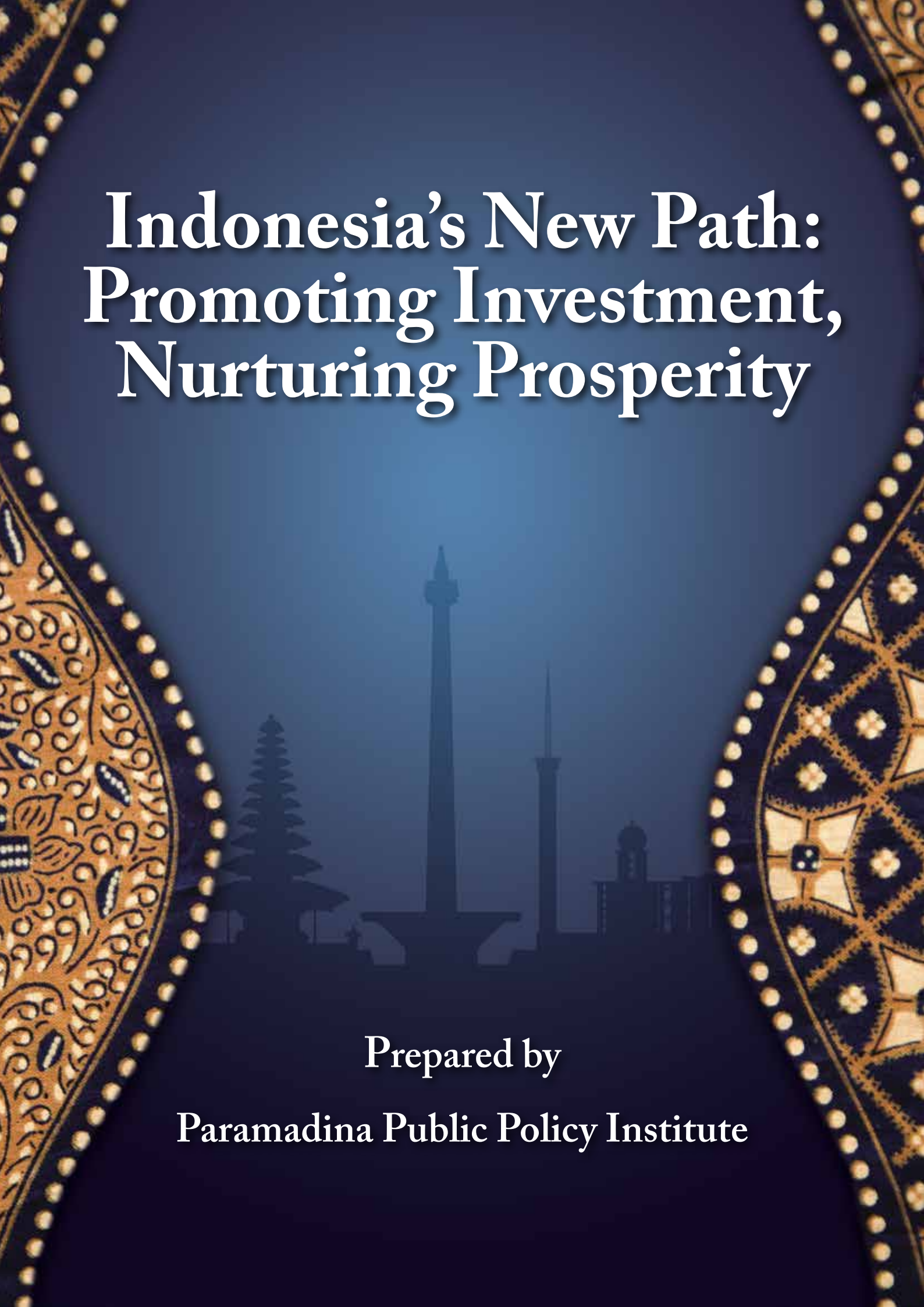
Indonesia's New Path: Promoting Investment, Nurturing Prosperity



Prepared by

Paramadina Public Policy Institute

U.S. CHAMBER OF COMMERCE
International Affairs

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 550 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.

