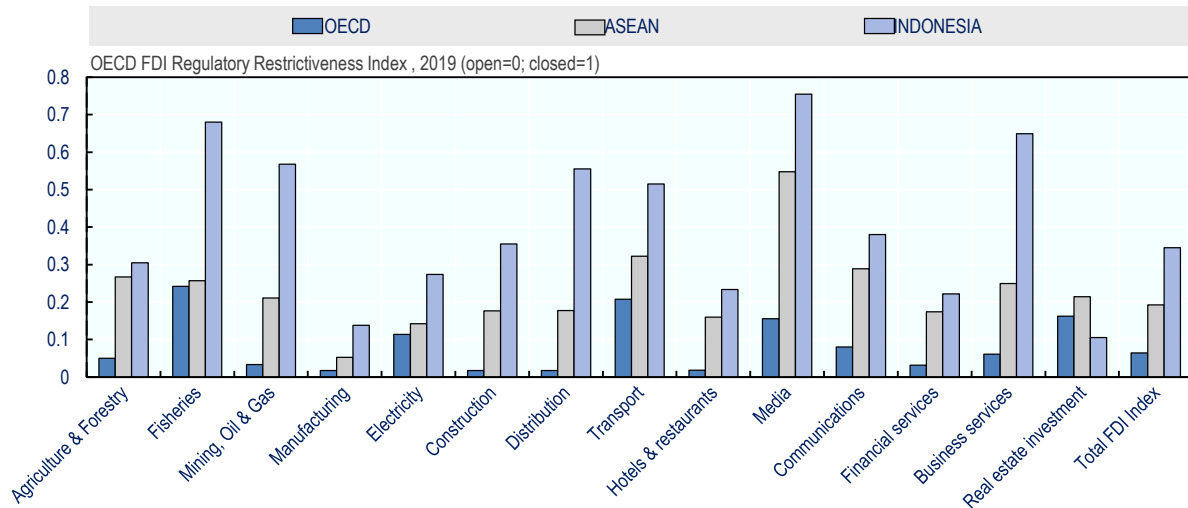


Source: OECD *FDI Regulatory Restrictiveness Index* database, [www.oecd.org/investment/fdiindex.htm](http://www.oecd.org/investment/fdiindex.htm).

In addition to diverting potential FDI away from Indonesia and depriving the country of a relatively stable source of capital and foreign exchange for financing a structural current account deficit, these restrictions contribute to holding back potential economy-wide productivity gains. Restrictions in place often considerably exceed the ASEAN

average (Figure 4). By limiting competition and contestability, notably in services sectors, they prevent access to world class services inputs by downstream industries and consumers. Additionally, tapping into a larger pool of FDI might be critical for the economic recovery following the pandemic. Typically larger and more geographically diversified and productive, foreign-owned firms are overall more resilient to crisis.

**Figure 4. OECD FDI Regulatory Restrictiveness Index, by sector: Indonesia vs. ASEAN vs. OECD, 2019**



Source: *OECD FDI Regulatory Restrictiveness Index* database, [www.oecd.org/investment/fdiindex.htm](http://www.oecd.org/investment/fdiindex.htm).

Only a bold and comprehensive reform package can allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness to international investors. The elimination of all sector-specific foreign shareholding restrictions could bring Indonesia significantly closer to OECD levels of openness. Overall, the impact of substantial FDI liberalisation can be sizeable. Indonesia’s inward FDI stocks, for instance, could be up to 85% higher if it were to reduce FDI restrictions to the 25<sup>th</sup> percentile level of the *OECD FDI Regulatory Restrictiveness Index*, all else held equal. The government’s intention to massively revise Indonesia’s FDI regime in the context of the Omnibus Law on Job Creation is, therefore, a timely and welcome step for increasing Indonesia’s appeal to international investors. 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 government 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. 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. Without reforms, Indonesia

remains at a relative disadvantage compared to its regional peers and the chances of attracting needed FDI in the aftermath of the pandemic may be slim.

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

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 and have not changed significantly in recent years. These protections generally provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are also seen to be robust.

Clarifications may improve the existing legal frameworks to protect investors' intellectual property and land tenure rights. 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. The government has also 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. Sustained momentum is needed to improve the regulatory climate supporting the digital economy.

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. Despite these important reforms, some stakeholders still cite concerns with the lack of transparent and fair treatment in the Indonesian court system. For these reasons, many firms prefer to use alternative dispute resolution rather than litigation to settle their disputes. Bold thinking may thus be required to dismantle these negative perceptions on 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.

