Taking Stock

US–Indonesia Investment 2015

Paramadina Public Policy Institute
2015

Taking Stock

US-Indonesia Investment 2015

Principal Author

Bima Priya Santosa

Editor

A. Lin Neumann

Associate Editors

Paul Goddard, John Goyer, Mary Regina Silaban

Graphic Designer

Elsid Arendra

contents

preface

Paramadina Public Policy Institute (PPPI), the American Chamber of Commerce in Indonesia (AmCham) and the U.S. Chamber of Commerce are pleased to release our third annual study on foreign direct investment in Indonesia.

Our groundbreaking 2013 study, "Partners in Prosperity: US Investment in Indonesia," found that American companies invested roughly $65 billion in Indonesia during the years 2004-2012.[1] The figures suggest that US companies may be the largest source of FDI for Indonesia. More importantly, we found that these companies were poised to invest another $61 billion over the following five years, assuming the business climate was ripe for the kind of ongoing partnerships that can assist Indonesia to meet its goals of reducing poverty and building a modern economy.

The follow-up 2014 study, "Indonesia's New Path: Promoting Investment, Nurturing Prosperity," was launched just one month after President Joko Widodo took office.[2] There were high expectations for the new administration due to the president's personal popularity and his ambitious development goals, particularly on infrastructure, energy and social programs.

In early 2015, President Joko took the bold step of revoking the controversial fuel subsidy, thus showing his willingness to make hard fiscal choices to build infrastructure. However, progress toward achieving these development goals has slowed due to economic uncertainty fueled by external conditions, weaker domestic growth, the falling rupiah and domestic policy challenges. The World Bank (2015) has stated that for Indonesia to return to sustainable levels of higher economic growth, the success of the government's infrastructure drive is crucial, along with further improvement in the business environment to reignite private investor sentiment.

Our 2015 study, "Taking Stock: US-Indonesia Investment 2015," has two main aims. First, it reports on key developments over the past year in Indonesia's investment environment, placing them in the context of longer-term growth and against the backdrop of the ASEAN Economic Community, which is to

> "There were high expectations for the new administration **due to the president's personal popularity and his ambitious development goals**, particularly on infrastructure, energy and social programs."

1 "Partners in Prosperity: US Investment in Indonesia," AmCham Indonesia and the U.S. Chamber of Commerce with Paramadina Public Policy Institute, Gadjah Mada University, and Ernst & Young, 2013.

2 "Indonesia's New Path: Promoting Investment, Nurturing Prosperity." AmCham Indonesia and the U.S. Chamber of Commerce with Paramadina Public Policy Institute, 2014.

come formally into effect at the end of 2015. Based on these developments, and on policy changes over the period, PPPI has updated its take on Indonesia's investment environment.

Second, the report provides a more in-depth examination of selected issues in several industry sectors. It is intended for an audience of policymakers, business leaders and professionals engaged in the Indonesian economy.

This report is a product of PPPI with input from AmCham Indonesia. It is delivered under the guidance of Bima Priya Santosa, Managing Director; Totok A. Soefijanto, Research Director; Senior Researchers Muhamad Ikhsan; Junaidi; Hendriana Werdhaningsih; and Researcher Muhamad Rosyid Jazuli. AmCham Indonesia Managing Director A. Lin Neumann served as executive editor on the project. AmCham's Communications Director, Mary Silaban, facilitated much of the research.

PPPI would like to express its thanks to the companies who support the US-Indonesia Investment Initiative. We have received valuable input from Ricky Pesik, Joshua Simanjuntak and AR Roy Berawi from the Creative Economy Agency, Shinta Witoyo Dhanuwardoyo of bubu.com and Sheila Timothy from the Film Producers Association of Indonesia.

PPPI also would like to express its appreciation to Oke Nuwan (Ministry of Trade), Natalia Ratna Kentjana, Buchara, Krisnawati, Rizky Wilfrida, Iwan Suryana (Indonesia Investment Coordinating Board), Adi Pasaribu and Herbert Siagian (Ministry of Home Affairs), Andang Bachtiar (National Exploration Committee), Syamsu Saliend (Ministry of Energy and Mineral Resources), Hanif Arkanie and Adityawarman (Directorate General of Taxation, Ministry of Finance), Gunawan Wicaksono (Bank Indonesia), Kukuh (Directorate General of Customs, Ministry of Finance), Kinarsashanti P (National Agency for Drug and Food Control), Sarno (Fiscal Policy Office, Ministry of Finance), Zafrullah Budiman, Herry Trisaputra Zuna, M Natsir, Suwanto, Muhammad Nizar (Ministry of Public Works), Niken Wikanti and Yolianda (Ministry of Agriculture), Arie Juliano Gemma (Creative Economy Agency), Ardiansyah Solaiman and Sendi Sugiharto (Film Producers Association of Indonesia).

The report is divided into four sections. We begin with an introductory narrative; Section I focuses on investment policy and the investment outlook; Section II examines the business environment and policies that have an impact across sectors; Section III looks at sector-specific issues and challenges; and Section IV examines the overall policy framework for investment and proposes a "bird's nest" approach that could help create a more open and effective investment environment.

For more information about PPPI please visit **www.policy.paramadina.ac.id.**

Photo: David Gita Rosa/ID

UNLOCKING THE DOOR

Executive Summary

Indonesia is frequently seen as the country of what will be. It has enormous – and still largely untapped – potential with a huge and growing domestic market, a youthful workforce and an abundance of natural resources that make it appear to investors as one of the last great places for global expansion. Virtually every major American corporate brand name has sought a presence in Indonesia in recent years. From consumer goods producers to fast-food outlets, entertainment giants to technology and e-commerce players, many big international companies see being in Indonesia as a strategic necessity. Less visibly, venture capital firms and financial service providers find Indonesia a lucrative destination where the future seems almost limitless.

As American companies seek expansion and new horizons in Indonesia, they join forces with established US energy and mining companies that have built vast industries here employing tens of thousands of Indonesians over several decades. In the process, they have provided a large chunk of government revenues. For all these companies, big and small, newcomers or veterans, Indonesia is a partner in their business future just as they are partners in Indonesia's growth and development. It is with that in mind that we engage with the government of Indonesia to promote a more vibrant investment climate and greater communication between US businesses, government policymakers and the people of Indonesia.

We are on a mutual search with Indonesian policymakers and the private sector to find the right combination of policies and incentives that will allow investors to feel confident and welcome and will provide the government with the employment, revenues and growth it needs to succeed long into the future. This report, along with our other advocacy and engagement efforts, is our way of trying to unlock the door to progress.

A joint AmCham Indonesia-U.S. Chamber of Commerce study in 2013 concluded that American companies had invested $65 billion in Indonesia over the previous eight years, making the US likely the country's largest source of foreign direct investment during a period of intensive growth. The same survey found that $61 billion was poised to come into the country given a conducive investment climate. Much of that investment – like Indonesia's own vast potential – remains in limbo, waiting for the time to be right.

As friends and partners in Indonesia's progress, we share the concerns expressed by senior government officials about overly complex regulations that can stunt economic growth and blunt Indonesia's competitive edge in the race to attract the kind of investment that will make the difference between ho-hum growth and true dynamism. Frankly, the more the government tries to tell investors how to run and manage their businesses (e.g. ownership levels, restrictive manpower rules, curbs on finances, etc.) the less attractive the investment market will be, especially if there are other "easier" alternatives within Southeast Asia that would still give companies access to the ASEAN Economic Community (AEC).

As we go to print, we are encouraged by the deregulation and stimulus packages recently unveiled by the government. There have been four packages of revised rules and regulations so far with many more to come including changes to the Negative Investment List (DNI). This is all welcome. It is time, frankly, for bold steps to unlock the doors to renewed progress in the Indonesian economy.

Three Steps

The president has asked for input on the deregulation packages from investors. We urge three steps that would grab the attention of business:

1. **Eliminate the Negative Investment List.** This policy sends all the wrong signals by emphasizing limits rather than growth and control rather than opportunity. Sensitive areas related to national security, for example, could be dealt with through a separate mechanism while the overriding message should be: let investors own their own businesses, set their own strategies and conduct business using their own proprietary methods that have proven successful in other markets.
2. **Eliminate currency controls.** Cumbersome restrictions introduced to the banking system recently are costly for investors and accomplish little other than to give jurisdictions outside Indonesia an edge in attracting investment.
3. **Stop restricting expatriate employment.** Hiring expatriates is costly but sometimes necessary and companies should be allowed to make their own staffing decisions. Having crucial executive and expert positions rejected by regulators is a burden to operations that costs Indonesia in terms of growth and productivity.

Today's Picture

Indonesia, of course, has achieved considerable progress in recent years. It has built a vibrant democracy and settled once-perilous questions of national unity and stability. Economic growth has been impressive and consistent if not spectacular at above 5 percent for more than a decade. Gross domestic product has nearly reached $1 trillion. At present, however, growth is projected to come in below 5 percent for 2015 due to a combination of internal and external factors including softer consumer spending and a slowdown in investment.

The administration of President Joko Widodo and Vice-President Jusuf Kalla, which is marking its first year in office, has highlighted infrastructure, food security, energy and electricity, industrial development, and science and technology as its main priorities. These are potential areas where the Indonesian government and US-based companies can collaborate in order to reach the administration's target of 8 percent economic growth by 2019.

Investment remains crucial for a growing economy such as Indonesia. Global trends show that foreign direct investment (FDI) has declined over the last two years, but Asia has maintained its position as the number one destination. Elsewhere in the ASEAN region, some countries are posting impressive growth by aggressively courting capital investment. Tough times for the rupiah and slower growth pose additional challenges for Indonesia in competing with other countries to tap potential FDI.

As in our 2014 report, regulatory uncertainty remains the most challenging issue faced by companies in Indonesia. A World Competitiveness Center report stated that business legislation is one of the lowest competitiveness factors for Indonesia. In the latest AmCham Singapore regional survey on ASEAN business Myanmar took over from Indonesia as the most attractive country for new business expansion in the region. This is an early warning sign for the Indonesian government to improve its investment climate.

Companies have been concerned for some time about the more inward-looking perspective on investment policy that has taken hold here in recent years. It is good to see that the president has taken on this issue with his deregulation packages. On the one hand, Indonesia is active in the G20, APEC and ASEAN, while on the other the regulatory trend has been restrictive. This has sent mixed signals to the market.

Access and Communication

Overall, our companies appreciate government efforts to streamline business licensing and permits through one-stop services. We are hopeful that the concentration on infrastructure will prove, over time, to be a major boost for the economy. There is a great need for improvement in the education system.

In addition, companies appreciate that this is a government that wants to engage. We have access to key policymakers and there is a willingness to have sometimes difficult conversations.

As it looks now, despite the government's commitment to enhancing the business and investment climate, the system itself is fragmented and uncoordinated with ministries often acting out of sync with one another. A primary challenge is to enhance investment-focused coordination. In Section IV of this report we propose a "bird's nest" approach to gradually enhancing effectiveness and coherence between regulators and stakeholders. The intricate make-up of a bird's nest is messy, but logically fathomable.

For this report, we conducted a qualitative study over several months, with information derived from interviews, secondary data and documents. These form the basis for specific assessments and recommendations in Sections 2 and 3. The key informants were top executives including CEOs of US corporations across diverse sectors. PPPI researchers interviewed the executives to gain their insights into the investment climate in Indonesia. Data was used to verify the conclusions.

"It is the journey that matters, not the destination," so the saying goes. This is an apt description of this study. Indonesia's investment climate can be improved through good policies and fewer and more effective regulations. But the human actors in the government and bureaucracy will determine the results. We hope this study also delivers an important message about maintaining a positive atmosphere and a friendly environment. Hopefully, good policies and good people will come together to produce a good economy.

SECTION

01

INVESTMENT POLICIES AND TRENDS

INDONESIA HAS SEEN SUSTAINED ECONOMIC growth of around 5-6 percent for more than ten years with the result that tens of millions of people have been lifted out of poverty. Until recently, this growth gave rise to expectations that Indonesia's upward trajectory was nearly inevitable, with policymakers frequently citing predictions that the country would surpass Germany to become the 7th largest economy in the world by 2030. In addition, Gross Domestic Product (GDP) was expected to reach US$1 trillion by 2014, a target that was missed due to a downturn in the global economy, falling commodity prices and the rupiah's depreciation against the US dollar. In relatively tough times, Indonesia's GDP growth fell to below 5 percent in the first two quarters of 2015 and it is expected by most estimates to remain below 5 percent for the year as consumer spending, the nation's growth engine, has slowed along with the rupiah's problems and shrinking commodity demand. As a result, President Joko Widodo's target of 8 percent economic growth by 2019 will depend largely on the success of the government's spending on infrastructure and improvements in the business environment to attract private investment. Proactive policies to realize Indonesia's economic potential are needed.

It is encouraging that the government has begun a series of deregulation packages – four as of this writing – that are attempting to untangle the thicket of often-contradictory and burdensome regulations and policies that investors say hamper their ability to do business. One cabinet minister recently told AmCham that the president is "enraged" by unnecessary and destructive regulations and that he is determined to change the situation despite the resistance found in the bureaucracy. In calling for massive deregulation during an AmCham event in October, Wijayanto Samirin, an economic advisor in the office of Vice President Jusuf Kalla, said, "If prosperity was measured by the number of regulations, then Indonesia would be rich. We have too many and have to eliminate 5,700 at the national level."

Priorities

The government's economic policy efforts for 2016 will focus on[1]:

1. **Food security.** One challenge is to improve the dataset on production and productivity and to better identify farmers and their needs. Agriculture is an emotional issue and policymaking has at times been distorted by faulty data. In our 2014 Investment Initiative report, we raised the issue of needing reliable data to make fact-based decisions on agricultural policy.
2. **Energy security.** Oil production has been declining for decades, while consumption is steadily increasing. This should create urgency among key stakeholders to tackle the challenge of declining oil prices. This is an area again, where regulatory uncertainty and frankly nationalist priorities have combined with lower prices to dampen the enthusiasm of investors.
3. **Maritime.** This sector was largely forgotten for decades, until President Joko made turning Indonesia into a "maritime axis" a priority. In this sector, which includes fisheries, ports and offshore energy development, the government seeks a balance between economic interests and environmental issues.

1 http://www.bappenas.go.id/index.php?cID=5009?&kid=1441600501

4. **Industry**. The domestic processing industry grew 4.6 percent in 2014, and for 2015 the most significant sub-sector for growth is food and beverages, followed by tobacco processing. One challenge is the ASEAN Economic Community (AEC), which will come into force at the end of 2015, and should considerably open markets over time to greater regional competition.
5. **Tourism**. In 2014, Indonesia hosted 9.4 million tourists, a figure concentrated in Bali and that is painfully low. Thailand, for example, with a population that is just over a quarter that of Indonesia, had 24.7 million tourist arrivals in 2014. The biggest challenge is to improve tourism infrastructure from accommodations to transport.
6. **Science and technology.** This sector's contribution to the economy remains limited, and the challenge is to leverage science and technology to increase national productivity to improve competitiveness. Investors are keen to increase their involvement in the IT sector, for example, but Indonesia suffers from a lack of clear incentives, broad-stroke imperatives on local content and the fact that neighboring countries have historically paid far more attention to developing tech capacity than has Indonesia.