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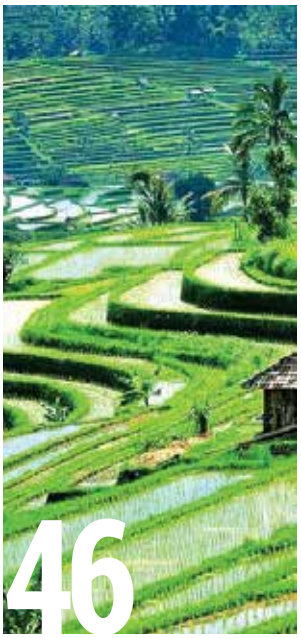
SECTORAL RECOMMENDATIONS



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.

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.

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.

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 sky rocketing. 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.

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

Recommendation Review relevant cost recovery regulations and procedures to avoid loop holes 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.

Sector-Specific Recommendations

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.

The extractive industry operates under numerous regulations issued by many local and national agencies.

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.

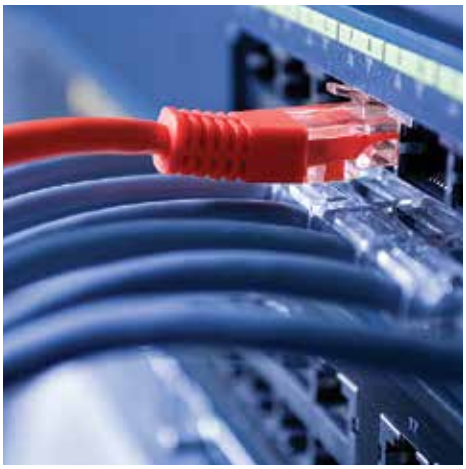
Recommendation The proposed regulation would be more effective if it described hazardous and toxic material clearly to avoid multiple interpretations that could criminalize corporate policy. The government may follow in the footsteps of other countries that have already been through the process of drafting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

Sector-Specific Recommendations

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.

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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.

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 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.

Sector-Specific Recommendations

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.

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.

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.

Sector-Specific Recommendations

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.

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.

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. 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.

The Report in Full

OVERVIEW

Cross-border flows of goods, capital, labor and ideas are the key features of globalization. With the help of technological advances, cross-border flows have become less expensive and more efficient, making globalization move faster. In this context, Foreign Direct Investment (FDI) plays a unique role. It is the melting pot of highly mobile goods, capital, labor and ideas. Consequently, the more globalized the world becomes the more important the role of FDI will be.

Some studies, including our previous study, "Partners in Prosperity: US Investment in Indonesia," conclude that FDI brings significant benefits both for corporations and investment-destination countries. FDI promotes job creation, skill and technology transfers, and increased tax revenue. In addition, FDI provides access to global markets, capital and talent. Failing to take full advantage of FDI potentially makes an economy less connected, dynamic and prosperous.

Countries in the Asia-Pacific region such as China, South Korea, Taiwan, Singapore and Malaysia, have been quite successful in taking advantage of FDI. It helps these open economies move up the global supply chain. In addition, inward FDI also stimulates outward FDI to neighboring countries, which improves overall economic dynamism and efficiency.

The Trend

Most countries, advanced and emerging alike, believe in the potential that FDI brings. As a result, for more than a decade, most countries have moved toward FDI-friendly policies. In 2013, approximately 73 percent of FDI-related policies that have been issued by countries globally have leaned toward more FDI promotion and liberalization; only 27 percent of countries have moved in the opposite direction by introducing more restrictive policies. This trend has been consistent since 2000.[1]

