Indonesia’s New Path: Promoting Investment, Nurturing Prosperity

Introduction

Indonesia at the end of 2014 is at the beginning of a new era filled with both great challenges and tremendous hope. The election of Joko “Jokowi” Widodo as president after the most closely fought contest in the nation's history, marks the first time an entrepreneur and a “common man” has become Indonesia’s president.

We are confident that the outpouring of enthusiasm that greeted Jokowi’s recent inauguration will help ease any lingering political tensions between the new administration and the legislative branch. There is indeed an air of change in the country.

Foreign investors have generally been impressed by the broad economic policy outlines sketched by the team of President Joko and Vice President Jusuf Kalla. Streamlined permit issuance, more rational regulations and cuts in a crippling fuel subsidy have all been promised and would be warmly greeted by investors. The US investment community is committed to working with the new government and legislature openly and transparently to realize our mutual goals of a more prosperous and forward-looking Indonesia.

Against this backdrop, we are reminded that American investors have been part of the Indonesian story for many decades, assisting in the growth of the country through numerous political transitions.

US investment in Indonesia dates back to 1924, when geologists from Standard Oil of California (now Chevron) first began operating in Sumatra. As our 2013 study, “Partners in Prosperity: US Investment in Indonesia,” found, 1 American companies invested roughly $65 billion in Indonesia during the years 2004-2012.

More importantly, as that study also found, US companies stand poised to invest another $61 billion over the next five years, assuming that conditions are ripe for the kind of ongoing partnerships that can assist Indonesia to meet its goals of reducing poverty and building a modern economy.

Mutual progress

To that end, AmCham Indonesia and the U.S. Chamber of Commerce were asked last year by the Indonesia Investment Coordinating Board (BKPM) to follow up on our initial study with recommendations for a way forward that is to the mutual benefit of the country and US investors. The new study, “Indonesia’s New Path: Promoting Investment, Nurturing Prosperity,” prepared by the Paramadina Public Policy Institute, is one result of the ongoing Investment Initiative we have undertaken with BKPM and our partners in Kadin and Apindo. We believe that implementing the recommendations in the report will encourage US and other foreign companies to get off the sidelines and increase their commitment to Indonesia.

To compile the recommendations, in-depth interviews were conducted with senior executives of multinational companies. These were augmented by discussions with experts, focus groups and policy makers. Not surprisingly, the interviews and discussions yielded a long list of issues. We chose to focus only on the three to four most immediately critical issues per sector.

As our 2013 report highlighted, US companies are among the largest – if not the largest – FDI investors in Indonesia. In that report, US investors listed three major constraints to future investment: (1) regulatory uncertainty and inapplicability of regulations; (2) lack of efficient

1 “Partners in Prosperity: US Investment in Indonesia,” AmCham Indonesia and the U.S. Chamber of Commerce with the Paramadina Public Policy Institute, Gadjah Mada University and Ernst & Young, 2013.
and reliable infrastructure; and (3) lack of quality human resources, especially for technical and managerial positions. In broad strokes, we believe the government must urgently tackle these constraints to unlock future FDI while also getting at the kind of specifics we cover in this report.

**Competition eases the road**

Each sector, of course, contends with different variables. Industries that rely heavily on government licenses and have limited market competition tend to face a more challenging investment environment compared to those that operate in sectors with more open market competition. In short, sectors in which the government determines the “winners” and “losers” have tough policy challenges and greater uncertainty. Sectors in which market competition is the key factor to succeed tend to face fewer policy hurdles. In this sense, the extractive industries and oil and gas sectors face the greatest regulatory challenges, while consumer goods, technology and financial services, even though they face significant issues, tend to be less problematic.

Regulatory certainty is crucial to creating a business climate that will attract and retain investment, both domestic and foreign. FDI operates in a global market in which countries compete to attract more FDI, especially high quality FDI that creates added value for host economies.

While Indonesia has made a lot of progress in promoting a better business environment, it still lags behind its main competitors for FDI. In short, Indonesia is not realizing its full potential. Indonesia has a long list of benefits other countries cannot offer, such as rich natural resources, a huge domestic market, a large work force and a relatively stable political environment.