The government, industry and other key stakeholders will need to cooperate creatively to achieve national growth targets and get the regulatory formulas right in these areas if growth targets are going to be met.

Table 1

FDI to selected regional and interregional groups of which Indonesia is a member

REGIONAL	2013		2014	
Interregional groups	FDI inflows	Share in world (%)	FDI inflows	Share in world (%)
	(billion of dollars)		(billion of dollars)	
APEC	837	57	652	53
G20	894	61	635	52
RCEP[1]	349	24	363	30
ASEAN	126	9	133	11

Source: UNCTAD, World Investment Report 2015.
For 2014 FDI, East and Southeast Asia received approximately $381 billion, a 9.6 percent increase from 2013, accounting for around 31 percent of the global share. The top 5 host economies in 2014 receiving FDI were: China at $128.5 billion. Hong Kong at $103.3 billion, Singapore ($67.5 billion), Indonesia ($22.6 billion), and Thailand (US$12.6 billion).

"The report shows that **investment policy trends continue to be geared predominantly** towards investment liberalization, promotion, and facilitation."

Table 2

Selected Receiving Economies for FDI

	Rank	FDI	FDI	Percentage Change
		2013	2014	
China	2	124	129	4%
Hongkong, China	3	74	103	39%
USA	1	231	92	-60%
Singapore	6	65	68	5%
India	15	28	34	21%
Indonesia	19	19	23	21%

Source: UNCTAD, World Investment Report 2015.

SECTION

01

INVESTMENT POLICIES AND TRENDS

FDI Trends

The World Investment Report 2015 found that global FDI fell by 16 percent in 2014 to $1.23 trillion, down from $1.43 trillion in 2013.[2] This decrease was influenced by several factors including the fragility of the global economy, policy uncertainties for investors and geopolitical risks. However, the report forecast an upturn in FDI to $1.4 trillion in 2015 and beyond ($1.5 trillion in 2016 and $1.7 trillion in 2017) due to US economic growth, the demand-stimulating effects of lower oil prices and accompanying monetary policy, and continued investment liberalization and promotion measures. Indonesia could benefit from an uptick in FDI if the policy environment is poised to attract investors.

Developing Asia was the number one destination for FDI from 2012-2014 (see tables 1 and 2), on average receiving $430 billion annually. The same period saw an average $338 billion in FDI for Europe, $174 billion for Latin America and the Caribbean and $218 billion for North America. Another trend highlighted in the World Investment Report is the impact of regional integration on FDI. Regional integration in Asia, for example through ASEAN, has had a significant impact on FDI.

The last ten years have seen a shift in FDI toward the service industry in response to increasing liberalization in the service sectors (trade, financial and insurance, electricity, gas, water, and waste management), the increasing tradability of services and the growth of global value chains in which services play an important role. In 2012, services accounted for 63 per cent of global FDI stock, more than twice the share of the manufacturing sector (textiles, chemicals, automotive). The primary sectors (mining, quarrying and petroleum) represented less than 10 per cent of the total. With Indonesia still heavily reliant on commodities and traditional sectors, the FDI trends should impact government efforts to attract FDI in services such as insurance and finance, which have enormous potential for growth in the country.

The World Investment Report also shows that investment policy trends continue to be geared predominantly toward investment liberalization,

2 United Nations Conference on Trade and Development (UNCTAD), World Investmeent Report 2015. http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

FDI Reporting in Indonesia: Accuracy Needed

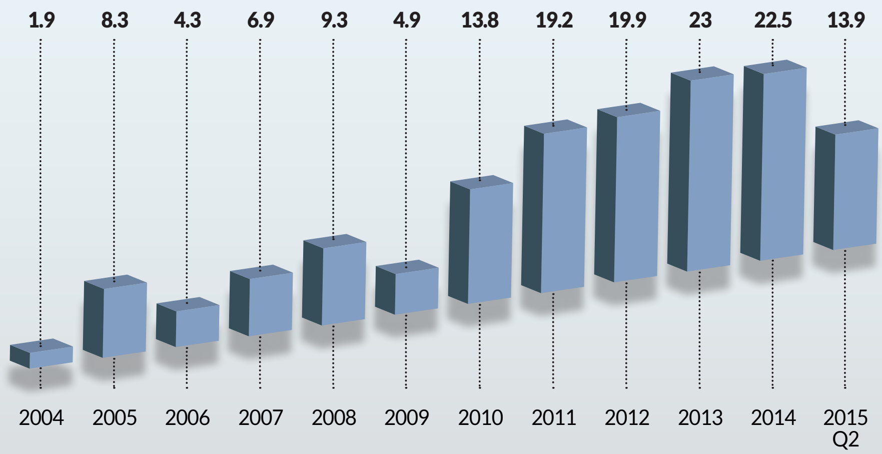
OVER THE LAST THREE YEARS OF working on the Investment Reports with AmCham and the U.S. Chamber, PPPI has raised concerns over the importance of quality data in order to make sound evidence-based policy choices. Policy for sectors such as oil and gas, mining, banking, non-bank financial institutions, insurance and leasing among many others are issued by different government bodies using different criteria. This can create confusion.

In terms of FDI, BKPM covers sectors based on business licenses, Bank Indonesia on the other hand records international capital flows as part of balance of payments statistics covering all sectors. The agencies in other words may see the investment picture through the lens of their own mandates and interests. It is all the more vital, therefore, that reporting on FDI inflows, be done using consistent criteria across agencies.

Another significant issue is identifying the countries of origin for inward investment. There is a tendency for some investors to invest in Indonesia through an affiliate located outside of the home country, which can distort the actual source of the investment. This data reliability issue has a potential impact on investment policy. Our findings align with a 2010 OECD report on Indonesia's two main sources for FDI statistics: BKPM and BI. On average, BKPM figures for FDI exceeded those from BI by 236 percent for 1990-2009. In order to provide reliable data for better policy making, the government needs to synchronize the country of origin and overall figures for FDI.

Table 3

FDI in Indonesia



Source: UNCTAD (2004-2012), BKPM (2013-2015 Q2)

promotion and facilitation. The focus has been on sector-specific liberalization (e.g., in infrastructure and services). Restrictions – such Indonesia's Negative Investment List – were related mostly to national security concerns and strategic industries (such as transport, energy and defense) globally. Indonesia's broader restrictions seem out of step with global trends.

Looking ahead, it is likely to be more challenging for Indonesia to tap global FDI. Given Indonesia's current stage of economic development, relying on boosting consumption, government spending and exports to promote GDP growth is becoming more difficult. To achieve its economic growth targets, stimulating the economy with more investment, both domestic and foreign, is the most reliable option, if not the only option. This imperative should inform the government's current efforts to eliminate regulations that impede investment, revise the Negative Investment List and offer easily understood incentives to investors. In a competitive regional climate, Indonesia has the market and the demographics to attract FDI but it has so far lacked the regulatory attitude and infrastructure to win the overall battle. This is the big challenge for the government.

Investment Trends

Our previous study "Partners in Prosperity: US Investment in Indonesia" concluded that FDI brings significant benefits both for corporations and investment-destination countries. FDI promotes job creation, technology transfers and increasing tax revenue. In addition, FDI provides access to global markets, capital and talent.

Recent developments have made the role of FDI in Indonesia even more strategic. The significant economic boom from 2004 to 2010 was in line with FDI in Indonesia. Table 3 illustrates FDI in Indonesia, with data from UNCTAD and BKPM from 2004 to the second quarter of 2015, in billions of US dollars.

The decrease in global commodity prices plus various other factors turned Indonesia's trade surplus into a deficit of $1.2 billion in 2012 and $6.1 billion in 2013[3]. The rupiah has also lost 40 percent of its value during the last three years, the budget deficit has widened and the balance of payments has worsened. The economy is not in a great shape. Table 3 shows the decline of FDI to Indonesia in 2015 compared to 2011. With the global FDI trend also declining, it is becoming more urgent for the Indonesian government to improve its business environment in order to attract FDI.

3 Central Statistics Bureau (BPS), 2014.

SECTION

02

BUSINESS ENVIRONMENT

AN OPEN AND COOPERATIVE SPIRIT AMONG government and investors is a necessary prerequisite to creating the kind of business climate that will best enable Indonesia to meet its goals for growth and prosperity. Ultimately, the recommendations we make and the challenges we cite in this report are offered in the spirit of partnership for a better future. We have been strongly encouraged, as we have already noted, by the level of engagement we have with the government and we look forward to finding solutions to issues in ways that will benefit the Indonesian people.

Our 2014 report, "Indonesia's New Path: Promoting Investment, Nurturing Prosperity," raised three primary challenges for doing business in Indonesia: regulatory uncertainty, human capital and infrastructure.

In 2015, the companies interviewed for this report were asked to name the biggest challenges they face doing business in Indonesia. The most challenging issue again was regulatory uncertainty (84 percent), followed by human capital and infrastructure, each named by more than 50 percent of respondents.

Our findings also are in line with the 2015 World Competitiveness Center (WCC) report, which ranked Indonesia as the 42nd of 61 countries surveyed, down from a ranking of 37th in 2014 and the lowest ranking among ASEAN countries surveyed.[4] The United States, Hong Kong and Singapore occupied the top three places, respectively. The WCC report cited numerous issues facing Indonesia:

- Build better political and policy coordination among government agencies;
- Speed up a large number of physical infrastructure projects and find adequate financial resources to carry them out;
- Business legislation needs to be dramatically improved.

The WCC noted that high "business efficiency" is the common factor among countries that do well in the rankings. Business efficiency is the extent to which the national environment encourages enterprises to perform in an innovative, profitable and responsible manner, the WCC said in a release. "Simply put, business efficiency requires greater productivity and the competitiveness of countries is greatly linked to the ability of enterprises to remain profitable over time," said Arturo Bris, the head of the WCC. "Increasing productivity remains a fundamental challenge for all countries."

This WCC report mirrors some of the key findings of the World Bank's annual Ease of Doing Business Index for 2015, which ranks Indonesia 114th out of 185 countries surveyed. Indonesia's

4 http://www.imd.org/uupload/imd.website/wcc/scoreboard.pdf

Graphic: environment-rrsteelfabricator.com ranking is far below neighboring countries Singapore (1), Malaysia (18), Thailand (26) and Vietnam (78). The report finds Indonesia falling below regional averages for such things as the time to secure business permits and costs associated with doing business.

The annual ASEAN Business Outlook Survey 2016, which is prepared by AmCham Singapore and surveys the attitudes of AmCham members throughout the region,[5] indicates that ASEAN markets have become more important for 53 percent of the respondents' worldwide revenues. However, the survey also reveals that for the last two years this revenue has decreased along with the slowdown in regional economies. As a result, respondents reported slightly less bullish numbers than in previous years. A rise in the middle/consumer class and limited growth opportunities in other regions are the top two reasons why ASEAN markets are seen to be of growing importance for companies.

The ASEAN Survey listed Myanmar as the most attractive country for new business expansion in the region, followed by Indonesia, Vietnam, and Thailand; in 2014, Indonesia was ranked first as an expansion destination.

In the first months of President Joko Widodo's government, the most visible effort to ease business conditions was the Indonesian Investment Coordinating Board (BKPM) move to accelerate processing licenses for investors through the establishment of its one-stop services (OSS) center, which centralized applications for dozens of permits and licenses in its office in Jakarta.[6] After a somewhat rocky start in January, the OSS operation has gradually expanded its scope and made Indonesia's licensing regime significantly easier. The companies interviewed for our report said they appreciate the government's OSS effort. Ministries and agencies are coordinating under BKPM to streamline business licensing procedures and to optimize the use of technology to minimize person-to-person meetings.

Deregulation Package

Battered by growth falling below 5 percent for 2015 and facing declining investor sentiment, the president overhauled the cabinet in August to put in place more experienced policymakers with instructions to get things back on track after months of sometimes contradictory policies and complaints from both the local and foreign private sector. In September, the government began issuing a series of deregulation packages aimed at stimulating the economy. "Believe me, we are serious about this and it will get better over time," a very senior official told us while we were preparing this report. "The government has done massive structural reform and massive deregulation," cabinet secretary Pramono Anung, one of the August appointees, enthused.

As of mid-October, the package, which is to include at least 154 regulations that hinder the investment climate, had included lowering diesel fuel prices, adjusting some import procedures, new

5 http://www.amcham.org.sg/public-affairs/publications/asean-business-outlook-survey-2016/

6 http://www.bkpm.go.id/contents/general/16/one-stop-shop#.VhWuRG42zuA

Table 4

Ease of Doing Business

Country	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Singapore	1	1	1	1	1	1	1	1	1	1
Malaysia	17	20	23	21	23	21	18	12	6	18
Vietnam	75	92	87	91	93	78	98	99	99	78
China	89	88	90	86	89	79	91	91	96	90
Philippines	113	129	135	141	144	148	136	138	108	95
Indonesia	**114**	**131**	**127**	**129**	**122**	**121**	**129**	**128**	**120**	**114**
Pakistan	61	69	74	85	85	83	105	107	110	128
India	116	124	120	132	133	134	132	132	134	142

Source: The World Bank Group (2015).

SECTION

02

BUSINESS ENVIRONMENT

tax incentives and promises to streamline business licensing further. The package also has taken steps to simplify minimum wage formulas and to unwind some restrictions on expatriate workers. The package has been met with enthusiasm by most business leaders. The stimulus plan – and central bank intervention – was credited with helping to strengthen the rupiah in mid-October but it remains to be seen if the country has turned a corner in terms of long-term sentiment.

But despite the government's efforts, Indonesia still faces major challenges to leverage its competitiveness in the region. After several years of inward-looking policies that have sapped investor enthusiasm, the conclusion of the Trans-Pacific Partnership (TPP) trade talks in October came as another wake-up call. Investors note repeatedly that Indonesia must compete for serious long-term investment with Vietnam, among others. Growth in the third quarter of 2015 for Vietnam – a TPP member country – was 6.8 percent and most experts say that after years of investor-friendly policies, Vietnam's manufacturing sector is poised to be one of the big winners from TPP. Indonesia, on the other hand expressed almost no interest in TPP until just recently, with officials only this year saying they may want to join the pact later if the opportunity arises.

The difficulties became clear to us in a recent discussion with a large American investor in Indonesia. The company had recently surveyed the terrain seeking to move a major manufacturing facility to one of several countries in Southeast Asia. An executive of the firm said he had talked to the headquarters team making the decision about considering Indonesia and was told the country was not even on the list. "It's too much trouble and too complicated," the executive was told. And the factory? It moved to Vietnam.