More than at any time in the recent past, investment, including FDI, is the focus of considerable attention from the Indonesian government. In the past, FDI was considered of marginal benefit to the country; it was good to have but not critical. Nowadays, FDI is considered a crucial stimulus for economic growth. This mindset change has been largely triggered by the massive growth of FDI moving into Indonesia over the last few years. In 2004, FDI amounted to $1.9 billion. Since then, FDI has grown continuously and reached $23 billion in 2013.[2] What does $23 billion mean? It is equivalent to twice the size of inward FDI to Malaysia or to Thailand, and six times the size of FDI to the Philippines. Even though much lower than the inward FDI to China of $123 billion and Singapore's $63 billion, this is still a major achievement.[3]

The Indonesia Investment Coordinating Board (BKPM) is seeking to increase FDI inflows in 2015 while also attracting more high-quality FDI in some focused and specific sectors including:

1. Export-oriented sectors including electrical equipment, metal, paper and textiles;
2. Import substitution of capital goods and raw materials: machinery, iron and steel, automotive and spare parts, and basic chemicals;
3. Import substitution of consumer goods: food and beverages, home appliances and refined oil products;
4. Downstream industries in refined minerals, agriculture (palm oil, rubber, sugar and cocoa), fisheries and forestry, including furniture and pulp and paper;
5. Industrial sectors with an increasing domestic consumption trend: principally cement and building materials;
6. Infrastructure development in energy, ports, roads, water supply, waste management and railways, with growth focused on public-private partnerships (PPP); and,
7. Tourism and creative industries.

Recent developments have made the role of FDI in Indonesia even more strategic. After experiencing a significant economic boom from 2004 to 2010, Indonesia's econ-

1 World Investment Report 2014, United Nations Conference on Trade and Development (UNCTAD).

2 Indonesia Investment Coordinating Board, BKPM, 2014.

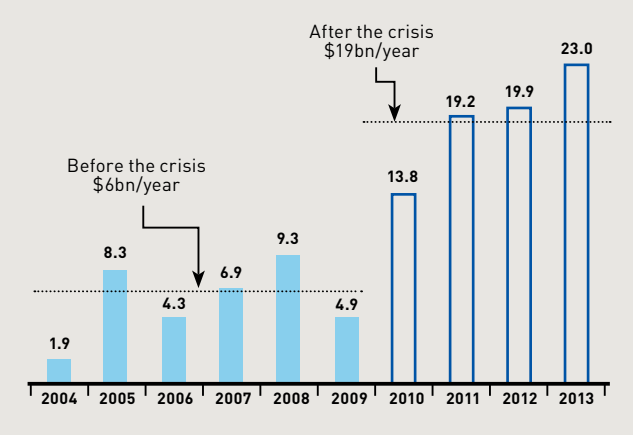
3 World Investment Report, 2014, UNCTAD.

omy has lost steam for a variety of reasons. A general decline in commodity prices, for example, has revealed Indonesia's economic weakness, which in the past was covered up by high commodity prices.

Commodities account for approximately 55 percent of Indonesia's exports. Four major commodities (coal, palm oil, oil and natural gas) represent close to 45 percent of total exports.[4] The decrease in global commodity prices and various other factors, have turned Indonesia's trade surplus into a deficit of $1.2 billion and $6.1 billion in 2012 and 2013, respectively, the first in several decades.[5] In parallel, the rupiah has lost 40 percent of its value over the past three years, the budget deficit has widened and the balance of payments has worsened. The economy is not in great shape although it is still far from entering a crisis. Nonetheless, given Indonesia's current stage of economic development, relying only on boosting consumption, government spending and exports to promote GDP growth is not realistic. Stimulating the economy with more investment, both domestic and foreign, is the most reliable option.

