Innovating Indonesian Investment Regulation:

The need for further reform

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Executive Summary

Considering Indonesia's continued economic resilience during and following the global financial crisis the economic outlook for the archipelago should be rosy.

Recent data from the government's statistics agency showed economic growth in the first quarter of this year to be 6.5%. Coupled with limited export exposure to American and European markets in favour of ASEAN nations and China, Indonesia saw relative investment stability throughout the global financial crisis.

The contribution of foreign direct investment to economic growth is clear because it provides countries with the necessary finance to build infrastructure and grow industries that employ workers and pay taxes. However, with other countries slowly pulling themselves out of recession the environment for accessing investment finance is going to become increasingly constrained and governments are going to need to continue reform to make them a safe and attractive destination.

Indonesia's recent history provides good foundations that should be built on. Since the mid-1980s successive governments have progressively liberalised government restrictions to make it a more attractive destination for foreign investment. The 2007 investment reforms that granted national treatment for foreign investors and established a transparent 'negative' list for out-of-bounds investment sectors were considered a watershed in Indonesia's economic strategy. But the job is not done.

Concurrent with pro-investment regulation reform nationally, immature local governments are increasing investment burdens, often through opaque measures, that are creating perceptions of risk. And these perceptions are being exacerbated by politics. These perceptions couldn't come at a worse time and are being confirmed by international ratings agencies. Earlier this month, Standard & Poor's released a report examining 2009 investment reforms, concluding that subsequent regulations provide 'greater clarity' toward a negative impact on the mining sector caused by decentralized decision making, which could hit bottom lines.

Without improvements, these perceptions of investment risk could make it significantly harder for attracting private investment. But it could also flow through to projects of government priority. With national plans outlining that the government is expecting 64 % of all capital for infrastructure projects to come from the private sector it is going to need to look at innovative financing and ownership structures such as public-private partnerships.

Having legislative and regulatory requirements for shares of government ownership naturally lends itself to sovereign risk when the priorities of governments and foreign investors collide. The situation is made worse when local and national authorities are also fighting.

Instead of trying to manage these priorities the government should be looking toward further investment law reforms that consider the benefits of removing government ownership investment requirements all together. Liberalizing investment ownership laws doesn't preclude the government securing their share of the dividend of exploiting Indonesia's scarce natural resources which can still be secured through well-designed licensing agreements.

Choosing to focus government interests through contracts rather than ownership is also replicable irrespective of investment type and avoids fostering risk perceptions from the government involving itself where it has little expertise.

1.0 Introduction

The island archipelago of Indonesia is symptomatic of the challenges facing developing countries.

It's heavily dependent on its natural resources to fuel development from a subsistence economy to a manufacturing and services economy. However, it faces environmental challenges as it seeks to exploit its natural resources sustainably and ensure the economic and social dividends to the poor.

As Indonesia develops it also faces challenges developing its legal and governance infrastructure. The spectacular democratisation process has helped foster political acceptance for government but also instability as many immature local governments have grown and are developing governance structures that are inconsistent with national policy.

This challenge is sending inconsistent messages to the international investment community and challenging the potential for growth.

The contribution of foreign direct investment (FDI) to economic growth is clear because it provides countries with the necessary finance to build infrastructure and grow industries that employ workers and pay tax. It also frees up domestic savings to finance other activities and increase overall economic welfare.

Indonesia has made significant strides in reforming investment laws and regulation towards liberalisation.

However, with other countries slowly pulling themselves out of recession the environment for accessing investment finance is going to become increasingly constrained and governments are going to need to continue reform to make them a safe and attractive destination.

This is the challenge that Indonesia now faces.

This occasional paper looks at the investment opportunity Indonesia faces and considers the recent history and future direction of investment regulation to continue supporting economic development in Indonesia.

2.0 The importance of foreign direct investment

FDI makes an enormous contribution to driving economic development in developed and developing countries alike. For developing countries the benefits are particularly acute because of the limited capacity to raise investment finance from domestic sources.

FDI enables economic development allowing countries to build the industries and infrastructure to harness the potential of their natural endowments for local consumption and exports. Without FDI countries rely on domestic sources of investment finance which limits their capacity to economically develop.