**Recommendations**

Policy recommendations should be clear, measurable and applicable. They should not be too general or too narrow. The policy recommendations we outline follow this approach. We begin with an abridged version of our recommendations, which is followed by a longer look at the research and detail behind each recommendation.

The report covers several sectors: oil and gas, extractive industries, information technology, consumer goods and health care, agriculture and financial services. We start with a set of cross-sector policy recommendations that have an impact on the overall business environment.

Our recommendations are intended to be seen in the spirit of cooperation and equal partnership that has long marked the experience of American companies operating in Indonesia. These suggestions represent the continuation of an ongoing dialogue between American investors and the Indonesian government.

We strongly believe the new government has the courage and commitment to promote policy reform and improved regulations as a way to facilitate greater investment for the good of the Indonesian people. As major investors operating in Indonesia, we are committed to working hand-in-hand with government to reach the mutual goal of good, well-implemented investment policies. At stake is the future growth of the Indonesian economy and the long-term well-being of the Indonesian people.

The US investment community is committed to working with the new government and legislature openly and transparently to realize our mutual goals of a more prosperous and forward-looking Indonesia.
Abridged Findings

BUSINESS ENVIRONMENT: CROSS-SECTOR RECOMMENDATIONS

It is no secret that despite the great opportunities, doing business in Indonesia is not easy. The challenges include slow bureaucracy, corruption and complicated, often-contradictory regulations. Our findings in this report are in line with numerous surveys and rankings. For example, the World Bank’s 2014 Ease of Doing Business index ranks Indonesia No. 120 out of 189 countries surveyed, far below our neighbors, No. 1 Singapore, No. 6 Malaysia and No. 16 Thailand.

Challenge 1: Lack of regulatory consultation

In our discussions with companies, executives raised concerns about the lack of consultation between the government and the business community in the policy making process. Policies that are impractical or that abruptly change the existing rules are seen as counter-productive. One well-known example is the 2009 Mining Law and the relevant government regulations and decrees, which have been revised several times. Key aspects of the implementing regulations concerning value-added processing of raw minerals by 2017 were very difficult to implement. An abrupt change in the export tax created further difficulties.

Another example is the 2012 government regulation on household waste, or extended producer responsibility. The key aspect of the regulation requiring all producers to limit, recycle or reuse waste is also seen as impractical. Ideally, regulations should be passed only after thorough studies and consultation with industry or the public. Moreover, reliable data should always be used to inform open and transparent policy making discussions.

Recommendation Consultation with the business community and other stakeholders would be welcomed as an integral part of the policy making process. Open and transparent discussion based on reliable data is urgently needed.

Challenge 2: Land acquisition for infrastructure

Most infrastructure development requires that land be acquired. Following the post-1998 political reforms, land acquisition became a major handicap for infrastructure development, causing logistical costs to soar to the highest in the region.

In response the legislature passed the 2012 Land Acquisition Law and various implementing guidelines. The regulations provide more certainty in the land acquisition process and allow landowners to receive fair payment. Implemented properly, it could potentially eliminate the role of rent-seekers who complicate land acquisition. The problem with land acquisition now is not so much the regulations but the lack of effective implementation.
Recommendation: The government can build public awareness about the Land Acquisition Law and ensure that best practices from successful projects are used in the future. Projects such as the South Sumatra Toll Road have successfully utilized the law; other strategic projects, such as the Jakarta MRT and the Batang PLTU power plant, should become the new government’s focus and thus showcases for the land acquisition policy.

Challenge 3: Setting minimum wages
Wages are a sensitive issue in every country. For US companies here, minimum wages are rarely an issue, since on average American companies compensate workers at rates significantly above the minimum wage. However, US companies face an indirect impact through general business uncertainty.

According to the 2003 Labor Law, minimum wages should be determined by annual tri-partite meetings between provincial governments, labor unions and the employers association. The yearly tri-partite meetings, however, often spark trade union actions. Many regional governments tend to give in without factoring in labor productivity and the capability of employers, especially small and medium enterprises, to absorb wage increases. In the long run, such arbitrary raises constrain the hiring of new employees and contribute to unemployment.

Recommendation: To reduce business uncertainty, the manpower ministry could require tri-partite negotiations every three years instead of annually. Wages also need to be set with an agreed and transparent formula to avoid uncertainty. The government might also consider introducing incentives for the private sector that promote programs to increase labor productivity.