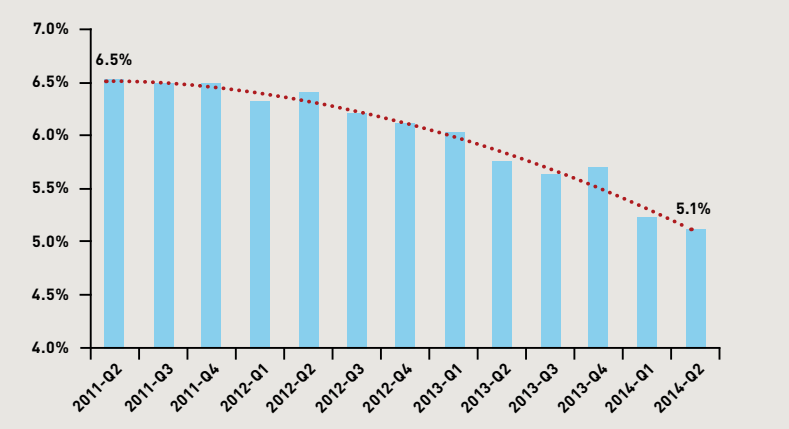
Commodities account for approximately 55 percent of Indonesia's exports. Four major commodities (coal, palm oil, oil and natural gas) represent close to 45 percent of total exports.

Figure 1: Inward FDI in Indonesia (In $ billion)



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

Figure 2: Quarterly GDP Growth



Source: Bank Indonesia 2014 & Author calculation

4 Bank Indonesia, 2014.
5 Central Statistics Agency (BPS), 2014.

JOKOWI-JK ACTION PLAN

The new government under the leadership of President Joko "Jokowi" Widodo and Vice President Jusuf "JK" Kalla has ambitious but hopefully realistic economic targets. Jokowi-JK aim to grow the economy at 7 percent and beyond, a target also set by the outgoing administration of President Susilo Bambang Yudhoyono, which was not met.[6] Higher economic growth is also needed to absorb the two million new job seekers who enter the job market every year.[7] Without vibrant investment, including FDI, the target will not be achieved and both unemployment and the poverty rate will potentially increase.

Jokowi-JK have stated that collaboration between government, state-owned enterprises and the private sector is the key to growing FDI and reducing unemployment, poverty and income inequality. The two leaders, who both have entrepreneurial backgrounds and reputations for "hands on" leadership, promise that the government will do whatever it takes to promote investment in crucial areas like infrastructure, education and health by the government, SOEs and the private sector.

The new leaders insist that creating an enabling environment for business to flourish is a top priority. This consists of several main points including improving the regulatory environment, promoting a better infrastructure and logistical system and improving human capital and labor productivity.

On numerous occasions, Jokowi-JK have stated that improving the ease of doing business in Indonesia is crucial. Jokowi has promised to promote a more efficient bureaucracy by introducing e-government and reducing inefficient face-to-face meetings. Another priority is simplifying overly complex investment-related regulations that have long been a concern to many investors by implementing a one-stop-shop approach and ensuring that business licenses are processed in less than 15 days. In regard to land acquisition, which has been a handicap for infrastructure development, the incoming administration is also intent on fully implementing Law 2/2012 concerning land acquisition for public projects. One hopeful sign is that during his tenure as governor of Jakarta, Jokowi had some success in helping major projects like the MRT to deal with land acquisition issues.

The new leadership team also understands that inefficient logistics have been a major handicap for Indonesia's competitiveness. Improving the transportation system is one of their priorities, as they envision reducing logistic costs by 5 percent per annum.[8] Among the major plans are creating a "sea toll," a regular and efficient maritime transportation network to connect Indonesia's five major islands; building a double-track railway system on major islands, including Sumatra and Sulawesi; and improving highway networks on major islands.

The new government has also made electricity capacity development a priority. There are plans to build 10,000 MW of electricity generating power every 3 years to catch up with rising demand. Energy sources will be diversified, using coal, hydro, gas and geothermal.

To promote better quality human capital, the new government will make 12 years of education compulsory for all Indonesians by providing free education from elementary school through high school. For those already entering the job market, the government plans to create 100 techno-parks in various cities to train and educate workers to improve their productivity.

In health, the new government will promote the newly established universal healthcare service, BPJS. Under this system, all Indonesians will have affordable and accessible health care; for the poor, health care can be accessed for free. In order to support these initiatives, the new government is committed to allocating 20 percent and 5 percent of the state budget for education and health, respectively.