Despite wariness of the benefits of FDI throughout much of the 20th Century, it has become accepted as making a positive contribution to economic growth by financing domestic industry development and has a lower risk profile for capital flight during economic downturns. Other significant contribution of FDI is the transfer of technology and skills that international companies possess but are often unavailable within developing countries and the development of local industries that develop to support investments.[1]

3.0 Indonesia's economic resilience

Working from a low base, Indonesia is one of the stand-out economies in the South East Asian region and offers long-term economic growth prospects. Based on current projections the nation's GDP is set to more than double from 2006 levels by the end of this year from USD$364.4 billion to $777 billion, as is GDP per capita.[2] Furthermore, in 2009 Indonesia's real GDP growth had the third highest of the G20 countries.[3]

Figure 1 | 2010 Indonesia economic fact box

Population (millions)	237.6
Working age population (millions)	171.0
Total employment (millions)	107.4
GDP at current prices and current exchange rate (USD$ billions)	540.3
Per capita GDP at current prices and market exchange rate (USD$)	2,349.4
Average annual real growth over previous 5 years (per cent)	5.6
Current account (USD$ billions)	10.7
Export of goods (USD$ billions)	118.0
Import of goods (USD$ billions)	85.3
Outstanding external debt (USD$ billions)	172.3

Source: Organisation for Economic Cooperation and Development, 2010, "OECD Economic Survey, Indonesia", v2010/18, November, Paris, France.

In the 1990s Indonesia was one of the worst hit economies during the Asian economic crisis prompting considerable capital flight and economic liberalisation in response to international financial support.

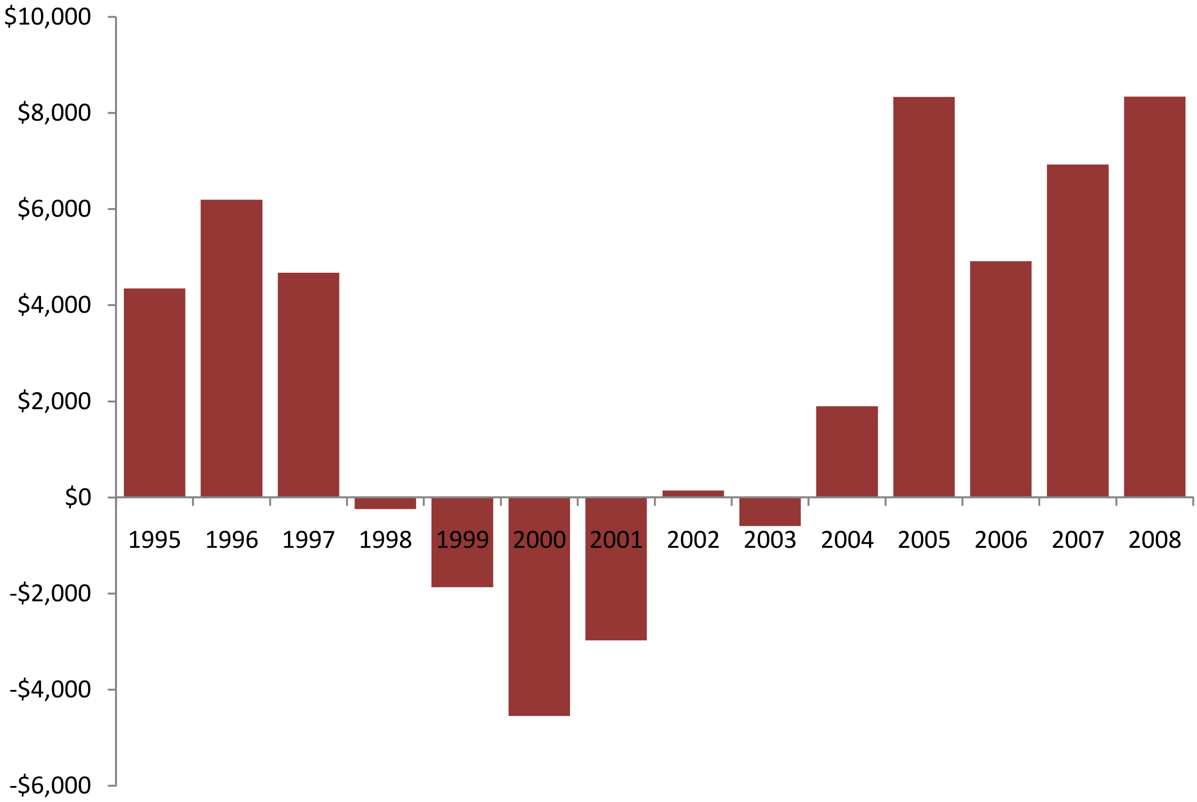
Recent economic history of Indonesia shows a country going through transformational reform from a poor subsistence economy to a major economy with a mix of industries based on its differing stages of economic development.

[1] Gray, M., 2002, "Foreign Direct Investment and Recovery in Indonesia", Backgrounder, Institute of Public Affairs, v14/2, Melbourne, Australia.
[2] Department of Foreign Affairs and Trade, 2010, "Indonesia Fact Sheet", Commonwealth of Australia, Canberra, Australia at http://www.dfat.gov.au/geo/fs/indo.pdf.
[3] Organisation for Economic Cooperation and Development, 2010, "OECD Economic Survey, Indonesia", v2010/18, November, Paris, France.