Fighting corruption has also been a priority for many years. The Corruption Eradication Commission (KPK) has played a major role in building public awareness and trust through impressive results, including conviction of high-ranking government officials. A number of public sector reforms to improve transparency, reduce bureaucracy, and encourage public engagement in the policy cycle also contributed to strengthening public integrity. A new KPK law was passed in September 2019, however, which has the potential to jeopardise the influence and independence of the commission. As the causes of corruption are deep-rooted, the government could reinforce efforts to reduce bureaucracy and build a culture of integrity at all levels of the public sector.

Investment protection provided under investment treaties can also play an important role in fostering a healthy regulatory climate for investment. 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 investor-state dispute settlement. The government is well aware of these ongoing challenges. 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. 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 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.

### **3. Embracing promotion of responsible business conduct can lead to far-reaching and strategic successes in attracting FDI**

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. 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.

Indonesia was one of the first countries to integrate corporate social responsibility and corporate philanthropy within the legal framework during the previous decade. Recent efforts have looked to further promote RBC, including in sustainable finance and when it comes to business and human rights. A notable effort has also been Indonesia's ambition to introduce transparency of beneficial ownership information.

These developments are positive; 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 of COVID-19 on Indonesia's manufacturing sector and the environmental costs that growth so far has brought. Alignment with international RBC standards can be an important signal to investors and the market, and 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..

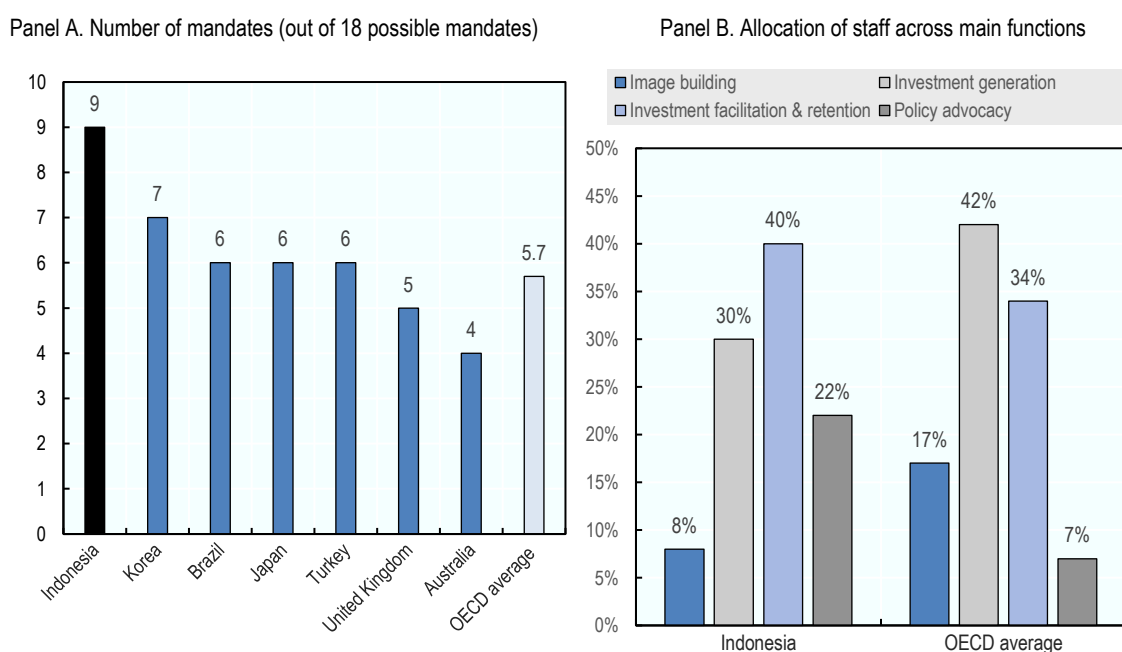
Against this background, it will be important to ensure that the implementing regulations for the Omnibus Law on Job Creation include due consideration of environmental and social impacts of business operations and that streamlining of administrative procedures does not come at an unintended expense on the workers and the environment. In a broader COVID-19 context, where FDI has plummeted globally and significant adverse impacts on inclusive growth are expected – if the concerns about the environmental and social issues are not taken into account – the law may have the opposite effect than intended on investment. Making RBC due diligence a standard operating procedure in this context should be considered. Additionally, 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, systematic, meaningful and transparent.

The policy recommendations in the Review suggest 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 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.