Challenge 4: Redundant permit processes
Numerous documents are needed each time an Import Permit (PI) application is made, some of which remain the same from application to application. Additional documents lengthen processing time and frequently result in delays that add to financing, warehousing and logistics costs for a wide range of businesses.

Recommendation: The trade ministry might streamline the permit process by using an on-line system integrated with the industry ministry. Before an on-line system is in place, digital submission of documents should be allowed so that basic information can be retained electronically for faster processing.
**Sector-Specific Recommendations**

1. **Oil & Gas Industry**

Indonesia’s oil and gas investment climate is highly volatile. Indonesia has gone from being an oil exporter to an oil importer, with extraction being cut roughly in half since the mid-1990s to 800,000 barrels per day, while domestic demand is skyrocketing. This is indicative of a lack of investor enthusiasm due to regulatory uncertainty and bureaucratic constraints. This imbalance will potentially become the country’s most significant obstacle to high economic growth.

Oil and gas requires huge investments in both exploration and exploitation; these investments have a very long payback period, making certainty of contracts critical.

**Challenge 1: Confusion and criminalization over cost recovery**

Cost recovery as part of a standard Production Sharing Contract (PSC) is a mechanism between the government and oil and gas investors to repay costs associated with exploration. Costs are not recovered during exploration, but must be fulfilled by the state later. There are frequent problems with cost recovery, be it from the oil companies, state supervisory agencies, line ministries or the Attorney General’s Office and the courts, mainly due to differences of interpretation among parties. The principle difficulty comes when disputes arising from PSC project implementation are sometimes handled under criminal law. These should be governed by the dispute resolution process under the terms of the PSC, which is based on civil law principles. One such issue was a bioremediation project in which Chevron’s employees and contractors were criminally prosecuted by the Attorney General’s Office over a civil issue, despite both former regulator BPMIGAS and the Ministry of Environment saying no rules had been broken.

**Recommendation**

Review relevant cost recovery regulations and procedures to avoid loopholes and standardize interpretations. Emphasis can be given to building a common understanding of cost recovery and dispute resolution with the Attorney General’s Office and the courts. The interpretations should be consistent with the intent of the PSCs, which includes a commitment to settle disputes under the terms of the PSC.

**Challenge 2: Legally binding Production Sharing Contracts**

Legal certainty and contract sanctity are critical for oil and gas investors. Regulations that threaten contract sanctity are a major concern. One such regulation applies revised tax and cost charges retroactively, meaning that contracts can be changed unilaterally. This goes against longstanding principles in Indonesian law and has potentially negative long-term implications.

**Recommendation**

Revise the retroactive provisions in the regulation. The government and its investor partners would be better served by being in an equal contractual position in which contract sanctity is upheld.
Challenge 3: The conflicting role of SKK Migas

The Special Task Force for Upstream Oil and Gas Activities (SKK Migas) was created to oversee and help implement upstream oil and gas business activities based on Production Sharing Contracts. Its role is to facilitate the exploitation of oil and gas in order to optimize the benefits for the Indonesian people.

However, SKK Migas also plays the role of regulator and it is often too involved in the day-to-day activities of oil and gas companies, such as expatriate hiring decisions and approval processes. This dual role makes it hard for SKK Migas to be effective and also puts PSC contractors in a difficult situation. In effect, SKK Migas’ conflicting role as both regulator and implementer has made it more dominant than the PSC contractors. The situation has become a major handicap for enhancing oil and gas production and attracting more FDI.

Recommendation
Move SKK Migas from micro management to a focus on producing more oil and gas by first, strengthening its role as a facilitator in the upstream oil and gas business, and second, limiting its authority to issue burdensome regulations by transferring this role to the energy ministry.

Challenge 4: Renewing Production Sharing Contracts

Twenty-three major PSCs will expire between 2018 and 2021. These contracts can be extended for a maximum of 20 years, but unfortunately, the government has yet to initiate discussions for renewal or renegotiation of the contracts and this has led to reluctance on the part of PSC holders to make major new investments.

Foreign companies are the primary participants in the oil and gas sector, along with state-owned giant Pertamina and Medco Energi, the country’s largest listed oil company. Maturing fields and reduced exploration activity have contributed to declining oil production and with demand up sharply, imports must pick up the slack. Hence, it is crucial for the government to improve the investment climate in the oil and gas sector by renewing PSCs.