Concurrent with economic reforms, Indonesia has become a model for governance reform having gone through a radical and relatively peaceful process of democratisation and decentralisation of government. While Indonesia's pathway to democracy through the election of a President and Parliament are regularly acknowledged, some of the most radical reform has occurred in the last decade at a local level through the democratic election of hundreds of local governments with considerable power.

During this time of political and economic structural reform, economic success has been achieved during a period of international economic instability. However, despite the setbacks of the 1997 Asian financial crisis and the 2008/09 global financial crisis economic growth has continued to power ahead because of Indonesia's exposure to ASEAN markets and China and limited exposure to United States and European markets. [4] According to the OECD the "impact of the global financial crisis on GDP was comparable to the 2002 episode of financial duress and much more muted than during the Asian crisis".[5]

Graph 1 | Indonesia's inflows of foreign direct investment

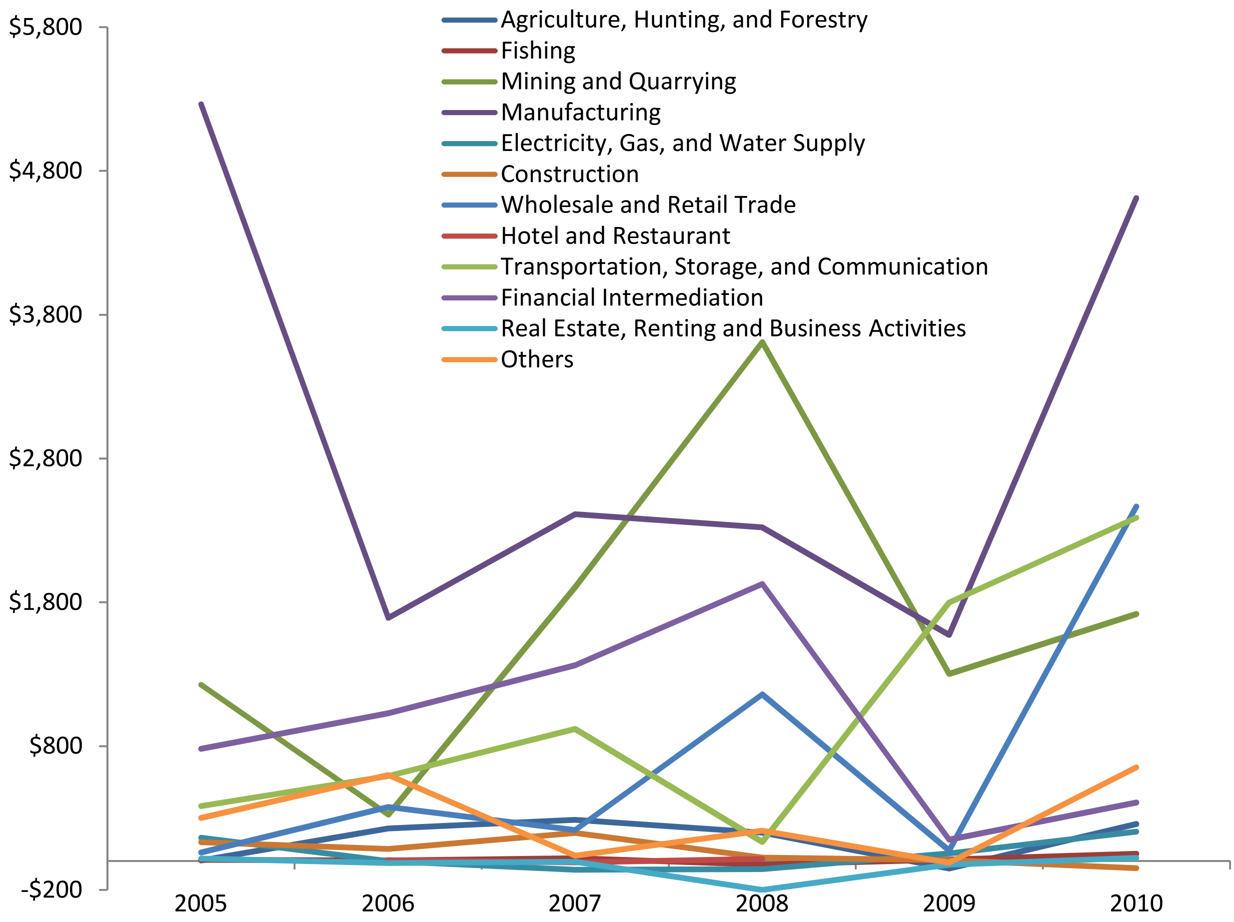


Source: Organisation for Economic Cooperation and Development, 2010, "OECD Investment Policy Review: Indonesia", Paris, France.