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

The Indonesian Investment Coordinating Board, or BKPM, is the government’s implementing arm on investment promotion, facilitation and regulation. BKPM is a large organisation with a high number of official mandates, more than in many other investment promotion agencies (IPAs) around the world (Figure 5, Panel A). Its regulatory role, focusing on investment facilitation and policy-oriented tasks, is prominent and has been dominating the agency’s mind-set and strategic orientations (Figure 5, Panel B). While this tendency has been instrumental in advocating for a business-friendlier environment in Indonesia, including for FDI, it has also affected its ability to conduct targeted investment promotion. The focus of its investment promotion strategy remains too wide to be fully impactful and measurable. 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.

**Figure 5. BKPM’s institutional characteristics vs. international peers**



Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

BKPM also 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 across government actors can now and then lead to overlap or inconsistent policies or initiatives. This complexity is amplified by the important role played by local governments in investment promotion and facilitation (see next section). Reinforcing BKPM’s leadership role would help make it



a more impactful institution and deciding whether to upgrade it to a minister level or to keep it as an operational agency would clarify and strengthen its mandate.

As part of its investment facilitation efforts, the government established in 2018 the Online Single Submission (OSS) system to make the licensing process more efficient and transparent, and ultimately reduce corruption and informality. In practice, however, investors still have to cope with many procedures and requirements that cannot be processed by the OSS, which has also been facing implementation problems and resistance at local level. The Omnibus Law on Job Creation seeks to further ease and harmonise the business licensing process by amending laws related to a wide array of economic sectors and limiting the regulatory role of local authorities.

The government would be well advised to also systematically identify business regulations that can be eliminated without undermining the much needed labour and environmental protection safeguarding a more inclusive and sustainable development pathway. Achieving an environment of trust through meaningful stakeholder consultations will be key for the law's successful implementation. While BKPM organises ad hoc business consultations, wider, transparent and timely dialogue mechanisms could help reconcile the sometimes conflicting views on investment-related matters across different stakeholders.

Tax reform is another pillar of Indonesia's strategy to enhance the investment climate and promote the country as an attractive investment destination. Indonesia's tax incentives are among the most generous in the region, but their potential to attract investment should be weighed against the resulting costs in terms of tax complexity, neutrality and revenue forgone. New cost-based incentives were introduced in recent years to promote labour-intensive sectors and activities with socio-economic spillovers, such as research & development 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) makes the intended policy objective less clear, however.

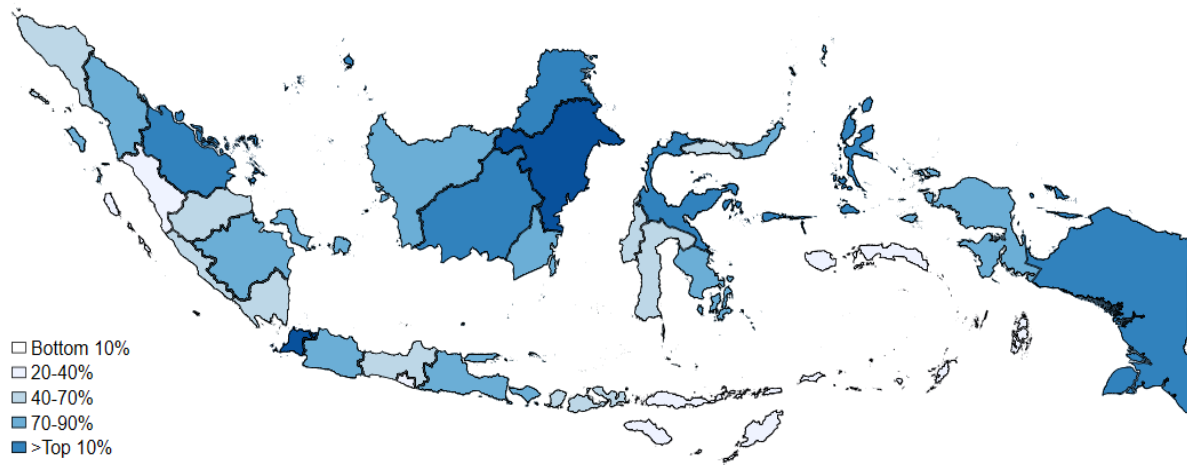
The wider tax incentive scheme continues to be complex due to multiple – in some cases, overlapping – incentives and the density of the current legal framework. Tax incentives in Indonesia are introduced through multiple legal instruments, which can be modified by further regulations – for example, introducing additional requirements – that amend prior ones, thus increasing the legal complexity. While significant efforts have been made to increase transparency and communicate incentives more clearly, further measures should focus on helping investors to have a full overview of how incentives apply.