We are not unsympathetic to the complexities of Indonesia's democratic environment, which is also one of the country's great strengths. Promoting sound business policies requires support from a broad range of central government and regional government agencies, and coordination is a challenging issue in a democratic and decentralized context. Based on our interviews, companies appreciate the current administration's ease of access to policy makers, and the willingness of policy makers to engage in difficult conversations with the business community. To move forward, we believe, a deeper partnership with business is needed for the country to reach its goals.

Photo: Moh. Defrizal/GA

Business Climate Issues

Challenge 1: Inward Looking Tendencies

Effective and open policies relating to trade in goods and services can support more and better quality investment and help facilitate Indonesia's greater integration into the global economy and boost productivity. While the government has reduced some constraints on trade and streamlined border procedures, companies still note difficulties with permitting for imports and an overall climate – which may be changing – that seemingly views limiting imports as a policy goal. Indonesia has been sending mixed signals to investors: on the one hand, it is an active member of the G20, APEC, and ASEAN; on the other hand, there has been a trend toward trade restrictions and quotas in certain sectors over several years.

Patunru and Rahardja (2015) finds that tariffs have decreased, while non-tariff measures have increased. This could drive up prices for consumers at a time when their purchasing power is declining, and may also undermine the competitiveness and productivity of Indonesian firms.

One example of inward-looking polices is Law 13/2010 on Horticulture, which states that the export of horticultural products is allowed only after fulfilling domestic needs (article 87). Article 88 states that the import of horticulture products requires a permit from the Ministry of Trade (MoT) under recommendation from the Ministry of Agriculture (MoA).[7] Companies say these restrictions impede some investment plans that are reliant on imports of horticultural products.

Under a general climate of inward-looking sentiment, actions that can impede investment may not always come from legislation. One example is the decision of the Constitutional Court to revoke the 2004 Water Law earlier this year on the grounds that private companies should not be allowed to profit from such a natural resource. The court case was pushed by Muhammadiyah, the nation's second largest Muslim organization, as part of what its leadership calls a "constitutional jihad" against the legal infrastructure of the market economy as a way of combatting globalization and market liberalism.

After the ruling, water management reverted to a decades-old law in the interim while the government drafted new regulations that will allow business to continue to use water for industry. In the meantime, numerous investors face legal threats and uncertainty.

7 As of Sept. 5, 2015 there is a MoA regulation draft that requires foreign entities with ownership in the horticulture sector to sell a portion of their ownership stake to a domestic entity. The maximum foreign ownership is to be limited to 30 percent. This type of policy can send mixed signals to investors while the government is trying to attract FDI.

Issues raised by companies with respect to the investment climate

Figure 1

Other regulations restrict exports in favor of "downstreaming," a general policy direction intended to increase domestic value added by supporting an economic sector whose output is used heavily by another sector domestically, or which uses significant input from another domestic sector.[8]

In addition to laws, court actions and non-tariff barriers such as beef import quotas that have been periodically used supposedly to boost domestic production incentives, the Negative Investment List (DNI), which is issued by Presidential Decree, also sends contradictory messages. The most recent list reduced some foreign investment restrictions, allowing as much as 51 per cent foreign investment in advertising (previously 0 per cent) and 85 per cent in pharmaceutical manufacturing (previously 75 per cent). But at the same time, the list increased foreign ownership restrictions in other areas, such as distribution of products (previously no restrictions, now 33 per cent) in an attempt to protect local companies. The net impact of the DNI for some investors is to walk away from Indonesia in search of friendlier jurisdictions.

It has recently been quietly announced that the DNI will be reviewed for changes by the government, the first such review by the Joko administration. Investors would welcome significant liberalization as a way to attract more investment into the country.

Some regulations also derail investments for non-economic reasons. Earlier this year, the then minister of trade banned the sale of beer in minimarkets nationwide as a way to curb underage drinking, drying up 60 percent of retail outlets. Earlier, beer companies had been encouraged by the industry ministry to increase production and they were taken by surprise by a move that severely limited sales and sharply cut revenues. There are laws already on the books against underage drinking that had likely not been heavily enforced in some jurisdictions.

Impact

The increasing tendency to be more inward looking is likely to prove counterproductive for the Indonesian economy by limiting investment, dampening business enthusiasm and leading to the wasteful allocation of resources. Non-tariff barriers, quotas and other restrictions that attempt to guide the market and favor one group over another have in the past led to cronyism, corruption and bad investment decisions in Indonesia. The country has prospered during periods of openness.

8 Patunru and Rahardja (2015)

Recommendations

Rather than pursuing protectionist policies, the Indonesian government needs to adopt the goal of having a well-regulated market economy in which the private sector can make business decisions with relatively little interference. The basic ingredients of sound public policy should focus on infrastructure, educational improvement, lowering logistics costs and the consistency of rules and regulations. The government needs to continue to relax restrictions on foreign investment if it wants the benefits of globalization to flow into the country. We are encouraged that the Joko administration appears to be endorsing a policy shift in this direction.

Challenge 2: Lack of Regulatory Consultation

Our results show that there are two major shortfalls in Indonesia's public policy: first a lack of policy applicability; and second, abrupt changes in policy. Law 10/2004 on the Formulation of Regulations, article 53, states that the community is entitled to provide oral or written input into draft laws and regulations. Law 12/2010, which amended Law 10/2004, goes further by expanding the community's right to provide input into draft laws. Policies that cannot practically be implemented or which abruptly change existing rules can be counter-productive to the investment climate.

One example that highlights the lack of consultation is BI Regulation 17/3/PBI/2015 regarding Mandatory Use of the Rupiah within the Republic of Indonesia. The regulation, which came into effect on March 31, 2015 for cash transactions and on July 1, 2015 for non-cash transactions, comes some six years after Law 7/2011 on Currency was enacted. The regulation contains strict penalties and administrative sanctions for non-compliance. Breaches of the obligation to use rupiah and to accept rupiah in payment are punishable with imprisonment of up to one year and a fine of not more than Rp200 million. Failure to use rupiah in non-cash transactions can result in fines of up to Rp1 billion and a ban on participating in the forex payment system.

For companies who already have a commitment to settle payments in foreign currency as stated in a contract, or insurance that is written to cover foreign currency exposure, it is not an easy task to comply with the regulation. Companies also have to invest in updating internal systems to adjust to the regulation. Much time and effort has been spent to comply with the regulation. At the end of the deadline, for certain sectors, the government postponed the regulation and said it would work out case-by-case exceptions, but it was unclear how the process would work and companies were left with numerous unsettling questions. There was no broad opposition to the general principle of using rupiah but the details were vexing. Had the government consulted with key stakeholders while the law and regulations were being drafted, the regulation could have been amended to allow necessary exceptions such as invoicing in dollar equivalents on the date of settlement. Consultation is a way to avoid inapplicable and conflicting policies that may disrupt economic activity.

Impact

Frequent and unexpected changes in regulations create unnecessary uncertainty, which negatively impacts the investment climate in Indonesia.

Recommendation

The government should consult systematically with both local and foreign businesses through business associations or sectorial groupings. Consultation already is supposed to be a required step in designing new policy or reviewing and amending existing policies. There also needs to be cooperation between government and business to create or enhance think-tanks that can be used to evaluate policies and identify potential problem areas before regulations are issued.

Challenge 3: Manpower Regulations

The release in July of Ministry of Manpower Regulation 16/2015, which went into effect the day it was issued with no prior consultation with foreign investors, had an unsettling and confusing impact on the business community. It also came after a long series of unspoken measures that were tightening the ability of foreign companies to hire expatriates.

Under Regulation 16 on Procedures to Employ Expatriates, the following provisions apply:

1. The ratio of expatriates to local employees was increased to 1:10, meaning a company must employ ten Indonesians for every expatriate. In the past, the practice had some flexibility, usually 1:3 or 1:5. The new ratio is expected to have a major impact on the establishment of representative offices in Indonesia, which are usually small companies or smaller operations that plan to increase as investment increases.
2. Temporary Work Permits are now required for any short-term job performed in Indonesia by company employees including providing guidance, counseling, training or conducting audits and attending meetings. In the past these routine functions were covered under an easily obtained business visa.
3. Work permits are also now required for non-resident company directors. The regulation also calls for non-resident directors to hold stay permits (KITAS), which are issued by the Immigration Department under the Ministry of Law and Human Rights not Manpower. It is unclear if this portion of the regulation will be enforced.

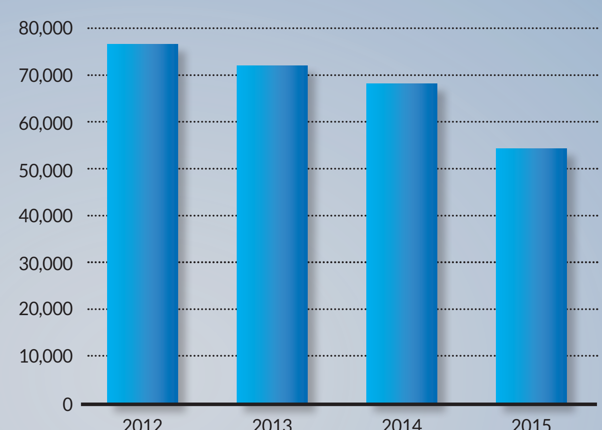
Regulation 16 added to a general feeling among both Indonesian and foreign companies that Manpower regulations and actions are designed to prevent foreigners from working in Indonesia. This is despite many studies that show that expatriates have a significant multiplier effect on economies. Indonesian Trade Minister Tom Lembong was quoted by Bloomberg as saying, the restrictions on foreigner permits and local worker quotas is "a big problem" being created by bureaucrats. "For every one expat worker who comes in, that person creates between three and 12 jobs," Lembong said in an interview with Bloomberg. "You have to understand this is not coming from the president."

Anecdotally, companies report long delays in issuing normal work permits and many rejections of workers, including executives, needed to direct Indonesian operations. The result has been a drain on productivity and negative sentiment among investors who worry that they may not be allowed to make their own staffing decisions in Indonesia. They note that expatriates are expensive and that companies generally want to hire local employees when they can find qualified personnel. The number of foreigners working in Indonesia in recent years also has been steadily declining, as can be seen from the following chart:

Table 5

Too Many Expats?

Indonesia has made it harder to employ foreign workers, whose numbers have been dropping each year since 2012.



Source: Ministry of Manpower; 2015 figures as of August.

Impact

The immediate impact of Regulation 16 was confusion. The procedures for getting Temporary Work Permits were unclear and many companies simply stopped inbound travel to Indonesia. In a global economy, Indonesia is competing with its ASEAN neighbors and others for business. Regulation 16 appears to be discouraging businesses from meetings, audit sessions or training programs in Indonesia. Neighboring countries that don't require short-term work permits will benefit.

Recommendation

As we were going to print, it appeared that the more onerous provisions of Regulation 16 were being withdrawn. We hope this proves to be the case. Indonesia should clarify forcefully that the country is open both to foreign investment and necessary foreign workers, especially executives and experts, and streamline procedures to obtain working visas to be in line with other countries in ASEAN. It is destructive to the business climate for foreign experts and executives to feel unwelcome.

> "Indonesia, Malaysia, Thailand and the Philippines are competing with each other to offer **the most attractive investment** destination for FDI."

Challenge 4: Competitive Tax Incentives

The new administration took a bold step in January 2015 by revoking the fuel subsidy and thus creating fiscal space to finance priority programs in infrastructure and education. The business community widely applauded the move.

The government has also leveraged fiscal policy to attract FDI inflow by offering targeted fiscal incentives such as tax holidays and specific subsidies. It is unclear how many investors have taken advantage of these incentives.

Taxation and incentive policies in Singapore and Malaysia are intended to create an investment friendly regulatory environment. Singapore's traditional goals of tax reform, for example, have been used to help build a dynamic and successful economy by: attracting foreign investment; reducing business costs; gaining national and international competitive advantages; and providing adequate impetus to the local and foreign workforce to continue working there (Asher, 1987).

Almost all economies in the region extend tax incentives to investors. They offer such incentives as tax holidays, income tax exemptions or reduced tax rates, investment allowances and customs duty exemptions for equipment and goods destined for production in designated remote areas.[9] The basic tax incentive in Indonesia is a tax holiday for three years in Bali and Java, and for five years everywhere else depending on a number of qualifying factors. The government introduced a new tax holiday regime by opening up incentives to approved projects in certain industries. Some respondents in our research say that the incentive structure in Indonesia needs to be simpler and more aggressive if the country is to match the incentives being offered by other ASEAN countries.

Impact

Indonesia, Malaysia, Thailand and the Philippines are competing with each other to offer the most attractive investment destination for FDI. In such a competitive market, Indonesia needs to benchmark its tax incentive policy with its regional competitors.

Recommendation

The government needs to leverage its tax incentives policy to foster a positive investment environment. It also needs to ensure that investment/tax incentives are non-distorting, transparent and broad-based.

9 UNCTAD (2000). Tax Incentives and Foreign Direct Investment.

If prosperity was measured by the number of regulations, then Indonesia would be rich. We have too many and have to eliminate 5,700 at the national level.

WIJAYANTO SAMIRIN

SECTION

03

SECTOR-SPECIFIC FINDINGS

Agriculture

PRESIDENT JOKO WIDODO HAS MADE FOOD security a priority issue for his administration. While the goal of food security is both admirable and understandable, investors and traders in local agriculture have raised a number of issues. Figure 2 below captures the issues raised by companies, principally in two areas. First, restrictive trade policies that limit the growth of the sector and potentially raise consumer prices; and second, infrastructure as the biggest challenge to enhancing productivity and investment in the sector. If these two areas are addressed, the government has the opportunity to enhance its food security priorities.

Making agriculture a more attractive sector for investment can increase food security in Indonesia. Both domestic and foreign investment in agriculture has remained relatively low when compared with

Figure 2

Issues raised by companies with respect to food security.

www.nationalhandcraft.com

Photo: Moh. Defrizal/GA

the economic importance of the sector in terms of its share of gross domestic product (GDP) and employment. Foreign direct investment (FDI) in particular is constrained by increasing restrictions on foreign ownership. Low land registration levels and complicated land rights hinder domestic and foreign investors. Inadequate infrastructure, mainly in transportation and irrigation systems, is a major disincentive for investors.

In general, there is increasing concern that "food security" has come to mean "food self-sufficiency" in areas like soy beans, onions, garlic and beef, leading to erratic policies that periodically restrict imports, cause price hikes and create artificial shortages. Indeed, in areas like beef where strict quotas have come and gone repeatedly in recent years, it seems obvious that Indonesia has neither the arable land nor the infrastructure to meet domestic demand at a reasonable price.