Recommendations
The investment climate would be improved if the government decided on the future of the 23 contracts, whether to extend or to select new contractors to manage the oil and gas blocks. We also recommend that the government issue a regulation providing transparency and clarity for the PSC extension process, which should put the national interest first and be concluded as soon as possible to enhance business certainty.

The review process should focus on what steps are necessary to maximize production and value of the oil and gas assets within the PSC. Global and local expertise and knowledge must be considered when deciding the best scenario.
2. EXTRACTIVE INDUSTRY
Mining makes a significant contribution to Indonesia’s economy, representing about 16 percent of Indonesia’s exports and a major share of tax revenue. Public policy in the extractive industry needs to be based on reliable data and thorough study.

The extractive industry operates under numerous regulations issued by many local and national agencies. A lack of coordination and agreed goals has led to a lack of regulatory coherence, causing Indonesia to miss many opportunities.
Challenge 1: Domestic ore processing: uncertainty and lost opportunity
Requiring mining operators to invest in domestic smelting facilities was introduced after the 2009 Mining Law was passed with the intention of creating more value for the domestic economy. But the one-size-fits-all approach has had a negative impact on employment, the balance of trade and the value of the rupiah. The industry has suffered in the eyes of investors as the value-added policy has been seen as impractical and counter-productive for the industry.

Recommendation We recommend avoiding blanket policies and instead giving mining operators options to measure the profitability of smelting activities for different minerals and plan accordingly. Realistic timeframes are needed and feasible smelting activities need to be separated from economically nonviable smelting operations.

Mining companies that find building smelters to be economically unfeasible, might be allowed to pay additional royalties. If designed properly, an enhanced royalty system could potentially provide greater economic benefit for the government.

Challenge 2: Overlapping mining permits
Overlapping permit areas for mining exploration are common in Indonesia. This occurs due to the lack of coordination and conflicting authority among the ministries of mining and forestry and local governments.

Since local governments also have the right to issue certain types of mining licenses, there is a tendency to issue multiple permits to increase local government income. One baseline obstacle is the fact that the various agencies involved all use different maps, a major factor in creating confusion.

Recommendation The central and local governments would be well served if they used one reliable national map for any permit activity to avoid conflict. This “One map policy” can help rationalize the permitting process. The Presidential Delivery Unit for Development Monitoring and Oversight (UKP4) has initiated a one map initiative, which the new government may want to enthusiastically support.

Challenge 3: Proposed environmental waste regulation
Combining economic progress and environmental preservation has become a key development theme. The Ministry of Environment has proposed a new draft regulation on hazardous waste management that uses a vague definition of toxic waste, or B3, which could be open to multiple interpretations. B3 is defined in part as a substance that “directly or indirectly could pollute the environment, destroy the environment and/or endanger the environment...”

Several industry associations have raised concerns about the vague definition; they also worry that authority to handle B3 waste will fall to regional governments that may have only a limited understanding of environmental issues. There are concerns about related permits and licensing and the possible criminalization of company actions over what constitutes B3.

Recommendation The proposed regulation would be more effective if it described hazardous and toxic material clearly to avoid multiple interpretations that could criminalize corporate policy. The government may follow in the footsteps of other countries that have already been through the process of drafting regulations related to hazardous waste.
3. INFORMATION TECHNOLOGY INDUSTRY

Indonesia’s technology industry is experiencing rapid growth driven by overall economic performance and an emerging tech-savvy middle class. Retail hardware, enterprise software and cloud computing are all expected to be key drivers of medium-term growth, and the country has been among the top five markets for Facebook and Twitter since 2010. Investment is needed to sustain the momentum.

Cloud computing remains limited, Internet penetration is only about 22 percent and access to broadband is limited and prohibitively expensive. Cyber security is another obstacle. In 2013, it was reported that Indonesia was responsible for 38 percent of the world’s malicious Internet traffic, surpassing China as the leading home of online attacks.
Challenge 1: Localization of data centers
A regulation to build local data centers appears to require companies that provide any kind of electronic services to put their data centers and disaster recovery centers inside the country. This actually cuts across and affects many other industries such as banks, insurance companies, airlines, e-commerce, education, logistics, health care, etc. In a modern economy, information technology is not just a sector by itself; it is a crucial driver of efficiency and cost savings for all industries.