## **5. Decentralisation has come with opportunities for regional development but also with challenges on investment climate improvements**

Indonesia has embarked on ambitious decentralisation reforms over the past two decades, which have shaped regional development and the geography of investment across the country (Figure 6). Decentralisation was seen as a vital complement to the democratisation process and a reaction to the inherently centralised approach in a country with strong cultural diversity and stark regional inequalities.

**Figure 6. Investment per capita across Indonesian provinces**

Realised foreign and domestic investment per capita (1990-2019), percentile distribution

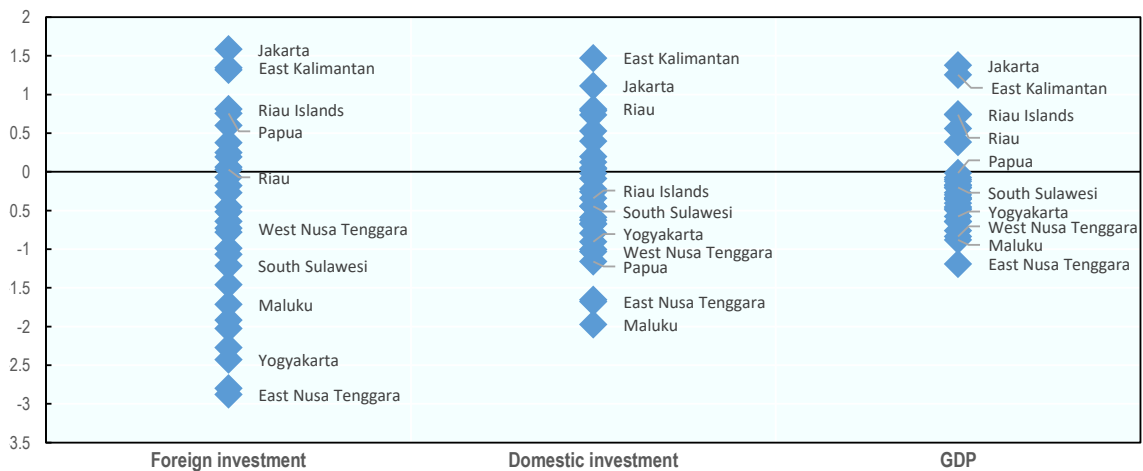


Source: OECD based on BKPM and Statistics Indonesia 2015 “Intercensal Population Census”.

Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia. After decades of concentration on the island of Java, there is a catching-up in the level of investment by the other islands, albeit partly driven by foreign exploitation of natural resources. Resource-scarce and least developed regions continue to attract little investment after regional autonomy. Foreign firms’ unequal distribution across regions may also hinder the wider process of regional convergence and such inequalities could feed a geography of discontent. Figure 7 shows that FDI in Indonesia is more concentrated in the most dynamic regions than are regional domestic investment and GDP. The COVID-19 crisis may exacerbate existing regional disparities.

**Figure 7. 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.

Indonesia has been struggling to find the right balance in the sharing of investment policy responsibilities across different tiers of government. To reduce the complexity and uncertainty of the investment environment, the central government has adjusted the legal framework for local governance several times, through back and forth movements of decentralisation and recentralisation. 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 (PTSPs), and the introduction of the OSS later on, the lack of co-ordination, the unclear division of authority and overlapping regulations remain important challenges and create room for regulatory capture by local government.

In 2020, the enactment of the Omnibus Law on Job Creation is seeking to harmonise central and regional regulations and ease the investment process. The rationale of centralising investment policymaking and business licensing is, in part, because less developed regions do not always have adequate institutional and technical capacities. Local bodies may be well-placed to assess business opportunities and risks, however, and should at least have a clear role in this process, even if ultimately the decision-making process is re-centralised. In the current crisis context, subnational investment agencies are also well-positioned to deliver much needed aftercare services to established investors. Building gradually their capacity can thus be a more sustainable approach, promoting shared responsibilities over top-down governance.

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 BKPM. The recent Special Economic Zone programme aspires to overcome previous shortcomings of zone-based policies by involving subnational governments in the decision-making process and granting non-fiscal incentives to facilitate a more conducive business environment and preserve fair competition between firms inside and outside of zones, although fiscal incentives continue to be the norm. Apart from investment promotion, broader regional development policies to improve the quality of education, infrastructure and governance continue to be critical to attract FDI with higher development impact. For instance, increasing the presence of KPK in provinces, particularly in those with business sectors at high risk of corruption, will help improve local governance.

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