Challenge 1: 'Inward' Looking Policy

Indonesia's "inward looking" policies limit openness in the agriculture industry. Law 13/2010 on Horticulture, article 100 (3) limits foreign ownership to 30 percent. The law provided a four-year adjustment period; hence full compliance is required by the end of 2015. This policy makes it clear that Indonesia does not welcome FDI in the sector. According to this law, everyone engaged in horticulture should prioritize domestic goods and services (article 71) and the export of horticultural products is allowed only after fulfilling domestic consumption needs as identified by the government (article 87).

Law 7/2014 on Trade is also problematic. Article 35 states that the government has the authority to prohibit or limit the import of certain products in the name of the "national interest." There is a risk of different interpretations on how the prohibition or limitation shall be implemented. Article 54 states that the government may restrict the import of various goods to maintain the balance of trade. However, exports are also subject to restrictions when the domestic supply is deemed insufficient or when the government determines the need to increase the domestic value added. Article 70 states that if the price of an imported good is lower than the "normal price" and causes a loss or potential loss to domestic producers, the government is obliged to take anti-dumping measures. There is no clarity on what "normal price" means.

Impact

Indonesia's agricultural trade regime is restrictive compared to other Asian countries, and markets for selected products remain tightly controlled by the state. These may deter foreign investors, who are needed to achieve the government's own growth targets.

Recommendation

The Indonesian government needs to relax restrictions on foreign investment and foreign trade to spur agricultural development. The government should also give incentives for companies to conduct research in Indonesia to promote the transfer of technology for the benefit of the domestic economy, and to empower local smallholders. In addition, credible research and stakeholder consultations should be conducted prior to implementing any import prohibitions or restrictions, with both domestic impacts and international obligations being considered.

Challenge 2: Evidence-Based Policy

Law 18/2012 on Food was enacted to strengthen the principle of food sovereignty and food self-reliance. The law

Photo: setkab.go.id

mandated the establishment of the Food Security Agency to report directly to the president and play a major role in managing the supply and demand of food products. The agency should be in place by the end of 2015.

We raised the issue of data reliability in our 2014 investment report. The 2012 Food Law mandated the establishment of a Food Information System to ensure data reliability in the decision making process. It authorizes the government to regulate trade in food through price and quantity stabilization, food reserve management and the development of a good investment climate for the food business. Article 55 states that the government is obliged to stabilize the supply and the price of staple foods at both the producer and consumer levels. Such stabilization is intended to protect "the income and purchasing power of farmers, fishermen, small and micro food enterprises, as well as consumers' welfare."

There are, however, wide disparities between industry and government agriculture data. For example, total corn production was 18.5 million tons for 2013, based on data from the Central Bureau of Statistics (BPS), while the industry reported that total corn production was no more than 8 million tons. This discrepancy has had a negative impact on government decisions about corn imports.

> "Indonesia's agricultural trade regime is restrictive compared to other Asian countries, and markets for selected products remain tightly controlled by the state."

Photo: Moh. Defrizal/GA Asep Fathulrahman/BS

Impact

There is an urgent need to create a robust data collection methodology if the Food Security Agency is to make well-informed decisions on food policies for the good of the nation. There is a danger of severe market distortions – and higher prices for consumers – if the Agency bases its decisions on unreliable data.

Recommendation

The government needs to engage key stakeholders to develop a better methodology to collect data. It is imperative for the new Food Security Agency to ensure that it has reliable and valid data if it is to achieve evidence based-policies. It would also be useful for there to be an ongoing formal working group comprised of domestic and foreign agriculture companies and government officials to meet regularly to discuss agriculture policy and data.

SECTION

03

SECTOR-SPECIFIC FINDINGS

Consumer Goods

FOR 2015, THE WORLD BANK HAS projected slower economic growth for Indonesia, with GDP expanding at only 4.7 percent in 2015. Much of this is due to external factors, but domestic conditions contribute to the slump. Fixed investment contributed 1.4 percent to GDP growth year-on-year in the first quarter of 2015 – or half its average annual contribution in 2010-12.[10] During this period, private consumption, an engine of growth for the Indonesian economy, weakened. For example, car and motorcycle sales declined by an average of 20.7 and 32.2 percent, respectively, in April and May compared with the previous year. However, Indonesia is still Southeast Asia's most promising consumer market, with a large population and long-term prospects for growing income.

Indonesia is continuing its efforts to ensure greater consistency in policies and laws between the central and local governments. Currently, the central government says it is scrutinizing at least 154 regulations that hinder the investment climate.

There is a looming crisis. Last year, the Halal Law was enacted on the final day of the legislative session, making halal certification mandatory for all food, beverages, drugs, cosmetics, chemicals, organic and genetically modified products sold in Indonesia, and for the machinery and equipment involved in processing these products. Companies have three years before vast new halal certifying and auditing agencies are up and running. This law will have a huge impact on industry if implemented and companies are waiting for the technical details of the regulation.

Indonesia also has more stringent halal regulations than other countries in the region. With the ASEAN Economic Community (AEC) coming into force at the end of 2015, the government needs to align itself with regional standards in order to avoid requirements that potentially decrease efficiency and competitiveness, and increase costs for customers.

10 http://www.worldbank.org/en/news/feature/2015/07/08/indonesia-economic-quarterly-july-2015

Photo: Emral Firdiansyah/ID

Challenge 1: Tax and Excise

The key feature of the government's revised 2015 budget was an ambitious target to increase total revenue by 14.6 percent, and tax revenue by 30 percent. However, weak revenue realization in the first half of 2015 raised concerns that the target may not be met. In an attempt to reach the revenue target, the government has announced a number of measures to increase tax collection. However, investors worry that these efforts are directed more toward existing taxpayers, particularly foreign investors, rather than identifying new taxpayers.

The government is considering revising sales and excise taxes for vehicles, fuel, and tobacco. Related regulations are Law 39/2007 on the Amendment of Law 11/1995 on Excise, Law 28/2009 on Regional Taxes and Levies, and Ministry of Finance (MoF) Regulation 205/2014 on the Amendment of the Regulation of the MoF Regulation 179/2012 on the Tobacco Excise Tariff.

Impact

The tax and excise regimes are creating an investment climate that is less competitive than that of Indonesia's neighbors and that will potentially reduce investors' appetite to expand their operations in Indonesia.

Recommendation

The government needs to consider using its tax and excise regimes as tools to improve the investment climate. This would include adjustments in government policies to ensure simplified and transparent tax and excise systems. There is a need to give clear incentives for taxpayers that already comply with regulations while ensuring that investment incentives are transparent and easily understood. Lastly, plans to expand the tax base, both revenue and excise, should be detailed in order to ensure that investors are fully informed.

Challenge 2: Work Permits

Indonesia's consumer goods sector has proven to be resilient during economic crises and foreign companies thus see great potential for continued investment in Indonesia, both as a market in its own right, and as a link in the global supply chain. While Indonesia is directing resources toward improving its educational system, the demand for skilled talent is high, and cannot always be met by the limited availability of local professional and technical talent. Thus, companies need to bring in foreign talent, not only to maximize production but also to transfer knowledge, expertise and experience to local employees. However, companies complain

Figure 3

Identifies issues raised by consumer companies with respect to the investment climate.

SECTION

03

SECTOR-SPECIFIC FINDINGS

that they are unable to adequately manage foreign talent because of work permit limitations that impose de facto quotas and require them to rotate out foreign executives and experts.

US companies generally want to hire local talent to the greatest extent possible. Our 2014 study revealed that 84 percent of the US companies operating in Indonesia have a workforce comprised of least 70 percent Indonesian nationals. However, companies often face difficulties in hiring specialists for short-term periods. In each phase of a project, different numbers of experts and different types of talent are required. Hence, flexibility is needed to adjust to rapidly changing needs. A related regulatory challenge arises when a company wants to make Indonesia its Asian regional hub or headquarters. Doing so will mean that companies must attract more international talent to work at headquarters; but obtaining the necessary work permits is so difficult that it is a disincentive to making Indonesia a corporate hub.

The Ministry of Manpower (MoM) has issued regulations for specific sectors, for example MoM 12/2015, 16/2015 and 17/2015 have all restricted the ability to hire and use foreign experts.

Impact

The difficulties in obtaining work permits and the excessive requirements regarding rotation of foreign personnel is a disincentive for new investment and investment expansion, and means that Indonesia could lose opportunities to host regional corporate hubs or headquarters. It is also disruptive of existing operations and costs Indonesia revenue in terms of hotels, airfares and other local expenses.

Recommendation

The government needs to relax restrictions on foreign manpower, including work permits. The regulations need sufficient flexibility to adjust to companies' needs at different phases of projects or business development. Let companies determine their own manpower needs based on cost, needs and efficiency.

> "US companies generally want to hire local talent to the greatest extent possible. Our 2014 study revealed that **84 percent of the US companies operating in Indonesia have a workforce comprised of least 70 percent Indonesian nationals.** However, companies often face difficulties in hiring specialists for short-term periods. In each phase of a project, different numbers of experts and different types of talent are required. Hence, flexibility is needed to adjust to rapidly changing needs."

Challenge 3: Halal Law

In 2014, the Halal Law was enacted on the final day of the legislative session, making halal certification mandatory for all food, beverages, drugs, cosmetics, chemicals, organic and genetically modified products sold in Indonesia, and for the machinery and equipment involved in processing these products. Companies have three years before new halal certifying and auditing agencies are up and running.

As a result, Indonesia will likely have more stringent halal regulations than other countries in the region. With the ASEAN Economic Community (AEC) coming into force at the end of 2015, the government needs to align itself with regional standards in order to avoid requirements that potentially decrease efficiency and competitiveness, and increase costs for customers.

Impact

This law will have a potentially huge impact on industry. The Halal Law should avoid creating technical barriers to trade that may impact the harmonization of requirements under the terms of the ASEAN Economic Community. Increased complexity may also result in increased costs given the complexity of products and the large number of ingredients in different products.

Recommendation

We recommend extensive consultations with foreign and local investors in the drafting of regulations to implement the Halal Law. The procedures should be as simple as possible and avoid costly procedures that could harm consumers. A number of areas in the Law are unclear with regard to practical details and investors are seeking clarity in order to avoid misunderstandings.

While foreign and local investors support the intent of the law to protect the rights of Indonesian consumers, we counsel a practical approach that is in harmony with both ASEAN and international best practices.

Few industries in Indonesia have benefitted from rising purchasing power as much as consumer goods sector.

Photo: Emral Firdiansyah/ID

SECTION

03

SECTOR-SPECIFIC FINDINGS

Creative Industry

THE INDONESIAN GOVERNMENT HAS recognized the potential for creative industry to spur economic growth; but getting the formula right has been a challenge. Foreign investment in the film industry and in movie theaters, for example, areas that would seem rife for investment, given the relatively low number of screens in the country and undercapitalized film-production, remain closed according to the Negative Investment List, despite calls by leading Indonesian creative economy officials for changes. Undoubtedly, big entertainment players from the US, for example, see the enormous potential in Indonesia both as a market and a production hub, but they recognize that restrictions and uncertainties also need to be addressed in the sector.

The Ministry of Trade launched a Creative Economy Road Map in 2009. In 2011, creative industry was put under the Ministry of Tourism and Creative Economy. This was changed by President Joko Widodo's establishment of the new Creative Economy Agency (Bekraf) as a stand-alone body to promote 15 creative industry sub-sectors. The Bekraf roadmap on creative economy identifies investment as a priority, with institutions and infrastructure in a wide number of areas needing attention. Global expertise also needs to be tapped to foster domestic capacity in areas such as animation and computer graphics.

Investors say privately that with the right kinds of incentives to develop a wide range of enterprises, a booming creative industry could be built in Indonesia. Companies are wary, however, of a negative investment list restriction of 51 percent ownership in most areas and an outright ban on investment in others; they are also concerned about

Photo: mytcr8tiv.wordpress.com

Issues identified by experts with respect to creative economy.

Figure 4

whether manpower restrictions will be eased to allow companies to hire the foreign talent they may need initially to train local people and put up the kind of sophisticated operations that now exist in Singapore and China.

Potential investors also say that greater direct foreign investment in areas like film production and distribution and software would help spur better enforcement of laws against rampant intellectual property theft across the creative industry sector.

Challenge 1: Intellectual Property Rights Protection

The essence of the creative economy is intellectual property and its protection under Indonesian law both in writing and enforcement. Indonesia has enacted Law 28/2014 on Intellectual Property Rights (IPR), showing considerable political will to combat IPR violations. However, there are challenges that require both capacity building and greater public awareness of the benefits of such protection, as anyone visiting widespread DVD piracy stands that operate openly in the country knows. IPR not only protects the idea but also optimizes the economic value of it. Bekraf argues that IPR violations are often caused by difficulties in accessing the original product, because it is either too expensive or scarce in the market. Bekraf's chief deputy for IPR, Ari Juliano Gema, told an AmCham forum in May that piracy happens due to three main factors: price considerations; lack of access to original copies; and the assumption that piracy is not a crime. In addition to enforcement, he outlined the need for public education on the value of original products, a point we agree on. We also believe that greater market access for investors over time will address the issues of price and scarcity hand-in-hand with enforcement of laws against intellectual piracy.

Indonesia is a signatory to many international treaties and conventions covering IPR and continues to formally meet international standards. In 2006, the National Task Force for IPR Violations was established with the aim of improving prevention through better law enforcement and education for government institutions and the public at large about IPR matters. After almost a decade, IPR enforcement remains a major hurdle and Indonesia is generally recognized as having a high incidence of IPR violations. Further efforts need to be made to raise public awareness and build institutional capacity. The International Intellectual Property Alliance said in a 2014 report that to "create a healthy copyright market in Indonesia, its Copyright Law should be reformed;

serious enforcement deficiencies addressed; and market access barriers lowered."[11]

Bekraf outlined three strategies for IPR optimization: establishing a task force for IPR violation claims; organizing social campaigns about the negative effects of piracy; and promoting innovative legitimate businesses that give people easy access to affordable and high quality original products.

More positively, we are encouraged that Bekraf is now working with industry stakeholders and lawmakers to form an anti-piracy task force, which will help facilitate requests from rights holders on piracy matters, monitor the progress of anti-piracy activities and ensure that enforcement measures remain high on the agenda. We further applaud Indonesia for its efforts in starting to block websites that distribute pirated content. The initial data compiled during August-September 2015 indicates a promising degree of efficacy in the initial round of blocking such material and we look forward to more rounds in what promises here, as elsewhere, to be an ongoing battle. We encourage Indonesia to continue to direct resources toward these important efforts.

Impact

Lack of law enforcement in IPR protection means there are few incentives for content creators, local or foreign, to be productive. Investor hesitation and less productive content creation limit the potential growth of the creative economy.

Recommendation

The government needs to reinforce ad hoc institutional arrangements to promote coordination and further reform. However, these arrangements require political support at the highest level in order to overcome resistance from other parts of government, and also need clear roles and missions, adequate resources and qualified staff.