The law has been widely criticized by business for a number of reasons, starting with the definition of “public service” (pelayanan publik), which can be interpreted to mean “service to the public” or “service by government institutions.” If every business that serves “the public” has to localize its data centers this would have a negative impact not only on big multinational companies but also small and medium enterprises.

Recommendation
The government needs to clarify what is meant by “public service.” Ideally, the term means government services and would exclude the private sector. We also recommend that a solid regulatory body implement the regulation in line with the realities of the IT sector.

Challenge 2: Establishing a local IT ‘industry’
The ministries of trade and industry have issued regulations that require holders of an Import Permit (PI) who have been appointed by an overseas manufacturer to “establish an industry” of consumer technology products in Indonesia. Companies are given three years to comply with a regulation many find confusing.

The government wants growth in domestic manufacturing especially in the tech sector where Indonesia has seen a flood of low-priced goods from China enter the market. Developing manufacturing by decree in this fashion, however, could harm investment. Multiple interpretations of the policy also add to continuing business uncertainty.

Recommendation
The term “establish an industry” is unclear and should be clarified in a way that does not create additional burdens for industry players. We also recommend that the trade ministry issue guidelines on exemptions that are mentioned in the regulation but not spelled out.

Challenge 3: Indonesia Broadband Plan 2014-2019
An Indonesia Broadband Plan, 2014-2019 was established in 2014 by Presidential Decree. This constitutes Indonesia’s IT blue print and was developed over two years by the government in coordination with the Ministry of Planning and in collaboration with the coordinating economic ministry and the communications ministry. Mastel and Kadin also contributed to the plan. The plan was developed with considerable input from public stakeholders including IT societies, academe and user groups.

The plan is intended to guide the nation’s IT ecosystem with a clear target to build the industry in terms of both the infrastructure, and non-infrastructure sectors. There are five project priorities within the plan: E-govt, E-edu, E-logistics, E-procurement and E-health. However, the business community has concerns over the implementation of the plan in the future.

Recommendation
It is hoped that the new government will adopt the Indonesia Broadband Plan, 2014-2019 as its IT blue print for the next term. The plan, if implemented properly and supported by the new government, could be a vital component of the country’s growth.
Sector-Specific Recommendations

4. CONSUMER GOODS & HEALTH CARE
While the Indonesian economy has grown by an average of 5.7 percent per year over the last decade, consumer spending has increased by double digits annually during most of the same period. With a burgeoning middle class, investors are increasingly drawn to the country’s domestic consumer market.

Challenges in the consumer industry include rising wages, higher energy prices, electricity rate increases, the shifting value of the rupiah, dependence on imported raw materials and weakness in human resources.

In the health care sector there are unique challenges related to the supply of highly trained personnel. We are encouraged by the recent passage of the Healthcare Professionals Bill and the Nursing Bill, which will establish a legal umbrella for healthcare professionals.

Importantly, the bills open the way for foreign healthcare professionals including foreign nurses to work in Indonesia if they fulfill government criteria. The bills also help address the need to distribute health care more evenly in the country.

Challenge 1: Harmonization of local government regulations
Indonesia’s decentralization process has been largely positive for the economy. However, it has also had an adverse impact on the business climate, in part due to the increasing number and complexity of business regulations issued by local governments, many of which are out of sync with regulations issued by the central government. Increased regulatory complexity means higher costs for producers, higher prices for consumers and a lack of accountability in local government.

Recommendation
The government needs to urgently reconcile rules issued by regional administrations with national laws. Existing laws call for such a process but the central government must take the lead in order to promote efficiency and benefit consumers.

Challenge 2: Halal requirements
The Indonesian Council of Ulama (MUI) has been the body that grants halal certification. Under a just-passed Halal Law, halal certification will require a longer process involving two new agencies, the National Halal Product Certification Agency and the Ministry of Religious Affairs, in addition to MUI.