6 During the late President Suharto's 32-year reign, Indonesia's economy grew at an average rate of 7.3 percent per annum.
7 Ikhsan Muhamad, "The Role of a Flexible Labor Market to Address Unemployment," ("Peran Pasar Tenaga Kerja yang Fleksibel Dalam Mengatasi Pengangguran"), Institute for Economic and Social Research (LPEM), University of Indonesia, 2005.

8 Currently, Indonesia spends 27 percent of GDP on logistic costs, the highest in the region. It is projected that by 2019, logistic cost will be reduced to 20.8 percent of GDP, on a par with Thailand currently.

Maintaining Investor Confidence

FDI, as opposed to international trade and portfolio investment, is a long-term commitment with enduring benefits for the country and its people through human resource development, technology transfer and contributions to government revenues. Making that commitment requires investor confidence in a given country. The more predictable the future of a sector, the more confident investors in that sector will be. Unfortunately, while Indonesia's potential remains high, the investment climate is far from ideal. Investor confidence in Indonesia has deteriorated in some sectors over the past few years due to regulatory challenges and other uncertainties. It is a discouraging reality but also an opportunity for dramatic improvement as a new government comes into office.

The new leadership team also understands that inefficient logistics have been a major handicap for Indonesia's competitiveness.

Looking at recent results for the AT Kearney Foreign Direct Investment Confidence Index provides some insight into how global investors rank FDI destination countries. In 2010, Indonesia ranked No. 20 among 25 FDI destinations in the survey; by 2012, Indonesia's position had improved significantly to No. 9, a huge jump. Unfortunately, various issues, including several legal cases involving international investors between 2012 and 2014, negatively impacted Indonesia's position. By 2013, Indonesia had slipped to No. 24 out of 25 countries in the survey; in 2014, Indonesia was last at No. 25.[9] In the same period, other countries in the region improved their ranking in the survey, including Malaysia (No. 15) and Singapore (No. 9).

9 Ready for Takeoff, AT Kearney Foreign Direct Investment Confidence Index, 2014.

Among the cases casting a shadow over the investment climate are criminal prosecutions over civil disputes, including the Chevron bioremediation corruption case,[10] which has become a topic of international discussion and concern among current and potential investors. The recent uncertainty in regard to mineral processing and exports has also heightened investor concerns.[11]

Urgent Task

The rise in investor uncertainty has occurred at a time when Indonesia most needs additional investment to stimulate the economy. While FDI has grown over the last four years, it is likely to slow sharply in the near future if there is no significant improvement in the investment climate. The concern is on the sustainability of future growth. A time lag exists between investor awareness, investor decisions and investment realization. In short, investment that occurred in 2013 was likely the result of investment decisions taken several years previously.[12] In other words, inward FDI in 2013 was a reflection of previous investor confidence in Indonesia. It is very likely that Indonesia's decline in the Kearney Confidence Index in 2014 will be reflected in slower FDI inflow in 2015 and beyond.

The global economy has recovered from the 2008 crisis. Global GDP growth has returned to a normal rate of approximately 4 percent per annum. On the one hand, stronger global growth benefits Indonesia from an international trade perspective. Conversely, from an FDI perspective, global strengthening creates additional FDI competition for Indonesia.

The global FDI market is highly competitive, and this benefits investors who have many alternative countries to invest in. It is a buyers' market, and countries compete for FDI, especially the high-quality FDI that provides added-value to host economies. This makes the task of the new government to improve investor confident more urgent and important.

10 http://www.thejakartapost.com/news/2013/08/06/criminalization-oil-and-gas-sector-a-nightmare-investors.html
11 http://www.thejakartapost.com/news/2013/06/17/legal-uncertainty-remains-big-problem-ri-mining-sector.html
12 Source: interviews with foreign companies participating in this study. They cite a time lag of two to five years for investment decisions to be realized.

Sectors in which the government determines'winners' and 'losers' tend to face greater policy challenges and uncertainty.