The impact on investment has been comparable. As Graph 1 shows, the Asian economic crisis prompted capital flight, which took many years for Indonesia to recover from. In the lead up to the global financial crisis Indonesia's FDI had returned to, and exceeded, levels seen in the late 1990s. And while there was some slowing around the global financial crisis, inflows in FDI in the first quarter of 2010 were some of the highest in the previous decade.[6]

[4] World Trade Organisation, 2007, "Trade Policy Review: Report by the Secretariat: Indonesia", (Revision), Geneva, Switzerland.
[5] World Bank, 2011, "Indonesia Economic Quarterly: 2008 again?", Washington DC, United States of America.
[6] Organisation for Economic Cooperation and Development, 2010, "OECD Investment Policy Reviews: Indonesia", Paris, France.

Graph 2 | Indonesian foreign direct investment inflows by sector (USD$)



Source: SEKI, Bank Indonesia

However investment capital has not flowed equally across the economy with certain economic sectors receiving a much larger share. Graph 2 shows the recent receipts of FDI into Indonesia indicating that the manufacturing, mining and real estate sectors are those that have received significant investment capital. While most sectors lost investment capital during the 2008/09 global financial crisis, they have mostly returned to comparable levels as the international economic environment has stabilised.

The picture of origins of FDI capital is less clear. Singapore is clearly the largest investor into Indonesia and dramatically exceeds that of most other nations. Of the remaining significant economies, as Graph 3 shows, many have seen a s decline as an origin of investment capital, particularly the United States and European Union (though peaks of United States investment dropped off prior to the global financial crisis).[7] Despite the global financial crisis, the only country that appears to have consistently been increasing its investment finance into Indonesia has been Australia.

On a sectoral basis the picture for Australian investment is relatively clear. As Graph 4 shows the real growth has been in construction with investment into manufacturing and mining dipping in 2006 and 2007 and not returning to previous levels.