The new law covers halal certification – including imports – in the food, beverage, cosmetics and pharmaceutical sectors. There are concerns because Indonesia’s rules are more stringent than other, more conservative Muslim-majority countries. In addition, Indonesia does not recognize halal certification from other countries, which may result in redundant processes for imported products and materials. The addition of more government agencies will possibly make an already complex process more costly and cumbersome.
Recommendation The government may wish to harmonize Indonesian halal standards with common practices in the region, using other countries’ best practices as a benchmark. Industry would benefit if the new certification agency provided one-stop services for businesses applying for halal certification and labeling.

Challenge 3: Mandatory extended producer responsibility

Extended producer responsibility (EPR) is used to improve environmental practices in waste management. A 2008 solid waste management law requires companies to take responsibility for solid waste, including after sale. The law is being implemented under a 2012 government regulation. Manufacturers must establish recycling channels, and use materials that can be re-used, re-cycled or easily decomposed. Implementing EPR will put additional burdens on producers, with consumers facing rising costs. With companies responsible for consumers’ waste under the law, collecting and managing waste from products distributed throughout Indonesia will become even more complicated.

Recommendation The government may consider revising the regulation that mandates companies to be responsible for recycling consumer products and packaging to make it more applicable in the Indonesian context.

Challenge 4: Mandatory food labeling

Mandatory health messages related to sugar, salt and fat content in packaged and processed foods were introduced by a Ministry of Health decree as a tool to prevent the rise of non-communicable diseases (NCD) such as diabetes and hypertension. In principle, the industry supports improved nutritional literacy and greater health awareness among consumers, but significant concerns remain toward the approach suggested in the decree. A thorough study need to be done to ensure that the decree will have a positive impact on NCD in Indonesia. In addition, the decree will increase costs substantially for both producers and importers and could potentially act as a barrier to trade in ASEAN, since other countries intend to focus more on consumer education.

Recommendation The government might consider reviewing the decree on the basis of thorough study. It also could take into consideration benchmarking Indonesia’s policy against those of neighboring countries to prepare Indonesia for the ASEAN Economic Community.

Implementing EPR will put additional burdens on producers, with consumers facing rising costs. With companies responsible for consumers’ waste under the law, collecting and managing waste from products distributed throughout Indonesia will become even more complicated.
5. AGRICULTURE
The Indonesian agricultural sector is also “home” to the nation’s poverty. Almost 40 percent of the Indonesian work force is employed in agriculture, which represents just 13 percent of the economy and grows at a rate about 2 percent slower than GDP. Indonesia will not be able to reduce poverty and income inequality significantly without improving the economic well-being of the agriculture sector. To that end, we believe agriculture policies and programs that encourage further research and development, promote enhancements in agricultural infrastructure, establish efficient local markets and foster trust-based open trade will help Indonesia reach its goals.

Investment in agriculture also offers a largely untapped potential for investors because it is highly labor-intensive and requires relatively little capital investment. Unfortunately, Indonesia remains restrictive towards FDI in the sector.
Challenge 1: The Food Security Agency & data reliability

Under the 2012 Food Law, the government must create a Food Security Agency to enhance food sovereignty by managing supply and demand. The body is required to lower imports in order to stimulate domestic production. It is set to be operational by the end of 2015.

To achieve food self-sufficiency, the government is using output and input subsidies, and payments for the provision of services to achieve its objectives. But if it is not conducted properly the use of import restrictions could result in increased costs for consumers and may ultimately hinder agricultural competitiveness. Because the new agency has vast authority over food imports, there could be market problems if the agency uses unreliable data. Indeed we believe weak data could hamper Indonesia’s food security target.

Recommendation

The new Food Security Agency needs to quickly develop strong institutional capacity and this will require government support. Because the law mandates the establishment of a reliable food information system for the agency, the agriculture ministry might share its data collection methodology with the new agency and also collaborate with industry to collect and verify data, in order to improve data quality.

The Food Security Agency might also be well served by pursuing policies that are rooted in market incentives and support comparative advantage, allowing farmers to respond to market signals and grow the crops that farmers view as the most profitable to alleviate poverty. This will also help accelerate Indonesia’s middle class growth, and ensure that consumers can access the most affordable food.

Challenge 2: Unattractive investment environment

Agriculture is widely seen as the most efficient way for Indonesia to promote GDP growth, reduce inequality and lower poverty. But investment in agriculture lags behind other sectors. While it has increased greatly over the last decade, the share of agriculture as a percentage of total realized investment remains much lower than the share of the sector itself in the economy.