Challenge 2: E-Commerce

Investors say there is no clear policy roadmap for Indonesia's E-commerce industry, which by all accounts is poised for robust growth. There is uncertainty over regulations for the payment gateway and a ban on foreign investment in retail E-commerce, a factor impacting creative industries. The uncertainty on payment gateway policy limits the potential growth of the industry.

11 INDONESIA: International Intellectual Property Alliance (IIPA), Special 301 Report on Copyright Protection and Enforcement, 2014. http://www.iipa.com/rbc/2014/2014SPEC301INDONESIA.PDF

E-commerce regulations should also be concerned with consumer protection and legal protection for children. Some regulations have upset E-commerce players: Law 7/2014 on Trade; Ministry of Industry and Commerce (MoIC) regulation no. 290/2015; Law 8/1999 on Customer Protection; MoIC Regulation 19/2014 on Negative Content. At this time, the MoIC leads the trade ministry and Bekraf in drafting the E-commerce roadmap. In relation to the payment gateway, MoIC is collaborating with Bank Indonesia to create the regulations.

Restrictions on foreign investment in retail E-commerce through the Negatve Investment List also have limited access to capital and created unnecessary work-arounds that are inconvenient and do not benefit Indonesia. In some instances, domestic startups have been forced to take on foreign loans rather than sell equity stakes.

Impact

Investors are waiting to see the development of the E-commerce regulatory framework, which thus far has limited the potential growth of the industry.

Recommendation

The government needs to make sensible regulations to strengthen E-commerce. As the role of the state diminishes over time in these sectors, regulatory structures need to ensure adequate competition. Information Minister Rudiantara has recommended that E-commerce be removed from the Negative Investment List.[12] This should be encouraged.

Challenge 3: Creative Skills and Knowledge

The creative industry is driven by people and ideas as much as physical investment, and as such, has relatively low barriers to entry domestically. Regional economic integration, for example through the coming Asean Economic Community, can help drive further growth.

However, Indonesia is lagging behind in tapping the potential of the creative and film industries. Local talent tends to work more in roles as operators rather than creators. The education ministry and the Ministry of Research and Higher Education (MoRHE) need to be more concerned with human capital development in the creative industry, but few educational institutions are looking at the needs and opportunities in creative industry sub sectors

12 "Ministry mulling opening e-commerce to foreign funding," The Jakarta Post, March 3, 2015. http://www.thejakartapost.com/news/2015/03/03/ministry-mulling-opening-e-commerce-foreign-funding.html

“The creative sector is human capital-intensive, and as such, appropriate incentives are needed to develop and nurture the talent for the sector is to grow.”

such as digital and film. There are some vocational schools for digital operators, but they do not meet international requirements and standards. There is currently no regulatory framework that provides incentives to institutions or organizations that develop human capital for this sector.

Impact

Limited human resources in this sector inhibit the potential growth of the industry.

Recommendation

The creative sector is knowledge- and human capital-intensive, and as such, appropriate incentives are needed to develop and nurture the necessary talent for the sector to grow. Partnerships between foreign creative economy companies and local educational institutions could jump-start training opportunities. Lower barriers to foreign investment and lower restrictions on employing foreign experts in the creative economy who would transfer technology and skills to co-workers, would free up productive capital, much of which would inevitably be directed at training the domestic workforce needed to give Indonesia a 21st century creative economy.

Photo: LifeLike Pictures

SECTION

03

SECTOR-SPECIFIC FINDINGS

Extractive Industry

NATURAL RESOURCES INCLUDING minerals have long been important commodities for Indonesia, providing significant contributions to government revenue, economic growth and foreign exchange reserves. While government policymakers now emphasize broader industrialization goals, including in the mining sector, natural resources remain a major area of economic activity. In addition, the state has been heavily involved in Indonesia's extractive industry since independence. Under Article 33 of the 1945 constitution, natural resources are to be controlled by the state and used in a manner to "provide maximum benefit to the people." Interpretation of this clause has become a point of debate in recent years.

Falling global commodity prices have had a notable impact on Indonesia's recent economic performance. Figure 5 captures the issues raised by companies with respect to the investment climate. New exploration requires huge expenditures and a coherent government regulatory environment, and the overarching concern that companies cite is the lack of legal certainty to continue their operations.

Mining represented more than 20 percent of Indonesia's exports prior to the enactment of the ban on raw mineral ore exports in 2014, with export duties being a major source of tax revenue at that time.[13] Indonesia has huge mining potential, as indicated by the Fraser Best Practice Potential Index.[14] The index ranked Indonesia 35th in potential out of 122 countries in its 2014 survey. If mining policy is managed properly, there is scope for Indonesia to move further up on this scale. Unfortunately, the policies related to the extractive industry in Indonesia are taking the country in the opposite direction, with the Fraser index ranking Indonesia 112th of 122 in terms of regulatory quality, meaning it is seen as an unattractive destination for new mining investment. As a result, despite its great potential, Indonesia ranks 76th in terms of overall attractiveness for mining investors. Improving policy is an absolute necessity

13 http://www.thejakartapost.com/news/2014/01/27/challenging-times-ahead-indonesian-mining-sector.html
14 Fraser Institute (2014). Annual Survey of Mining Companies

Photo: hmtaupnyk.com

if Indonesia wants to improve its attractiveness to investors, especially in a low commodity price environment where exploration funds are limited.

The extractive industry operates under numerous regulations issued by many institutions, ranging from line ministries to local governments. The lack of coordination and differences in goals means that many regulations often lack coherence and/or applicability. Policy makers need to improve the quality of regulations – otherwise, Indonesia will not reap the benefits of future growth from this industry.

Challenge 1: Defining National Interest

The current Mining Law 4/2009 was a significant change from the previous mining regulatory regime. The law superseded the 1967 Mining Law that provided the framework for all of the country's pre-2009 mining concessions. One of the basic tenets of Law 4/2009 is that it explicitly sides with the government's interest. The law clearly states that – in the national interest – the government after consultation with the House of Representatives (DPR) may determine primary minerals and/or coal policy. The interpretation of this clause in subsequent enabling regulations has been a source of considerable disagreement between investors and policymakers.

It is the authority of the government, among others, to determine national policy and to grant Mining Business Licenses (IUP) or Special Mining Business Licenses (IUPK) and extensions thereof. The law does not address the controversial question of contract extensions, but Government Regulation (GR) 23/2010, and the latest amendment GR77/2014 on the implementation of the business of mineral and coal mining, regulates license extensions and attempts to impose these provisions on contracts and extensions. However, the law indicates that contracts should be honored until they expire, which if specifically addressed in the contract, would, as a legal matter, include extension provisions. Investors note that on major capital projects, extensions need to be applied for and granted many years prior to the expiration of the contract and that such extensions need to be in a form that provides for the same level of legal and fiscal certainty that exists under the contract in order to effectuate the substantial amounts of investment required for major projects.The Indonesian government pushed ahead with a mineral export regulation in early 2014, which called for the development of domestic smelters and banned raw mineral exports as well as mill-processed mineral products. The export ban has encouraged very little downstream investment in the country as numerous companies have argued that downstream expansion is not commercially viable, which has been exacerbated by the downturn in mineral prices and a global glut of smelting capacity in several minerals.

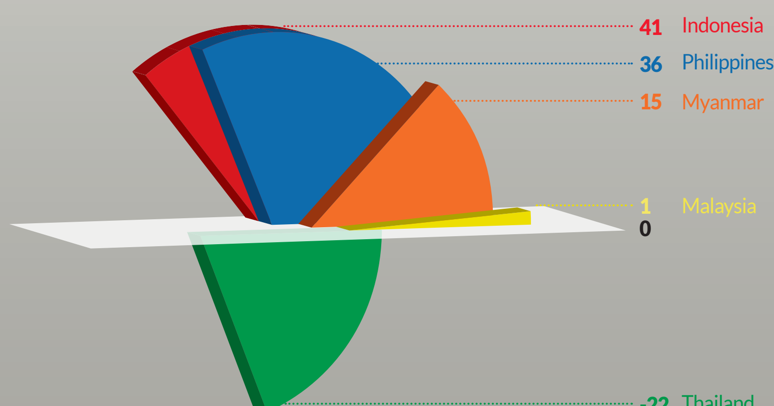
The potential exists for huge capital investment in the long

Table 6

Policy Perception and Investment Attractiveness

	Best Practice	Policy Perception	Investment Attractiveness	Gap
Philippines	65	121	101	36
Indonesia	35	112	76	41
Myanmar	31	64	46	15
Malaysia	121	120	122	1
Thailand	110	55	88	-22

Gap Attractiveness - Best Practice



Source: Fraser Institute (2014). Annual Survey of Mining Companies term, but the government has difficulty in aligning various laws, which are often contradictory and confusing. As a result, the country is unable to realize its objectives of managing mineral and coal resources in such a way as to increase the incomes of the community at the local, regional and national levels while simultaneously creating jobs and guaranteeing legal certainty in the sector. The difficulty is compounded by the emotional nature of the natural resources debate and worries over national sovereignty on the one hand and contract sanctity on the other.

Impact

Companies face difficulties in obtaining reasonable and timely assurances of new license extensions. Government Regulation 77/2014 Section 112B Paragraph 2 states that an extension request can be submitted to the Ministry of Energy and Mineral Resources two years, or up to six months at the latest, before the expiration of the contract of work (CoW). For major mining companies, the planning and development for mining production must take place many years before the expiration of a contract term. Furthermore, for those companies where the two year period starts in 2019, which is the final year of the current president's administration, it would be difficult for the government to take strategic decisions on mining contracts at that time. Without timely approval of an extension of operations many years prior to the end of a contract term, investments for development and processing facilities could be impacted because making such investments requires legal certainty and predictability.

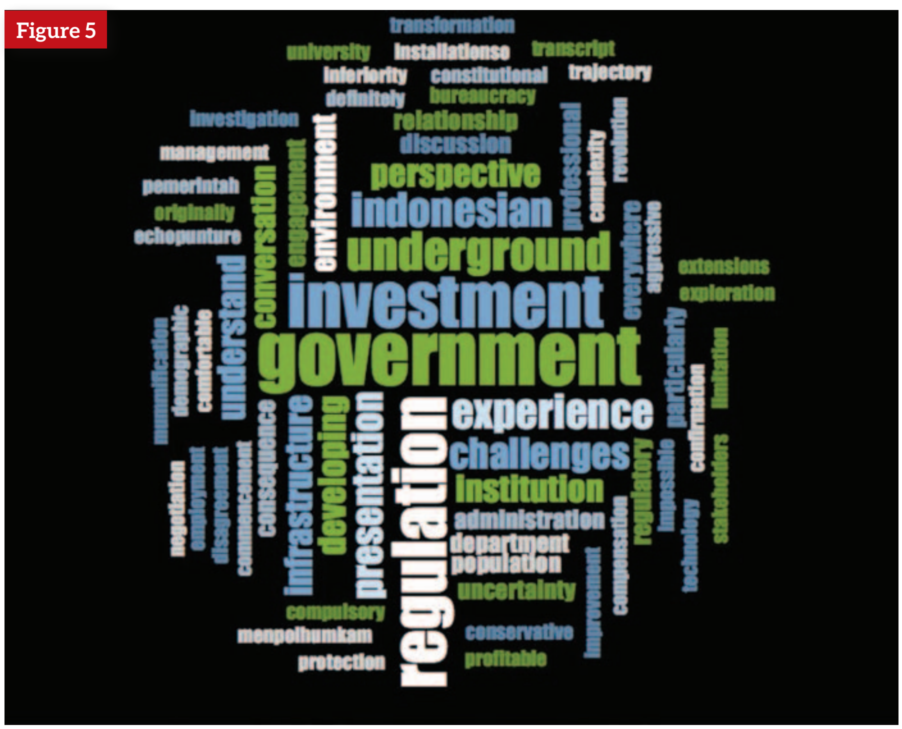
There have been indications of movement in this regard with the announcement in September by the energy ministry that investors can propose a contract extension earlier, from ten years to two years before the contract ends. The mining industry is also one of the government's targets for deregulation as announced by the president in September and greater flexibility in negotiating contract extensions is seen by the industry as a positive development that would allow for the kind of certainty and forward predictable planning needed to raise and commit to multi-billion dollar investments.

Recommendation

The government should consult with the DPR and other key stakeholders to determine primary mineral and/or coal policy in the domestic interest. Consistent with its authority to manage minerals and coal mining, the government should review Government Regulation 77/2014 in consultation with the business community and other

Issues raised by extractive companies with respect to the investment climate

Figure 5



stakeholders. The goal should be to create a more predictable and consistent legal and fiscal framework that will allow the private sector to make the long-term investments necessary in order for the sector to contribute to Indonesia's economic growth.

Challenge 2: Regulations that Hinder Operations

Indonesia has large reserves of natural resources, but regulatory uncertainty hinders foreign investment in the sector including vital exploration activities. We are encouraged that the government is making efforts to ensure greater consistency in policies and law. For example, its recent initiative to scrutinize 154 regulations systematically to inventory, review and simplify laws and regulations at all levels of government is a major step in the right direction. These laws also need to be aligned with implementing regulations.

Political reforms have strengthened democracy and local autonomy, but with policymaking now shared between the central and local governments, one consequence is that some regulations hinder mining operations. For example, Law 41/1999 on Forestry, which restricts open-pit mining and certain other non-forestry related activities within areas designated as protected forests; the law had no transitional provisions with regard to pre-existing mining contracts and licenses when it was implemented. The government protects existing contracts, allowing companies to continue mining activities until the expiry of the contract.

Another example is the new ocean zoning of the Ministry of Marine Affairs and Fisheries, which allows the ministry to ban mining operations if they are deemed to harm coastal areas and small islands.[15] This new policy will also target oil and gas operations.[16] Law 4/2009 on mineral and coal mining requires mineral and/or coal mining management, among others, to be based on environmental sustainability. One of the objectives of the law is to guarantee that mining respects the natural environment, while also guaranteeing legal certainty in business activities.

Photo: Moh. Defrizal/GA

Impact

The lack of reconciliation between, for example, the forestry law and the mining regulatory regime creates unnecessary risks for investors. This regulatory uncertainty deters new investment.

Recommendation

The government needs to continue and intensify its efforts to ensure greater consistency in policies and law governing the mining sector.

> “One of the objectives of the law is to guarantee that mining respects the natural environment.”

15 http://www.cnnindonesia.com/ekonomi/20150211120611-85-31275/menteri-susi-larang-aktivitas-tambang-di-pesisir-pantai/
16 http://www.cnnindonesia.com/ekonomi/20150213084117-85-31825/larangan-aktivitas-migas-di-wilayah-pantai-tak-berlaku-surut/

SECTION

03

SECTOR-SPECIFIC FINDINGS

Information Technology

INDONESIA HAS A RAPIDLY GROWING MIDDLE class of roughly 74 million tech-savvy people, most of whom are also active Internet users, and the information technology (IT) sector has already grown by more than 15 percent in 2015. Studies show the country has a strong economic outlook as consumers remain optimistic.[17] However, overall access to computers and Internet connections remains low, at around 20 percent and 21 percent, respectively.[18] Figure 6 captures the main issues frequently raised by companies during our interviews.