The Context

In 2013, AmCham Indonesia and the U.S. Chamber of Commerce, with the help of Paramadina Public Policy Institute (PPPI), Gadjah Mada University (UGM) and Ernst & Young (EY) wrote a comprehensive report titled "Partners in Prosperity: US Investment in Indonesia." The 160 page report clearly demonstrated the role that FDI overall, and US FDI in particular, has played, and will continue to play, in Indonesia's economy.

As our 2013 report highlighted, US companies are among the largest – if not the largest – FDI investors in Indonesia. Taking into account FDI in oil and gas, capital injection in the financial sector, retained earnings, M&A transactions and FDI channeled through other countries (such as Singapore), US companies' investment in Indonesia amounted to $65 billion from 2004 to 2012. Even more important, US companies stand ready to pour another $61 billion of new FDI into Indonesia in the next five years – provided that the investment environment is welcoming.

In our 2013 report, US investors listed three major constraints to future investment: (1) regulatory uncertainty and inapplicability of regulations, (2) lack of efficient and reliable infrastructure, and (3) lack of quality human capital, especially for technical and managerial positions. The government must urgently tackle these constraints to unlock future FDI.

In order to build on the 2013 report, the Indonesia Investment Coordinating Board (BKPM) requested that AmCham and the U.S. Chamber prepare policy recommendations with the ultimate goal of improving the business environment and encouraging more investment. AmCham and the U.S. Chamber, in collaboration with the Indonesian Chamber of Commerce (Kadin), The Indonesian Employers Association (Apindo) and with the support of PPPI, have prepared a set of cross-sector and sector-specific policy recommendations. These policy recommendations outline important policy changes major investors feel the government may want to consider. Some recommendations are self-explanatory and straightforward. Others need further analysis to promote applicability and reliability. Implementing these recommendations, we believe, will encourage US and other foreign companies to invest in Indonesia, and help Indonesia to realize its economic growth targets.

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POLICY RECOMMENDATIONS

Ideal policy recommendations are those that are clear, measurable and applicable. They should not be too general or too narrow. The recommendations in this report are based on comprehensive interviews with investors who are active in Indonesia. They represent not hard-and-fast prescriptions or demands but a continuing dialogue in which both sides – the government of Indonesia and foreign investors – share the common goal of seeing Indonesia and its people enjoy greater prosperity.

The sector-specific policy recommendations tackle six areas: oil and gas, extractive, information technology, consumer goods and health care, agriculture and financial services. In addition to the above sectors, we begin with several cross-sector policy recommendations that have an impact on the overall business environment.

Each sector, of course, contends with a different set of 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 competition. In short, sectors in which the government determines "winners" and "losers" tend to face greater policy challenges and 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 relatively less problematic.

Interviews with senior executives of multinational companies, and discussions with experts and policy makers were conducted as the basis for this report's recommendations. The in-depth interviews and discussions yielded a long list of issues that investors would like to discuss with the Indonesian government. However, in preparing this report, we sought to focus only on the three to four most immediately critical issues per sector. To ensure the applicability of the policy recommendations, several focus group discussions involving BKPM, business associations and senior executives were held to ensure the accuracy and applicability of the recommendations.