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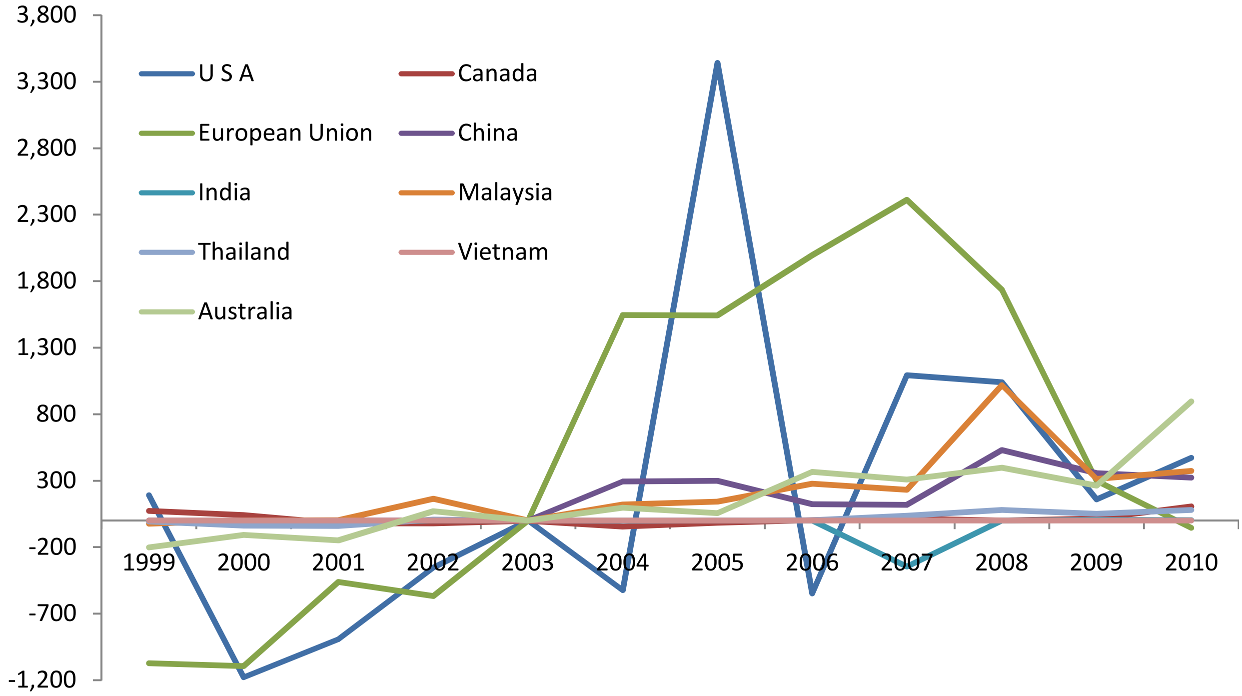
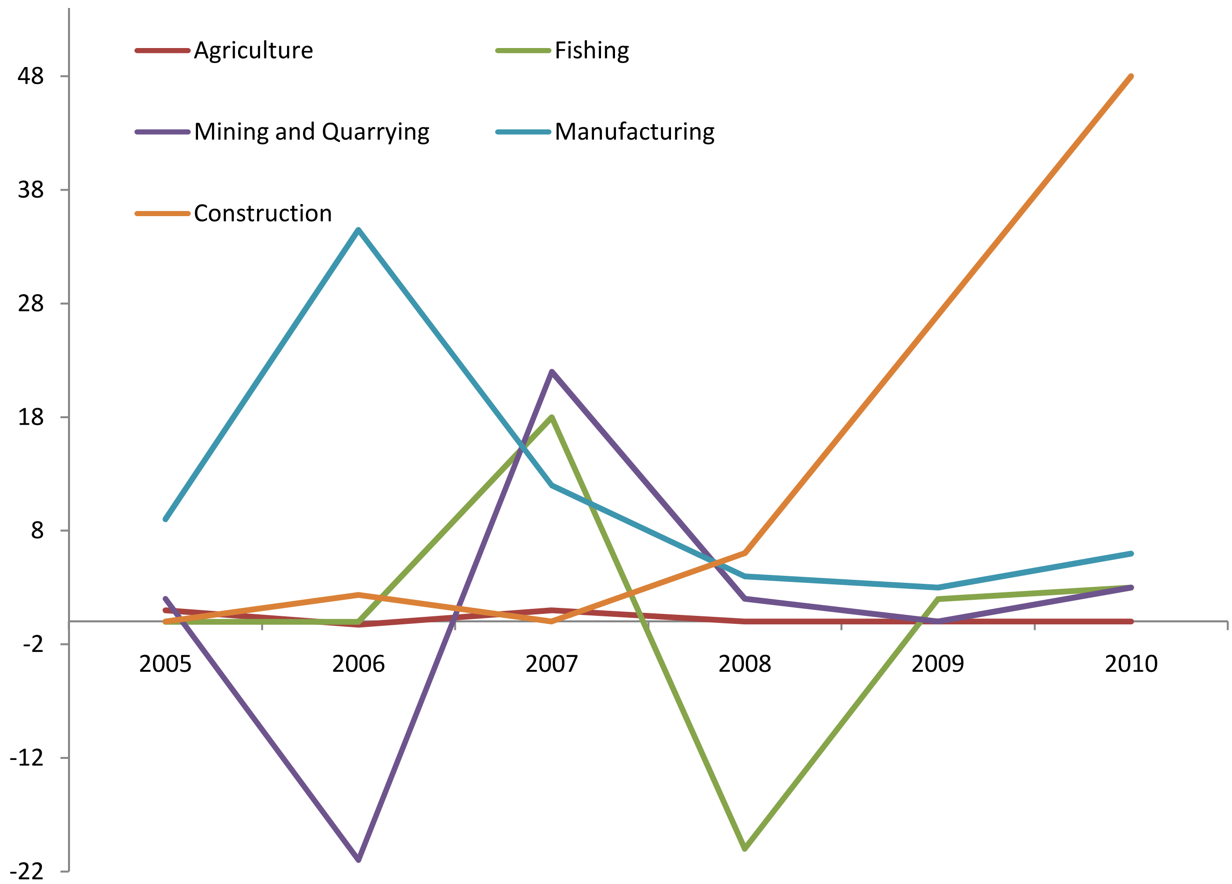
[7] Organisation for Economic Cooperation and Development, 2010, “OECD Economic Survey, Indonesia”, v2010/18, November, Paris, France.

Graph 3 | FDI flows into Indonesia by country of origin (USD$ millions)



Source: SEKI, Bank Indonesia.

Graph 4 | Australian FDI flows into Indonesia by sector (USD$ millions)



Source: SEKI, Bank Indonesia.

4.0 Recent investment reforms

Concurrent with the rise of many other developing nations in South East Asia, Indonesia has progressively liberalised investment regulations to shed its image as an unattractive destination for foreign capital. Figure 2 provides a summary of the history of Indonesian FDI reform since the mid-1980s showing consistent and progressive economic liberalisation.

The most significant reforms occurred recently in 2007 and 2009.

A core provision of the 2007 law was to afford foreign investors national treatment to domestic investors. Subsequent regulations to the law also established a negative list for foreign investment outlining which sectors of the economy have restrictions and therefore opening up all non-listed sectors to investment.

In comparison to previous regulation standards there is no "general approval process" required for foreign investment in Indonesia, although regulations that limit foreign ownership and sectoral investment restrictions do remain.[8]

2009 laws included further liberalisation, in particular in the mining sector, removing restrictions to foreign ownership and to allow new investment in the electricity sector where infrastructure needed to be built.