As with many other sectors, regulatory uncertainty remains an overarching concern. The challenge for government regulators is to help create an ecosystem for the IT industry that encourages investment and innovation. This implies significant incentives for investors and long-term investments by the government in both infrastructure and education. These steps will enable Indonesia to become part of the global IT supply chain. The government can use policies that help create an enabling environment by promoting competition through sound regulation and liberalization (World Economic Forum, 2015). Principally Indonesia needs to create a welcoming environment for investors at a time of intense competition among nations for FDI. We do not believe the "stick" of forced local content regulations is the best way to encourage the broad range of investments needed.

The government, including the ministries of trade (MoT), industry (MoI), education (MoEC) and communications (MoCI), needs to continue engagement with key stakeholders including foreign and local investors, universities and other centers of innovation. Such engagement we believe will foster more certainty, greater stakeholder input and the consequent development of more effective policies.

Our 2014 report showed that Indonesia's IT sector faced three major challenges:

1. Localization of data centers;
2. The requirement to establish locally based IT manufacturing in order to continue selling in the local market;
3. And the implementation of Indonesia's broadband plan.

After a year under the new administration, those challenges remain. However, if they are adequately addressed, Indonesia has an important opportunity to maximize the potential of its digital economy, and thereby help meet its economic growth targets.

Further, while there is seemingly great potential for further growth, it is essential that Indonesia develops its local talent pool in digital content creation. The market for education in understanding and using ICT technology remains low, particularly among small and medium businesses. This implies that people generally are not familiar with digital platforms and the way to utilize them (McKinsey, 2014). While investing in infrastructure is expensive and will take time to yield results, the government

17 Indonesia Information Technology Report, BMI Research, 2015
18 The Outlook for Indonesia's ICT Sector, Global Business Guide Indonesia, 2013

astragraphia/ag-it.com

should see digital education as a cost-effective way to enhance IT capacity relative quickly.

In this year's research, we found the main issues outlined below.

Challenge 1: Domestic Components for IT Products

AmCham Indonesia, the U.S. Chamber and our member companies have spent much of 2015 in a productive – if not always satisfying – dialogue with regulators over regulations requiring domestic or local components (TKDN) to be included in 4G cellphones and other IT products sold in Indonesia. This requirement is intended to address balance of trade concerns and to encourage collaboration between foreign manufacturing companies and the still-fledgling local electronics assembly and component manufacturing industries.

Unfortunately, the regulations are a considerable hindrance to attracting FDI. Companies frequently note that their existing supply chains do not run through Indonesia and that the country lacks the ability to provide the high-quality components sophisticated devices require. Some manufacturers have said privately that to manufacture some devices in Indonesia would cost as much as 80 percent more than building the comparable devices in existing factories elsewhere. These costs could result in lower quality devices for the local market and higher costs for consumers.

It is also still unclear how local content will be calculated. MoCI Regulation 27/2015 requires importers or manufacturers to increase the level of TKDN to 30 percent in 2017. Otherwise, their existing import licenses will be revoked and the products cannot be distributed. The latest MoI Regulation 69/2015 on provisions and procedures for the calculation of domestic components for industrial electronics and telematics gives guidelines for implementation, but the regulation remains ambiguous, making it difficult for industry to comply.

While industry is sympathetic to Indonesia's objective of encouraging domestic manufacturing via linkages with FDI, this objective can be achieved through other means. Some companies have tried to get the government to see R&D and knowledge transfer solutions in app development, for example, as a creative way to meet local content requirements while building a knowledge economy for the country. In addition, other solutions include capacity-building for local suppliers, including SMEs, and a "cluster-based" approach to investment attraction that leverages existing local competitive advantages in terms of manpower, skills and resources.

By being creative and seeking solutions that both enhance the 21st century digital economy and are realistic about existing global supply chains, we believe local content rules can be adjusted to the benefit of both Indonesia and investors.

Figure 6

Issues raised by IT companies.

Impact

While consultation and engagement have improved under the administration of President Joko Widodo, there is still a gap between the needs of investors and the policies being pushed by regulators. This creates confusion over policy implementation and inevitably delays investment decisions. This can also lead to a grey market in products for which local content is required. In this scenario the government could lose tax revenue and consumers could lose the protection of buying company-backed products. More broadly, the attempt to force rigid local-content percentages may lead some investors to forgo the market altogether.

Recommendation

The government needs to engage with the business sector to gather input on how to facilitate and encourage the development of backward linkages and spillovers from FDI to the local economy. The government should give incentives to companies willing to invest in not only hardware development, but also software and human capital development. However, it should not seek to compel such investments as a condition of selling in the market.

Challenge 2: Talent for the App Economy

In the drive to force local manufacturing, regulators have at times overlooked the increasing demand for digital services and content. In addition, with a huge potential market, Indonesia still lacks the talent to meet the demand to create digital products and apps. There is currently no systematic effort to create incentives that facilitate app economy development. A new initiative from the government to push the creative economy is expected also to attract investment and build the pool of talent for the app economy.

Instead of trying to catch up with neighboring countries that made a commitment to IT sector manufacturing decades ago, Indonesia should instead pursue human capital development in IT services such as mobile apps. A full-blown push into this knowledge sector can attract leading global companies and have tremendous spillover effects in e-commerce and other areas. According to a recent study, 86 percent of Indonesian households have mobile phones, and the demand for mobile apps will grow substantially.[19]

Impact

Indonesia is lagging behind in reaping the full benefit of the digital/app economy. The failure has created a shortage of IT talent. As a result, poaching of scarce talent among companies is rampant, hurting the growth of the industry.

Recommendation

Rather than seek a regulatory fix in the form of manufacturing and import restrictions, the government needs to strengthen incentives to

19 Indonesia: Road to the App Economy, Progressive Policy Institute, September 2015.

Graphic: wonderfulengineering.com

ensure adequate competition and the development of human capital. Partnerships are needed between educational institutions and the private sector to develop Indonesia's large potential talent base. Foreign investors can be a major ally in this process.

Challenge 3: Redundant Permit Processes and Labeling

While demand for IT products is growing, lengthy product shipment periods and permitting requirements hinder growth. Importers have to obtain permission from at least three different ministries for licenses and permits before products can be shipped. Further, numerous documents need to be submitted each time to different ministries, such as the Import Application (PI) permit. Some of these documents remain the same from shipment to shipment (for example, the appointment letter from the principal holder of the overseas brand). Each additional document adds time and expense to processing. Accordingly, the fewer documents that need to be reviewed, the faster applications can be processed and granted.

Moreover, current regulations require that all IT products carry local labeling, ostensibly for reasons of consumer education and safety. However, the regulations require labels not only on the packaging but also on the device itself, and labels must be affixed before products enter customs. Additional redundant labeling requirements are in place for IT product spare parts. Related regulations are MoT

Regulation 38/2013 regarding the Revision of MoT Regulation 82/2012 on the import of cellphones, handheld and tablet computers; MoT Regulation 108/2012 on the registration of cellular phones and handheld computers, which together with MoT Regulation 82/38 forms part of the overall licensing framework for importers; and MoT Regulation 67/2013 article 3, which requires that the labels be affixed before products enter the customs area.

Impact
The lengthy process for shipping and clearing IT products hinders the development of the market. Labeling requirements potentially increase the cost borne by customers. The higher costs potentially trigger grey markets for IT products with a subsequent loss of government revenue.

Recommendation
The relevant ministries – communications, trade and industry – need to reduce the overall time for inspection, permitting and licensing. There should be a one-stop service, allowing the digital submission of documents. The ministries should also create an online tracking system to increase efficiency. There is also a need to maintain a single folio/docket for each importer, containing their basic information and documents to reduce redundancy. To further expedite the process, the folio/docket could be stored on an electronic database that is open for the importer to edit/amend periodically to ensure that it contains the most up-to-date information.

Challenge 4: Forced Localization of Data Centers
This issue was explained in detail in last year's report, but we cite it again this year as a top priority given the potential disruption that implementation of this rule could mean for foreign investors in virtually every industry. Like any country involved in international commerce, Indonesia relies on and benefits from the seamless flow of information into and out of the country. E-Commerce and global data flows are essential not only for technology and Internet companies, but for manufacturers, banks and financial services, retailers, logistics and transportation companies, research and development centers, and small and medium businesses in every industrial sector. All these enterprises rely on data flows to create valuable products and services, enhance productivity, combat fraud, protect consumers, and foster economic growth, innovation and jobs.

Impact
In-country data storage requirements carry with them the danger of a number of unintended consequences. Decreased security is one possible result, as data security is not a function of where it is held, but how it is maintained and protected. Decreased competitiveness is another, as international transactions require the ability to assess creditworthiness, financial risk, and potential fraudulent activity, all of which depend on cross-border access to data. Further, requirements for local servers and data storage will result in fewer products and services being available for end-users. Finally, costs will increase for both producers and consumers, as in-country storage requirements add significant expense and complexity, and will strain the resources of local governments which often have limited IT budgets.

> “The relevant ministries – communications, trade and industry – **need to reduce the overall time for inspection, permitting and licensing.** There should be a one-stop service, allowing the digital submission of documents.”

Recommendation
There is significant confusion over the scope of the regulation, as it applies to public service companies, yet does not define that term, which potentially has unlimited applicability to small, medium and large companies in any industry. In addition, other aspects of the regulation, including the particular types of data that must be stored onshore, remain unclear. Clarification is needed urgently, particularly in light of the government's intention to have this regulation in place in 2017.

SECTION
03

SECTOR-SPECIFIC FINDINGS

Infrastructure

PRESIDENT JOKO WIDODO HAS MADE infrastructure a top priority, earmarking IDR112.4 trillion ($9.5 billion) in additional infrastructure funds to the 2015 national budget. This represents a 39 percent increase over the 2014 figure, largely made possible by money saved from scrapping most fuel subsidies in January 2015. The country greatly needs improved roads, ports, railroads, power plants, water facilities and broadband capability but the release of funds for projects was sluggish in the first half of the year, creating concern over the fulfillment of ambitious goals.

The infrastructure drive has drawn increased attention from US companies especially in the power, energy and IT sectors, but as with other areas of the economy, regulatory uncertainty remains the main concern for infrastructure investment.

Captures the issues raised by companies within the sector.

Figure 7

Photo: Infrastructure-fiskal.co.id

Infrastructure development raises a number of institutional challenges for government especially regarding coordination among ministries.

The high degree of overlap and need for integration with sectors such as energy and extractive industries, means that the key challenges those sectors face will have a broad impact on companies involved in infrastructure development.

“Infrastructure development raises a number of institutional challenges for government especially regarding coordination among ministries.”

Challenge 1: Land Acquisition for Infrastructure

The difficulty and complexity surrounding land acquisition is a major handicap for infrastructure development in Indonesia. Most infrastructure companies work hand-in-hand with state owned enterprises (SOEs) and line ministries to implement projects. This creates interdependency between private companies and SOEs, with the line ministries usually acting as the regulator.

An example is the 35,000 megawatt power generation program, one of the government's key infrastructure priorities. At a minimum, the state power operator PLN needs to coordinate with 10 government institutions: the Ministry of Agrarian and Spatial Planning and the National Land Agency in relation to land acquisition; the Ministry of Environment and Forestry for environmental impact assessment; the Ministry of Transportation for jetties and railway permits; the Ministry of Home Affairs for local government; the National development Planning Agency for planning; the Ministry of Finance for government guarantees; Indonesia's Investment Coordinating Board for principal licenses for foreign investment and the one-stop shop; the Ministry of Energy and Mineral Resources for sectorial policy and regulation; and the Coordinating Ministry of Maritime Affairs and the Coordinating Ministry of Economic Affairs for coordination. As a result, it is a challenge for project owners to execute their programs.

The government seems fully aware of the complexities of land acquisition and the potential brake it represents on growth but untangling the thicket of agencies and regulations has been daunting. Recent changes have somewhat streamlined the process. Land acquisition has been shortened this year to what can still seem a lengthy 428 working days, including any legal disputes. This change, however, should provide greater certainty in a land acquisition process that once could take years to complete while at the same time giving landowners the chance to receive fair payment.[20]

20 In the process, Law 30/2007 on Energy article 6(3) requires the government to take corrective measures required in energy crises and emergencies. Related laws that need to be considered are Law 2/2012 on land acquisition for development, Presidential Decree 30/2015 on the implementation of land acquisition for the public interest; Energy Ministry Decree 74k/21/MEM/2015 on the ratification of electricity supply business plans, and Energy Ministry Decree 3/2015 on procedures for power purchase. These newer regulations are intended to clarify the timing and procedures.

Impact

Delays in land acquisition slow infrastructure development, or prevent it altogether, and ultimately impose higher logistics costs on producers, which in turn handicaps Indonesia's ability to compete in the global market.

Recommendation

The Indonesian government should continue to reinforce the teams and task forces that have been created to address specific problems, such as the Performance Monitoring Unit under the energy ministry. These teams can leverage government capacity by drawing from the pool of qualified local experts and become advocates for reform within the bureaucracy of government institutions. Greater streamlining of land acquisition under the government deregulation drive is to be strongly encouraged.

Challenge 2: Harmonization of Local Government Regulations

Infrastructure development involves multiple stakeholders, from the planning stage to the handover of the project, with policy making shared between central and local governments and the executive, legislative

and judiciary branches. Indonesia's "big bang" decentralization in 1999 following the end of the Suharto era created major regulatory challenges, particularly coordination between the central and local governments. Some 85 percent of draft local regulations are incomplete, inconsistent or distort local economic activities (OECD, 2010). Some local regulations are redundant or obstruct the free flow of goods, services and persons between districts.

Companies operating in different regions across Indonesia are required to apply for various licenses in each locality, such as domicile permits and business permits. As a result, companies must go through often redundant licensing procedures even when the documents required for the licenses are the same. They must often repeat the process for every jurisdiction in which they operate. Law 28/2009 on regional and local taxes and levies attempted to clarify and limit the discretion of local governments to introduce new taxes and levies but much more needs to be done to create a more coherent and predictable operating environment.

Indonesia's decentralization is among the most sweeping such efforts ever attempted and makes sense given Indonesia's island geography and ethnic diversity. The government, however, is still struggling to ensure greater consistency in policies and laws. Law 2/2015 on local government[21] aims to rebalance power and authority between the central, provincial and district governments.

Impact

Local government regulations that are inconsistent or at odds with central government laws increase costs for companies. In the aggregate, this will reduce Indonesia's overall competitiveness and ultimately reduce government revenue and job creation.

Recommendation

The government should continue its efforts to ensure greater consistency in policies and laws. Law 2/2015 constitutes a major step in the right direction. The laws should be accompanied by their implementing regulations, and be developed in consultation with the private sector and other stakeholders.