Figure 3: Map of the Report

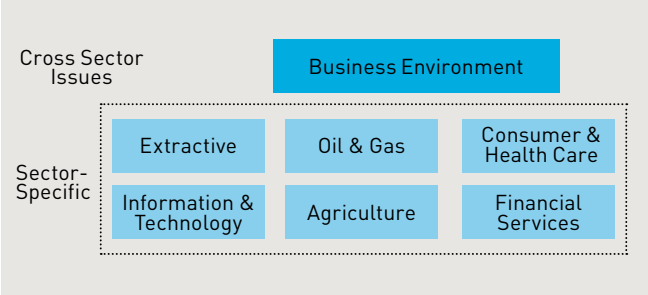
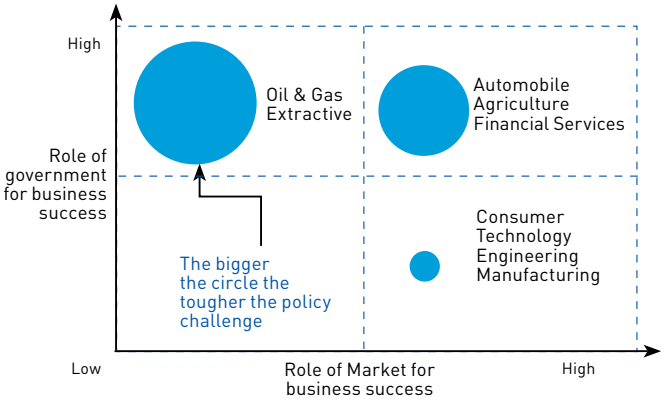


Figure 4: Government, Market & Policy Challenge



The recommendations in this report are based on comprehensive interviews with investors who are active in Indonesia.

BUSINESS ENVIRONMENT
Cross-Sector Recommendations

Our 2013 report "Partners in Prosperity: US Investment in Indonesia" showed that Indonesia presents great opportunities but that doing business in Indonesia is sometimes not easy. The challenges include slow bureaucracy, corruption and complicated, frequently changing regulations. Our findings are in line with the Global Competitiveness Report 2013-2014 issued by the World Economic Forum, which placed corruption and inefficient bureaucracy as the top handicaps for doing business in Indonesia. The ASEAN Business Outlook Survey 2014 listed Indonesia as the most attractive country for new business expansion in the region, followed by Vietnam, Thailand, and Myanmar. However, corruption was identified as the greatest drawback in Indonesia. Other significant challenges include moving products through customs, insufficient infrastructure and problematic laws and regulations.

This report also mirrors some of the key findings in the World Bank's Ease of Doing Business Index 2014. The index ranks Indonesia No. 120 out of 189 countries surveyed. Indonesia's ranking is far below neighboring countries including Singapore (No. 1), Malaysia (No. 6), Thailand (No. 16) and Vietnam (No. 99).[13] In the World Bank Index, Indonesia scores relatively well in protecting investors (No. 52) and trading across borders (No. 54); its major weaknesses are complicated procedures to start a business, pay taxes and resolve insolvency.

13 Doing Business, 2014, World Bank Group, http://www.doingbusiness.org/rankings.

In its current position, Indonesia ranks in the same league as Pakistan and India. It is below neighboring countries like China, Vietnam and the Philippines, and much lower than Singapore, Malaysia and Thailand. From 2006 to 2014, Indonesia's position decreased while other countries in the region, such as Malaysia and the Philippines, made significant progress.

The government is making efforts to improve the situation. For example, BKPM, with support from the World Bank, is in the process of implementing a single window policy to streamline business-licensing procedures and to optimize the use of technology to minimize person-to-person meetings. The Directorate General of Taxes is conducting various programs to simplify tax payment procedures and promote transparency.

Despite these laudable and serious efforts, Indonesia still has plenty of work to do. Promoting a sound business environment requires support from a broad range of national government and regional government agencies; coordination is a tough issue, especially in a democratic and decentralized Indonesia.

Figure 5: Ease of Doing Business Ranking (2006-2014)

Country	2006	2010	2014
Singapore	1	1	1
Malaysia	17	23	6
Thailand	23	12	18
China	89	89	96
Vietnam	75	93	99
Philippines	113	144	108
Pakistan	61	85	110
Indonesia	114	122	120
India	116	133	134

Source: The World Bank Group

CHALLENGE 1: LACK OF REGULATORY CONSULTATION

Lack of policy applicability and abrupt changes in policy are two major shortfalls in Indonesia's public policy. There is a consistent lack of consultation between the government and business community in the policy making process. This lack of government consultation is in contradiction to Law 10/2004 on the Formation of Regulations, article 53, which states that the community is entitled to provide oral or written input into draft laws and regulations. Law 12/2011 on the Formation of Regulations, amended Law 10/2004, article 96, and expanded the society or community's rights to provide input into draft laws with an emphasis on factoring these inputs into the final laws. However, the reality is that one-way policy