Concurrent to the general liberalisation trend the number of state-owned enterprises operating within Indonesia and providing a challenging commercial playing field for foreign investors has also been decreasing , except in key

Figure 2 | A chronology of Indonesian FDI liberalisation

1986
- Relaxation of limits of foreign ownership for export-orientated firms
- Several sectors previously closed to FDI are opened, including retail trade

1987
- Foreign investors allowed on stock exchange

1988
- 16-year ban on new on foreign bank entry removed
- Joint ventures allowed to distribute their products locally

1989
- Switch from Positive to Negative list, allowing hundreds of industries not on the negative list to be opened to foreign investment consistent with regulations
- Foreigners allowed to purchase 49 per cent of shares of listed companies

1994
- Minimum capital requirement for foreign investment removed
- Nine strategic sectors opened to 95 per cent foreign ownership
- Foreign ownership permitted throughout Indonesia raised from 80 per cent to up to 100 per cent
- Divestiture requirement reduced to only a token amount of local equity
- Domestic partnership requirements relaxed

1995
- Ten sectors removed from Negative list, including motor vehicles

1997
- Presidential decree removes 49 per cent foreign equity limited on listed shares purchased

1998
- Full foreign ownership in banking allowed

1999
- BKPM no longer requires Presidential signature for approvals
- Local content programme for motor vehicles phased out
- Full foreign ownership of holding companies allowed, including through acquisitions
- Several sectors opened further to FDI, including retail, general importing, palm oil plantations, broadcasting and downstream oil operations

2007
- Investment Law does away with general divestiture requirements
- New Negative List opens some sectors to greater foreign participation

2009
- Mining Law allows foreign ownership of concessions
- Electricity Law allows for private operators in areas not served by PLN

2010
- New negative list opens some sectors to greater foreign participation

Source: Adapted from Organisation for Economic Cooperation and Development, 2010, "OECD Investment Policy Review", Paris, France.

[8] Organisation for Economic Cooperation and Development, 2010, "OECD Investment Policy Reviews: Indonesia", Paris, France.

infrastructure and utility sectors which often have market dominance.

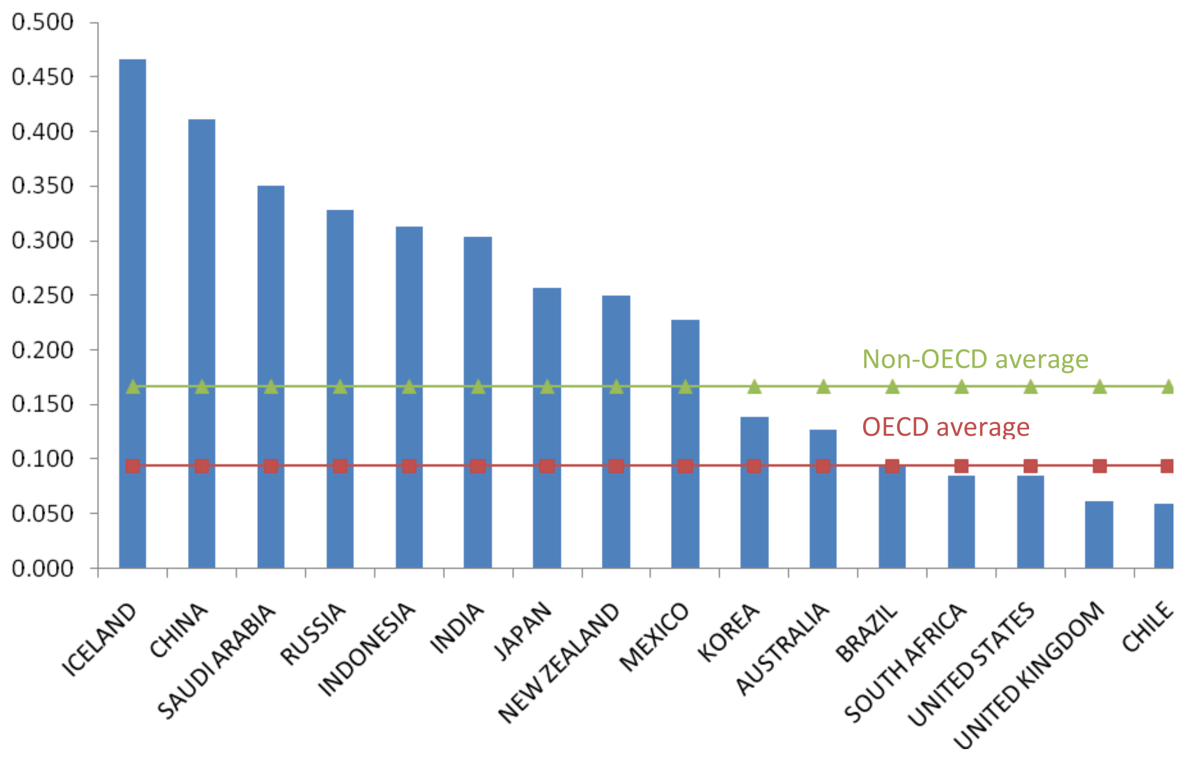
The benefits from investment liberalisation have delivered dividends by enabling sectors to seek foreign investment capital.