21 Law 2/2015 on local government is an amendment of Law 23/2014 on local government, emphasizing local elections for governor, mayor and regent. Besides elections, there are no major changes in Law 2/2015

Photo: Moh. Defrizal/GA

As friends and partners in Indonesia’s progress, we share the concerns expressed by senior government officials about overly complex regulations that can stunt economic growth and blunt Indonesia’s competitive edge.

SECTION

03

SECTOR-SPECIFIC FINDINGS

Insurance

THE INSURANCE SECTOR HOLDS THE majority of Indonesia's non-bank financial assets, followed by finance companies and pension funds. Total insurance assets were Rp755 trillion in 2014 (approximately $51 billion as of Oct. 2015), an increase of almost 17 percent from 2013. There are 141 insurance companies operating in Indonesia,[22] but the insurance and financial sectors are relatively small compared with other countries in the region and are dominated by banks. Long-term financing is still very limited and institutional investors have yet to become a source of long-term capital.

Insurance density in 2014, which illustrates the average amount each person spends on insurance premiums per year, increased 46.2 percent to Rp1.04 million (US$71) compared to 2013. This sharp rise was due to an increase in gross social insurance premiums by the new Social Security Administration Body (BPJS). The majority of insurance industry investment is in time deposits at 25 percent and insurance still lags behind the banking sector in terms of consolidation and capitalization.[23]

22 Otoritas Jasa Keuangan (OJK, Indonesian financial regulatory authority), 2015.

23 A number of business groups, including the U.S. Chamber of Commerce, AmCham Indonesia, the Global Federation of Insurance Associations and others have repeatedly raised concerns over foreign equity limitations in the insurance sector and the proposed policy of mandatory cessions to a state-owned reinsurer.
See www.uschamber.com/indonesia

Challenge 1: Foreign Ownership

Law 40/2014 on Insurance replaced Law 2/1992, and the industry is still waiting for the implementing regulation. Previously, Government Regulation 73/1992, Article 6, limited foreign ownership in insurance to 80 percent, creating a relatively open environment for foreign investment, compared to some more advanced markets in the region. Given the current, very low penetration rate alone, this market place continues to hold the potential to attract substantial international attention. There is plenty of room to grow.

Impact

A change in the policy of ownership would likely create operational and other concerns for both existing as well as potential new investors in this industry, deter further foreign investment in insurance and reduce the country's access to an important source of long term capital.

Recommendation

It is our hope that the Indonesian Financial Regulatory Authority (OJK), which oversees insurance, will not see the necessity to restrict foreign ownership further, as there is almost unprecedented room throughout the entire industry for domestic companies as well as foreign joint ventures to expand the safety net for Indonesia's

Graphic: www.kbllp.ca

Figure 8

Issues raised by insurance companies.

economy and the population at large. Additionally, policies governing private sector institutional protection, should be focused on public interest objectives through non-discriminatory means.

Challenge 2: Limited Pool of Talent

The latest insurance industry data highlights the dynamism of Indonesia's insurance sector. Life premiums have been growing strongly and are expected to continue to rise by 20-30 percent annually. This is being driven by a growing middle class and a better understanding of the benefits of insurance, as well as by supply-related factors such as the development of attractive new products by life insurers.

The growth of the industry needs a substantial pool of talent to service the expanding customer base and to comply with actuarial requirements, both in the life and the general insurance sectors. Based on our interviews, currently there are only around 100 actuaries in the industry, which creates an environment where qualified individuals are continuously moving to higher paying jobs at other companies in what is a seller's market for talent that not only interferes with quality standards in the overall marketplace, but also substantially increases cost that ultimately will be passed on to the policy holder. The industry is in urgent need of a larger pool of talent, but so far, there is no regulatory framework catering to this need.

Impact

Due to the limited pool of talent, as well as increasing restrictions regarding foreign expertise, the industry's ability to reach and service the market's potential is seriously impacted.

Recommendation

The OJK should consider incentives for companies that have development programs for human capital. One approach would be to embrace and promote the well-tested, but in numbers relatively small, MAGANG apprenticeship project as a key to developing quality talent growth in the industry. The spotlight needs to be on greater promotion of actuarial science within academia. Considering that it will take time to create the talent pool required for a dynamic insurance environment with almost unlimited growth potential, the government should also accept the continuing need for internationally experienced experts through the hiring of expatriates in key positions.

> “Mandating that reinsurance stay onshore, where capacity is limited and may fall short of international standards, **may turn internationally regarded top players in the reinsurance sector away from Indonesia**, a country with the very real potential for catastrophic natural events.”

Challenge 3: Mandatory Local Reinsurance

Over the past two years, the OJK has developed draft regulations that will force primary insurers to increase the amount of reinsurance procured locally to 50 percent. A state-owned reinsurer is being created in order to supply the required reinsurance capacity. The regulations are expected to come into force on Jan. 1, 2016.

Impact

Reinsurance exists in order to spread and diversify risk, including the protection of assets through funds that are not in the same geographic region as the asset being protected. Forcing a greater share of reinsurance to be procured locally concentrates risk in Indonesia.

Mandating that reinsurance stay onshore, where capacity is limited and may fall short of international standards, may turn internationally regarded top players in the reinsurance sector away from Indonesia, a country with the very real potential for catastrophic natural events. Alternatively, there is the possibility that middle-men involve themselves in the placement of excess capacity, driving up the cost without transparent competition. This “local content” requirement carries the potential for significant complications within the insurance sector.

International reinsurers are known globally to introduce new and improved products to markets they are servicing. Excluding them to any great extent from the local environment may drastically reduce this important benefit, resulting in higher premiums for the policy holders and slower development of the industry in general. This could deprive Indonesia of a bigger pool of investment capital generated by the insurance sector.

Recommendation

We recommend that Indonesia postpone the implementation of regulations on mandatory cessions until the merits of a broad range of policy options can be fully and thoroughly examined and discussed. For that matter, we also recommend the establishment of a working group (Forum Komunikasi) that would include local and internationally experienced insurance professionals and the regulatory body to hold regular and robust dialogues on all issues that may impact the growth of the Indonesian insurance industry. Such a dialogue would allow for the sharing of information on international best practices and standards and provide opportunities for capacity building and technical assistance.

Finally, with an eye on the planned creation of an Indonesian “giant” reinsurance company that will be involved in potential local mandatory cessions, as well as activities under the new ASEAN umbrella, we strongly recommend that the government pursue an internationally accepted rating standard, from AM Best or similarly qualified agencies, to guarantee the acceptability of transferred capacity without questions concerning ultimate financial security and the highest professional standards of the new entity.

"For all these companies, big and small, newcomers or veterans, Indonesia is a partner in their business future just as they are partners in Indonesia's growth and development."

SECTION

03

Oil and Gas

SECTOR-SPECIFIC FINDINGS

Photo: Moh. Defrizal/GA

REGULATORY UNCERTAINTY REMAINS the main issue faced by energy companies as shown in Figure 9, which has been compounded by delays in the renegotiation of Production Sharing Contracts (PSCs), almost of which fall due within the next ten years. The likelihood is that given the country's drive to control more of its natural resources, many PSCs will be given to Pertamina to operate. In addition to these concerns, energy players remain deeply worried about the potential criminalization of business activities, an issue raised in our 2014 report that has still not been resolved.

As outlined in our previous reports, Indonesia's oil and gas investment climate is highly volatile. The nation has gone from being a net oil exporter to a net oil importer, with extraction being cut roughly in half to 800,000 barrels per day since the mid-1990s, while domestic demand is sky rocketing (Table 7). This is aggravated by a lack of investor enthusiasm due to regulatory uncertainty and bureaucratic constraints. With literally billions of dollars in energy investments having been delayed or derailed by regulatory worries in recent years, the imbalance in production and consumption will potentially become the country's most significant obstacle to high economic growth.

Oil and gas requires huge investments in both exploration and exploitation, but with PSCs in limbo and global oil prices in decline many experts say that the costly exploration activities necessary for Indonesia to seek out more oil and gas reserves are unlikely to be carried out by foreign investors. These investments have a very long payback period, making certainty of contracts critical. Challenges seem bigger than opportunities; hence it is urgent for the Indonesian government to deepen its engagement with the business community.

In addition, issues that affect many investors, including delays and difficulties in land acquisition, and complex permitting regimes involving local and regional government, directly hamper expansion in the energy industry.

Some say the energy business in Indonesia is a declining industry, but it seems more accurate to say that it suffers from a declining resource base. There are prospective new projects in Indonesia but most are in high-risk deep water environments, which increases the level of investment needed relative to the size of the prize. With the right policies these can still be attractive, yet every delay or regulatory impediment adds time, effort and cost to such projects.

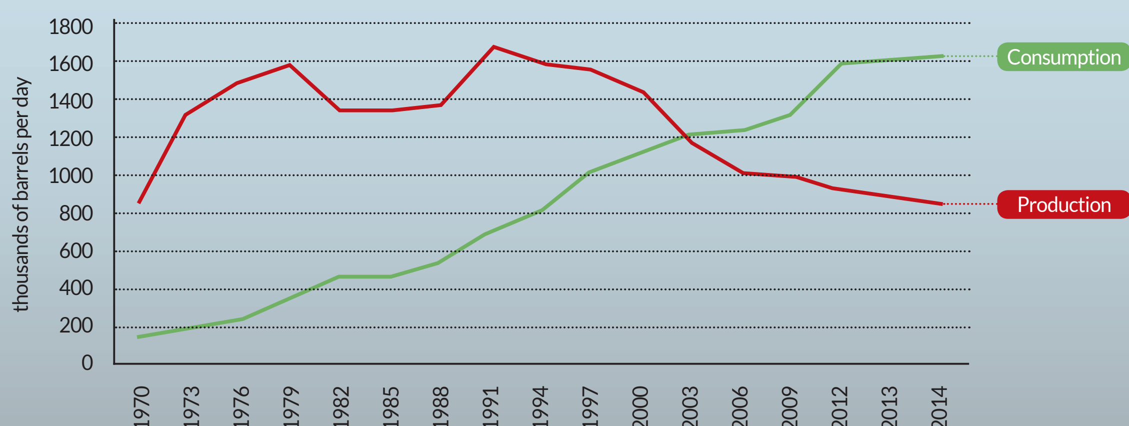
The challenge for the Ministry of Energy and Mineral Resources (MoEMR) is to encourage investment with new targets and policies to accelerate licensing and change fiscal and tax policies in the upstream oil and gas sector to incentivize and create stable, business-friendly conditions for current and onward investments in the energy sector. Oil and gas investors hope to experience easier and faster business licensing as some permits will be processed under the Indonesian

Figure 9

Issues raised by oil and gas companies.

Table 7

Indonesia's Oil Production and Consumption



Source: British Petroleum, Statistical Review of World Energy, 2015.

Photo: Moh. Defrizal/GA

Investment Coordinating Board's (BKPM) one-stop service (OSS). In August 2015, the ministry officially handed the procurement process of 10 out of 42 permits in the sector to BKPM, effective immediately. The ministry expects that by the end of 2015, all oil and gas permits controlled by the central government will be streamlined under BKPM's OSS. Also in August, the ministry announced that it had cut more than 60 percent of the bureaucracy in permit procurement – from 222 licenses to 42 licenses – during the last six months, with the hope of encouraging investment. While this has the potential to provide some relief, many of the delays are associated with complex bureaucracy in the regional/local governments.

SKK Migas, the upstream oil and gas regulator, has also issued a decree[24] to reduce its role in the day-to-day activities of oil and gas companies and to simplify procedures and processes for PSC holders. Companies have long complained that SKK Migas has micromanaged personnel decisions and other business issues. SKK Migas has pledged to work closely with contract-holders in the upstream oil and gas industry to create simpler, more streamlined practices to uphold price flexibility, easier field operations and greater cost efficiency. For successful implementation of this decree, it will be important to initiate the proper cultural change in all levels of SKK Migas.

Challenge 1: Natural Gas Management

One of the items on the energy ministry's stimulus agenda is a Draft Presidential Regulation on Natural Gas Management, which intends to create natural gas aggregators in Indonesia. Unfortunately, this initiative will likely disincentivize future risk-intensive upstream gas investment. It mandates that a PSC holder in a region would have only one party to sell gas to with a price based on an "economic rate of return." This could distort the market and create low returns for investors. Most importantly, a complex and far-reaching step like this should be taken only in consultation with stakeholders, including foreign investors and PSC holders.

Impact

This action if implemented could create a massive midstream and downstream monopoly that will work to maximize its own profit at the expense of the upstream risk-taking companies.

Recommendation

Articles in the draft regulation regarding the assignment of existing contracts to a gas aggregator need to be changed so that PSC holders have their existing contracts respected so that export prices can be competitive and provide better field economics and revenue-sharing for the government.

The establishment of a gas aggregator should only be considered for LNG imports from the global market, and the fulfillment of new/additional demands not yet served by existing gas sales contracts where direct sales from the upstream producer to the downstream consumer are not feasible.

Challenge 2: Fiscal and Tax Regime

Despite a brief upturn in crude oil output expected in 2015 and 2016, production will continue to decline beginning in 2017 in the absence of large new projects to replace mature fields. Despite

24 KEP/0018/SKKO0000/2015

this outlook, Indonesia still has below-ground potential that could be developed if the business environment improves.

To attract new investment, the government is relying on streamlining business licensing and permits and improving fiscal and tax policies. This is critical as Indonesia has one of the highest government takes in the world, making it difficult to compete globally. The main related tax laws are the Income Tax Law, the Value Added Tax (VAT) Law, and the Land and Building Tax.

Some PSCs signed prior to 2010 include a provision to allow interest costs on borrowing to be claimed as cost recovery on certain projects. But in practice, interest is generally not allowed to be claimed either as cost recovery or as a tax deduction unless specifically approved by the government.

The Ministry of Finance (MoF) also has issued regulations related to "other services" referred to in Article 23 Law 7/1983 on income tax, and a regulation related to the Land and Building Tax. MoF Regulation 141/ PMK.03/2015 applies a 2 percent income tax for services in the oil and gas sector, a policy that also hinders the appetite for investment. The MoF has issued Regulation 267/PMK.011/2014 on the reduction of land and building tax for the mining sector oil and gas exploration.

Impact

Indonesia has to compete with other countries to attract FDI in this challenging environment and improvement in fiscal regime and tax policies can be used as an incentive.

Recommendation

The government needs to ensure its fiscal regime and tax policy for upstream oil and gas is effective in attracting and sustaining FDI, and is non-distorting and transparent. The new Oil and Gas Law is in the discussion phase, and the streamlining of taxes across ministries and offering a fiscal regime that is effective at competing for global capital investment is a way forward for the government.

Challenge 3: Rupiah Transaction Obligations

Bank Indonesia's Regulation 17/3/PBI/2015 on the mandatory use of rupiah in Indonesia came into effect earlier this year, six years after Law 7/2011 on currency was enacted. The regulation contains strict penalties and administrative sanctions for non-compliance.