The 2014 revision of the so-called Negative Investment List (DNI), which sets ownership limits on foreign investment, increased restrictions on agriculture compared with the 2010 list. The 2010 law on horticulture also reduced foreign equity in horticulture businesses from 95 percent to 30 percent. That law has no grandfather clause and all investors will have to comply with the reduction within four years, including those who were in the business before the law was passed.

These restrictions are a major disincentive for FDI and could potentially hamper the achievement of food security targets.

Recommendation

The government may wish to consider that overly limiting foreign ownership in agriculture can hinder investment. The government could gain more benefits from foreign companies by requiring them to conduct research in Indonesia to promote transfer of technology for the benefit of the domestic economy as well as to empower local small agricultural businesses. In addition, limitations on foreign ownership should not be made retroactive.
6. FINANCIAL SECTOR
The Indonesian financial sector is relatively small compared with other countries in the region. Long-term financing is limited and institutional investors have not yet become a major source of capital. Indonesia opened up to foreign banks when the sector collapsed during the Asian Financial Crisis, allowing foreign ownership of up to 99 percent of local banks. Policies to ensure a level playing field for banks regardless of ownership structure should be maintained. The government also has taken several steps to improve the performance of the financial sector. Among others are the independence of Bank Indonesia and the establishment in 2013 of an independent Financial Services Authority (OJK) that took over monitoring and supervision of banks from Bank Indonesia (BI) in 2014. The new regulatory framework is amenable to a banking sector where loan penetration is relatively low and there is room for expansion. State banks and small private banks also remain sensitive to credit risk.
Challenge 1: Potential limitations on foreign ownership in insurance

Insurance is the second largest financial sector after banking. Current regulations limit foreign ownership in insurance to 80 percent, which is much higher than other countries in the region. A new Insurance Law was passed by the DPR recently that does not specify foreign ownership limitations. Implementing regulations will need to be passed that potentially could limit foreign ownership significantly. With the insurance penetration rate still very low, foreign investors are eyeing Indonesia’s insurance market and overly limiting foreign ownership may make it difficult for Indonesia to take advantage of this opportunity.

Recommendation The government may wish to assess foreign ownership limits in insurance to reshape implementation guidelines. The level of ownership should ensure the attractiveness of the insurance industry for foreign companies.

Challenge 2: Benefits from fees paid to OJK

OJK relies on fees from financial companies to run its operations. If the fees received during the year exceed the OJK budget for the next fiscal year, the excess is remitted to the state treasury or the Ministry of Finance. Unfortunately, there is a lack of clarity on the budget allocation restrictions. From the stakeholders’ perspective, the fee is seen as an additional tax burden.

The fee collection mechanism is also unclear. For instance, OJK has the right to reduce the fee to zero for a company in financial difficulty but there is no clarity on what is meant by “financial difficulty,” which may create accountability issues for OJK.

There is also concern about what companies will get in return for the fee. While it funds OJK the law does not explain the benefits given to companies. If companies see the fee simply as a new tax burden, the cost will go to consumers. The lack of clarity on exemptions and the proper use of the fee revenue could create future governance and accountability problems.

Recommendation OJK should restrict the fee to specific OJK activities and add more clarity on the benefits that stakeholders will get in return. Stakeholder concerns need to be addressed early in the game to create a win-win situation.

Challenge 3: Expediting the single identity system

Businesses depend on credit from banks and financial institutions for funding to drive expansion and growth. Banks and financial institutions, on the other hand, need reliable credit information to assess the credit worthiness of businesses and individuals before making loans. At the heart of this is a reliable system to support proof of identity.

Banks and financial institutions, on the other hand, need reliable credit information to assess the credit worthiness of businesses and individuals before making loans. At the heart of this is a reliable system to support proof of identity. The e-KTP initiative is a step in the right direction. Incorporating a microchip with biometric information, it will serve as proof of identity. Ideally it should also be enabled to “receive” cash and handle electronic payments. For the financially excluded and under-served, credit worthiness based on transaction pattern and history could potentially be established by banks and financial institutions. Therefore, a payments-enabled e-KTP not only contributes to financial inclusion objectives but will also result in increased efficiency in government disbursements.

Recommendation The new government could make the e-KTP initiative a policy priority and expand the system to include government disbursements and electronic payments.