As Graph 2 shows, despite the consequences of the global financial crisis, the sectors that have seen FDI flows grow are those that have already been partially liberalised.

In fact, Indonesia does deserve some praise for not turning its back on investment liberalisation from the challenges of the global financial crisis.[9]

However, facing a capital constrained world as developed countries pull themselves out of their recent downturns, Indonesia will need to continue investment reforms if it wishes to capitalise on the next period of economic growth.

Graph 5 | 2010 OECD Investment restrictiveness index



Source: Organisation for Economic Cooperation and Development, 2010, Investment Restrictiveness Index, Paris, France, at http://www.oecd.org/dataoecd/32/19/45563285.pdf

As Graph 5 shows Indonesia still ranks as one of the most restrictive economies in the world. While the OECD restrictiveness index primarily includes developed countries, the ranking of investment restriction should concern Indonesia as it seeks to compete against other emerging economies with comparable natural resources and manufacturing capacity that can service the Asia Pacific.

Further, Indonesia's ranking remains well above both OECD and non-OECD averages placing it in the club of a small number of highly regulated economies for investment.

[9] UNCTAD, 2010, "Report on G20 Trade and Investment Measures", at http://www.unctad.org//en/docs/wto_oecd_unctad2010d1_en.pdf.

5.0 Harnessing future growth through liberalisation

Considering Indonesia's economic experience during the Asian economic crisis it survived global financial crisis extremely well. Its resilience was built on a multitude of factors, but having a stable macroeconomic environment, despite fluctuations in international finance availability, helped Indonesia remain competitive in a region hungry for investment capital. But it must stay competitive if it wishes to build on its recent success and turn economic booms in China and across the ASEAN region into a domestic economic dividend to build industries and infrastructure, create jobs and continue lifting Indonesians out of poverty.

The OECD's investment policy framework provides a good guide for policy makers about the factors that matter in developing an attractive investment environment, including:

- A predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally.

- A stable macroeconomic environment, including access to engaging in international trade.

- Sufficient and accessible resources, including the presence of relevant infrastructure and human capital. [10]

The Indonesian government has already take strong steps on the first, but there remains challenges in all three areas including addressing customs service efficiency, opaque tax administration, labour market flexibility, poor infrastructure and uncompetitive investment laws and regulations.[11] .

One of the most immediate challenges that directly affects points two and three is under-developed infrastructure across the archipelago. Literature clearly shows a big risk to export industries because of challenges faced from infrastructure development resulting from poor roads and ports, as well as other essential utilities.

The lack of infrastructure affects two of the major sectors needed to continue Indonesia's economic growth – agriculture, manufacturing and mining. All currently make an important contribution to economic growth and will continue to do so during the current phase of Indonesia's economic development.[12]

The government is aware of this challenge and has committed itself to new investment amounting to 5 per cent of GDP over the next five years, with nearly 65 per cent of that sourced from the private sector through PPPs.

Financial sector regulation has already been reformed following the Asian economic crisis. Having a stable banking system has assisted in stabilising capital flows during the global financial crisis. However, regulations for financial sectors still have room for maturity, particularly to promote

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[10] Organisation for Economic Cooperation and Development, 2003, "Checklist for Foreign Direct Investment Incentive Policies", Paris, France, at http://www.oecd.org/dataoecd/45/21/2506900.pdf.
[11] United States State Department, 2010, "Background note: Indonesia", Washington DC, United States of America, at http://www.state.gov/r/pa/ei/bgn/2748.htm.
[12] World Trade Organisation, 2007, "Trade Policy Review: Report by the Secretariat: Indonesia", (Revision), Geneva, Switzerland.

domestic savings such as the pensions and insurance.[13] Having well-regulated financial markets will aid investment perceptions and build skills aiding the development of stable and reliable financial instruments that can then be utilised by both the government and private sector to raise financial capital.

The government is right to have identified that private capital will be vital for infrastructure development, but government ownership requirements for investment approval creates problems.

Indonesia is not alone in requiring government ownership in FDI.

But the greater the government required investment obligations, the greater the risk that government priorities will influence investment business decisions.

Coupled with local content and serving requirements, as well as uncertainty around the stability of licensing contracts, divesture requirements are particularly problematic requiring businesses to divest an ownership share for certain projects, such as mining, to government or the marketplace after set periods of time.[14]

Liberalizing investment ownership laws doesn't preclude the government securing their share of the dividend of exploiting Indonesia's scarce natural resources which can still be secured through well-designed licensing agreements.