Unfortunately, the currency law fails to elaborate on the precise scope of the mandatory rupiah-use requirement and the possible exemptions, giving rise to significant confusion and a lack of clarity as to when the rupiah must be used and when it is permissible to use foreign exchange.

The regulation has caused considerable confusion in the energy sector, where many companies already have a contractual commitment to settle payments in a foreign currency, or carry insurance covered in foreign currency. While foreign transactions can be settled in foreign currency, if those transactions result in domestic economic activity, those transactions must be in rupiah. There is an understanding between the energy ministry and BI that the special characteristics of the energy sector mean the implementation of the regulation for overall transactions needs time and flexibility.

Impact

The rupiah regulation was widely viewed by investors as rushed and incomplete in terms of its implementation and clarity. These unexpected changes create uncertainty, which negatively impacts the energy investment climate in Indonesia.

Recommendation

The government should consider earlier and substantive consultation with the business community over regulatory programs or changes to existing programs. Consultation is supposed to be a required step in designing new policy and when the government is reviewing or amending existing policies. In this case, the rupiah transaction regulation is another disincentive to investment in the energy sector and BI needs to consider revising BI Regulation 17/03/2015 in consultation with the industry.

> **"Despite a brief upturn in crude oil output expected in 2015 and 2016, production will continue to decline beginning in 2017 in the absence of large new projects to replace mature fields."**

SECTION

04

THE INVESTMENT POLICY 'BIRD'S NEST'

Indonesia has a heavily regulated economy, a fact that has often confused foreign investors who struggle to comply with a tangle of laws, regulations, permits and guidelines issued by numerous authorities – all in the interest of managing business activities but rarely in harmony with one another. It can be dizzying. The current government recognizes the inherent cost of this overregulation in terms of lost investment opportunities that ultimately burden the Indonesian people and slow the country's momentum. The problem is more acute as the rupiah weakens and commodity prices slump.

The ongoing series of deregulation packages being issued by the government represent a chance to reboot the regulatory environment and top officials in President Joko Widodo's government have gone out of their way to reassure skeptical investors that simplifying and harmonizing regulations will be a guiding theme for the rest of the president's term in office. Unveiling what he called a "massive deregulation" drive, the president said in September: "I want to underline that this economic package is aimed at stimulating the real economy, which will have an impact to our economy in the future."

But this is obviously not a new problem and we note that previous governments have also taken steps to encourage and promote investment. President Susilo Bambang Yudhoyono issued Presidential Instruction No. 3/2006 on the Investment Climate Improvement Policy Package, which sought to reduce licensing times, speed up customs procedures and simplify tax regulations for investors among other goals. It aimed specifically to step outside the regulatory framework to impose rationality, clarity and streamlining on the process. Internal progress reports on that effort, however, admitted that progress was slow.[25]

The 2007 Investment Law – Law 25/2007[26] – lists a number of provisions to reassure foreign investors including guarantees of equal protection and opportunity, safety from nationalization and expropriation and the right to repatriate profits. It seems to promise investors two-year work permits, which in practice have rarely been allowed recently, and outlines a number of other provisions. It seeks to strengthen institutions that serve investors and to eliminate past contradictory legal frameworks. But as with all laws in Indonesia, it is subject to interpretation through ministerial regulations that can often contradict one another or be out of step with the broader laws they are meant to clarify.

Taking account of the contradictions and inconsistencies, Law No.12/2011 on the Formulation of Laws and Regulations was intended to overhaul the process of issuing regulations and bring consistency to a process that involves central government agencies, ministries sometimes acting independently and regional governments. "There has been a growing awareness and understanding in the government of Indonesia during the last decade of the role of regulatory reform in facilitating economic development," the OECD said in a 2012 report. That same report concluded that the regulatory reform effort was essentially stalled.[27]

State of Play

Despite the awareness of the problem and various legal measures enacted, the overall regulatory system has been weakened through being fragmented and uncoordinated. Investors add privately that it often seems as if some policymakers instinctively distrust foreign companies and want to discourage their activities rather than follow the clear imperative from the president to attract foreign investment as a way to

25 Progress on Presidential Instruction No. 3/2006, Jan. 18, 2007. http://www.bi.go.id/en/iru/policy-document/economic-program/Documents/3cc581598b134db98d94660267d11704PolicyPackageforInvestmentClimate.pdf

26 http://www.bkpm.go.id/file_uploaded/Investment_Law_Number_25-2007.pdf

27 Government Capacity to Assure High Quality Regulation in Indonesia, OECD, 2012.

reach Indonesia's development goals.

To become effective, regulation requires a holistic approach. There needs to be an agency or institution with both the ability and the power to coordinate and oversee regulatory policy. This could be taken up by the Coordinating Economy Ministry, which to some extent already plays a key role from a sectorial perspective. Rigorous assessment of the costs and benefits of new regulatory proposals and existing regulations is required to avoid the confusion and contradiction that undermines confidence.

Transparency and public consultation are two key words for effective implementation. One issue that is often overlooked concerns implementation guidelines. The law provides statements of general principle, but in order to operate, it requires regulations to be issued in the form of ministerial or presidential regulations or decrees. This may delay implementation when guidelines must address politically sensitive and technically complicated issues. For example, the complex certificate of local content (TKDN) for the IT sector has been muddled and difficult for industry to understand.

Policy making also is shared between central and local governments, with decentralization a fact of life given Indonesia's geographic and ethnic diversity. It is also shared between the executive branch, the legislature and the judiciary, which simply adds more layers of complexity and the growing concern that the Constitutional Court, ruling on politically motivated judicial reviews, can also undermine investment, as happened with the overturning of the 2004 Water Law earlier this year.

Coordination is obviously enormously difficult, which may explain how a regulation requiring foreign employees of companies to get temporary work permits for any business-related meeting

«

In the energy sector, as in other sectors, companies are involved with numerous government bodies concerned with permitting, taxation and operational matters. Seen as a 'bird's nest,' this complexity could be a strength if properly coordinated.

> **"The nest analogy brings together** institutions and relationships, often **weak individually** but potentially **strong collectively,** to protect and promote a fragile good investment.**"**

or activity in Indonesia could come into effect.[28] That law had a potentially ruinous effect on foreign and local companies, many of whom halted inbound travel to Indonesia when they found they could not easily obtain the temporary permits. Hotels and airlines were also impacted as travel moved to neighboring countries to avoid possible noncompliance. It was a relief to investors when, as part of the government's deregulation package, the requirement was seemingly dropped as this report went to print in October. Had officials coordinated the issuance of the regulation with the private sector and others in the first place, the disruption it caused could have been avoided.

On a much bigger level, executing the government's 35,000 megawatt electrification program requires the engagement of multiple stakeholders and billions of dollars. Companies themselves may not be directly involved with the coordination of the key stakeholders, but it will have a major impact on project delivery.

The 'Bird's Nest' of Relationships

The coordination challenge is often illustrated as "horizontal accountability," or the ways in which multiple stakeholders affect each other's interests; this provides one reason why institutions tend to remain separate from one another and sometimes in conflict instead of working in collaboration. To overcome this problem, a holistic approach with clear goals – "promote investment, don't discourage it" – is needed so that agencies collaborate at times and stand apart at others.

Above we portray a "bird's nest" for one of the sectors discussed in the report. The nest analogy brings together institutions and relationships, often weak individually but potentially strong collectively, to protect and promote a fragile good investment. This is a fruitful way of understanding and conceiving relationships among key stakeholders, with the policy relationship based on mutual accountability. "Mutuality" allows for aspects of accountability based less on formal powers and assessments and more on subtle observing and advising. Policy relationships need to establish coherence and consistency across a given sector or jurisdiction. This could be done through routine policy coordination and establishing operational relationships among diverse agencies. For example, through studies, analysis, public outreach and promotion. This could be done by consistent formal or ad hoc interagency/departmental liaison work.[29]

This structure can hopefully function as a network in which the web of relationships can achieve a measure of order. The bird's nest also brings two additional issues: nests are rarely permanently set, but need constant tinkering and repair, so they change over time; and the diversity of nests provides a convenient reminder that there is no single ideal system design. It is a work in progress.

Making the Nest

In order to give the investment policy puzzle a holistic approach, we recommend that the government:

1. Continues to relax restrictions on investment, for example, by eliminating or greatly revising the Negative Investment List. Indonesia needs investment, both domestic and foreign, in order to achieve its growth targets;
2. Continues to eliminate unnecessary licenses and permits, pushing further the best practices of one-stop services (OSS);
3. Strengthens task force/ad hoc institutional arrangements to promote coordination and further reform. This approach requires great political will and support at the highest levels to overcome bureaucratic resistance and to help eliminate conflicts of interest that can undermine policy and harm the national interest.

28 Minister of Employment issued Regulation No. 16 of 2015 on the Procedure for the Utilization of Foreign Manpower.

29 Adapted from Sampford, Smith, and Brown (2005). From Greek Temple to Bird's Nest: Towards a Theory of Coherence and Mutual Accountability for National Integrity Systems.

“I want to underline that this economic package is aimed at stimulating the real economy, which will have an impact to our economy in the future.”

PRESIDENT JOKO WIDODO

references

A.T Kearney, Ready for Takeoff, 2014 Foreign Direct Investment Confidence Index.

A.T Kearney, Connected Risks: Investing in a Divergent World, 2015 Foreign Direct Investment Confidence Index.

Achmad Tohari (2008), Tax Incentives Competition for Foreign Direct Investment and Economic Integration in ASEAN, Unpublished Master Thesis, Utrech School of Economics – Utrech University.

AmCham Singapore, ASEAN Business Outlook Survey 2016.

AmCham Indonesia and the U.S. Chamber of Commerce (2013) in collaboration with Paramadina Public Policy Institute, Gadjah Mada University, and Ernst & Young, "Partners in Prosperity: US Investment in Indonesia."

AmCham Indonesia and the U.S. Chamber of Commerce (2014) in collaboration with Paramadina Public Policy Institute, "Indonesia's New Path: Promoting Investment, Nurturing Prosperity."

Arianto A. Patunru and Sjamsu Rahardja (2015), Trade protectionism in Indonesia: Bad times and bad policy. Lowy Institute Analysis.

Asher, M.G. 1987, "Tax Reform in Singapore," *The Indian Economic Journal*, 35(2).

BI Regulation No. 17/03/2015 Use of Rupiah in the Territory of the Republic of Indonesia.

Bisnis Indonesia, Oct 28, 2014.

BMI Research, 2015, Indonesia Information Technology Report.

BP Statistical Review of World Energy, June 2015.

Global Business Guide Indonesia, 2013, The Outlook for Indonesia's ICT Sector.

Government Regulation 79/2010 on Refundable Operating Costs and Income Tax Treatment in the Upstream Oil and Gas Industry.

Gustaf F Papanek, Raden Pardede, Suahasil Nazara (2014), *The Economic Choices Facing the Next President.* Jakarta: Center for Public Policy Transformation. October 2014.

Investment Insights, February 2015.

Law 10/2004 on Formation of Regulation Legislation.

Law 12/1994 on Land and Building Tax.

Law 2/2015 on Local Government.

Law 22/2001 on Oil and Gas.

Law 23/2014 on Local Government.

Law 28/2009 on Regional and Local Taxes and Levies.

Law 36/2008 on Income Tax.

Law 42/2009 on Value Added Tax.

Lisbet Steer (2006), *Business Licensing and One Shop Stops in Indonesia*, Jakarta: The Asia Foundation.

McKinsey Global Institute (2012), *The Archipelago Economy: Unleashing Indonesia's Potential,* McKinsey & Company.

Ministry of Communication and Information Regulation 27/2015 on Technical Requirements for Equipment And / Or Any Long Term Evolution Technology Standards-Based Telecommunication Devices.

Moekti P Soejachmoen (2012), Increasing Protectionism, *The Indonesian Quarterly* 1st Quarter 2012 Vol 40 No.1. page 99.

Ministry of Finance Regulation No 267/PMK.011/2014 on Reduction of Land and Building Tax For the Mining Sector Oil and Gas in Exploration Phase.

Ministry of Finance Regulation 141/ PMK.03 / 2015 on type Other Services referred to in Article 23 Law 7 /1983 on Income Tax.

Ministry of Industry Regulation 69/2015 on Provisions and Procedures for Value Calculation of Domestic Component for Industrial Electronics and Telematics.

Ministry of Trade Regulation 108/2012 on Registration of Cellular Phones and Handheld Computers.

Ministry of Trade Regulation 38/2013 regarding Revision of Minister of Trade Regulation 82/2012 on Import of Cellphone, Handheld and Tablet Computer.

Ministry of Trade Regulation 67/2013 Labeling Obligations in Indonesian on Products.

Sampford, Smith, and Brown (2005), *From Greek Temple to Bird's Nest: Towards a Theory of Coherence and Mutual Accountability for National Integrity Systems*.

SKK Decree KEP/0018/SKKO0000/2015 on Guidelines Supply Chain Management Operational.

TAF- USAID (2003), Indonesian Rapid Decentralization Assessment (IRDA), Jakarta: Indonesia, The Asia Foundation - USAID.

UNCTAD (2015), World Investment Report 2015, Reforming International Investment Governance, World Bank (2015), Indonesia Economic Quarterly: Slower Gains.

World Competitiveness, 2015, http://www.imd.org/wcc/news-wcy-ranking/

AmCham Indonesia

Formed in 1977, AmCham Indonesia is a voluntary organization of professionals representing American companies operating in Indonesia. AmCham Indonesia promotes the business interests of its members by identifying and focusing on critical issues that improve the business climate, actively engaging stakeholders to achieve mutual understanding, serving as a key resource for business information and delivering forums for US business networks. Since its inception, AmCham has grown to more than 600 members and represents over 250 companies.

The U.S. Chamber of Commerce

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors and regions, as well as state and local chambers and industry associations. Its International Affairs Division includes more than 50 regional and policy experts and 23 country-specific business councils and initiatives. It also works closely with 116 American Chambers of Commerce abroad.

KADIN

The Indonesian Chamber of Commerce is the umbrella organization of Indonesian business chambers and associations. KADIN focuses on all matters relating to trade, industry and services. The organization is highly committed to tapping the potential and synergies of the national economy, offering a strategic forum for Indonesian entrepreneurs. Its 33 regional Chambers (KADIN Daerah) and 440 district branches ensure national coverage. Because of this huge network, KADIN is the preferred partner for foreign companies initiating their engagement in Indonesia. Bilateral trade and investment relations are taken care of by more than 30 Bilateral Committees.

APINDO

The Indonesian Employers' Association is the only officially recognized employer's organization in Indonesia to deal with industrial relations and human resource development issues as mandated by the Indonesian Chamber of Commerce. Its vision is to create a better business environment for the business community in order to develop positive industrial relations and to support national development.

AmCham Indonesia

U.S. CHAMBER OF COMMERCE