Unfortunately at this stage the Indonesian government does not appear to be heading down this path.

Recent licensing requirements have shortened the timeframe and scope for them to be used as an instrument to secure Indonesia's national interest based on contracts.

Case study 1 | Newmont Nusa Tenggara

The recent challenges faced by mining giant Newmont surrounding its Newmont Nusa Tenggara gold and copper mining on Sumbawa Island are a perfect example of how the perception of investors being squeezed between national and local regulation is occurring.

By law ownership investment shares are required to be available for the domestic market. The national government has signalled its intent to purchase a 7 percent ownership share in the Newmont mining venture, despite protests of three local governments organized collaboratively who also wanted the investment opportunity placing the investment in doubt and with it Indonesia's reputation.

In response to the national government's action, the local administrations who want the stake for themselves are threatening to revoke mining licenses for Newmont.

Now the national House of Representatives has sided with the local authorities and has signalled it may sack the Finance Minister for taking up the share offer.

Such a scenario clearly creates problems with the individual company concerned. But the bigger issue is the impact politics could have on Indonesia's international investment reputation, and they are unlikely to be allayed so long as governments continue requiring ownership shares.

Source: Bisara, D., 2011, "Minister Facing the Ax, Jail over NNT deal: Lawmakers", The Jakarta Globe, Jakarta, Indonesia, at http://www.thejakartaglobe.com/business/minister-facing-the-ax-jail-over-nnt-deal-lawmakers/441770

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[13] Organisation for Economic Cooperation and Development, 2010, "OECD Economic Survey, Indonesia", v2010/18, November, Paris, France.

[14] Organisation for Economic Cooperation and Development, 2010, "OECD Investment Policy Reviews: Indonesia", Paris, France.

Furthermore, there are big risks specifically flowing from these issues as a result of Indonesia's spectacular democratisation process with local and national government investment laws and regulations contributing to perceptions of investment risk.

Local governments are now creating barriers to investment through the use of licensing regimes, taxes and other regulations that can duplicate, compete or replace previously withdrawn national obligations.

Without consistency local regulations are making the environment for investors less predictable; a situation exacerbated the further investments are away from Jakarta.

Earlier this month, Standard & Poor's released a report highlighting this point. The report looking into 2009 investment reforms concluded subsequent regulations provide "greater clarity" toward a negative impact on the mining sector because of the consequences of decentralized decision making which could hit bottom lines.[15]

[15] Standard and Poor's, 2011, "Indonesia's mining laws of 2009 and subsequent regulations: Unearthing the impact", Singapore, Singapore.

6.0 Conclusions

It is in the national interest of Indonesia to continue its investment liberalisation reforms.

Considering the uncertainty of the international economy and the emerging constraint to attract financial capital, investors are looking for locations to grow their capital - and that isn't where perceptions of sovereign risk remain.

One of the best ways to ensure Indonesia is competitive is to continue investment liberalisation.

With local governments becoming one of the major frustrations for investors, the necessity to remove politics from the investment environment is crucial.

It's clear that government ownership requirements are contributing and should be further liberalised, and where possible replaced by sophisticated contracts and licensing arrangements.

Choosing to focus government interests through contracts rather than ownership is also replicable irrespective of investment type and avoids fostering risk perceptions from the government involving itself where it has little expertise.

The development of such instruments is also vital for Indonesia to address another major barrier to future economic growth and attracting investment capital – underdeveloped infrastructure.

The benefits of doing so are also likely to flow throughout the entire economy.

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8.0 About the Institute of Public Affairs

The Institute of Public Affairs, founded in 1943, is the world's oldest free market think tank. The IPA is a not-for-profit research institute based in Melbourne, Australia with staff and associates based around Australia.

Think tanks act as public policy incubators and develop public policy solutions. The objective of the IPA is to promote evidence-based public policy solutions rooted in a liberal tradition of free markets and a free society. The IPA achieves these objectives by:

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- engaging with opinion leaders, stakeholders and public policy makers.

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- Energy
- Housing
- Industrial relations
- Taxation
- Investment

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Tim currently serves on the Department of Foreign Affairs and Trade's IP industry consultative group, is a Senior Fellow at New York's Center for Medicine in the Public Interest and is on the Steering Committee of the Sydney Opera House's Festival of Dangerous Ideas. He regularly appears on Australian and international television, radio and in print media and previously co-hosted ABC News 24 TV's Snapshot segment.

Tim's worked in international development across South East Asia, consulting and politics.

In 2009 The Australian newspaper recognised him as one of the ten emerging leaders of Australian society and is a recipient of an Australian Leadership Award from the Australian Davos Connection.

At University Tim was twice elected Student Union President as well as to the University's Board of Directors. He's currently completing a Graduate Diploma of Energy and the Environment (Climate Science and Global Warming) at Perth's Murdoch University.

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