Lack of Regulatory Consultation

Challenge	Impact	Recommendation
Lack of consultation between the government, the business community and other stakeholders in designing policy.	Inapplicable and abrupt changes in policy that create business uncertainty.	. Greater government consultation with the business community and other stakeholders as an integral part of the policy making process; . Open and transparent discussion at the draft regulation stage with affected constituents, based on reliable data and study; . Improve government and business community capacity to design policy through active partnerships with think-tanks and universities.

socialization by the government to the community is the most that can be expected currently before policy ratification.

Policies that cannot practically be implemented or which abruptly change existing rules can be counter-productive to economic development and investment. One example that highlights the lack of consultation is the mining export tax related to Mining and Coal Law 4/2009. From a business community perspective, key aspects of the Law concerning domestic processing for all types of minerals within four years were unrealistic and also unnecessary for certain minerals such as copper. Following the issuance of the Law, the government changed the implementing regulation several times, causing further uncertainty. The government issued Ministry of Finance (MoF) Regulation 6/2014 that allowed companies to export raw materials, but with an extremely high export tax rate of 20 percent, to be raised to 60 percent by 2016. Then, the Government issued another revision, MoF Regulation 153/2014, in which mineral producers are allowed to export raw materials with an export tax of 7.5 percent. Had the Government consulted with key stakeholders while the law and regulations were being drafted, inapplicable policy and the series of abrupt regulatory changes could have been avoided.

By mandating increased domestic value-added processing, the government meant to improve the potential of the industry to create wealth in the country. However laudable the goal, the impact of this rule on investor confidence may have adverse effects on what is one of Indonesia's key export sectors. The industry looked at the new export requirements as going too far, too fast and the consequences of compliance could end up damaging the mining sector more than it helps.

Another example of the lack of stakeholder consultation is Government Regulation (GR) 81/2012 on mandatory extended producer responsibility. This policy requires consumer goods companies to recycle and reuse waste as mandated by Law 32/2009 on Management and Safety of the Environment. Unfortunately, public consultation for GR 81/2012 involved primarily distributing the draft without proper discussion with the business community.

Impact

Frequent, unexpected changes in regulations create unnecessary uncertainty, which negatively impacts the business environment in Indonesia.

Recommendation

We recommend that the government consider consultation with the business community and other stakeholders as an integral part of the policy making process. Consultation should be a required step in designing new policy as well as when the government is reviewing or amending existing policies. Open and transparent discussion, based on reliable data and study, needs to be promoted. The government and the business community need to further equip themselves with the capacity to design effective policy by involving think-tanks or universities in the process.

Figure 6: Mineral Processing and Uncertainty

Law	Government Regulation	Ministry of Energy Decree	Ministry of Finance Decree	Ministry of Finance Decree
4/2009 Prioritizes domestic needs for coal and minerals by mandating value added processes.	**1/2014** Obliges smelting of minerals to be done in Indonesia.	**1/2014** Mandates value-added processing of minerals through industrial refining.	**6/2014** Imposes export tax on raw minerals that will eventually reach 60 percent in 2016.	**153/2014** Allows the export of raw minerals with an export tax of 7.5 percent as long as companies have concrete plans to build smelters.

Policy changes, in part due to policy inapplicability, create business uncertainty. If the government would involve the business community in designing policy, abrupt changes would be avoided.

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 in Indonesia. The lack of infrastructure development has caused logistical costs in Indonesia to be the highest in the region. By 2013, logistic costs represented 27 percent of GDP, much higher than in Thailand (20 percent), China (15 percent), Malaysia (13 percent) and Singapore (8 percent). [14] High logistic costs negatively impact the cost of production, and handicap Indonesia's ability to compete in the global market.

One example of land acquisition problems relates to the development of Jakarta's Outer Ring Road. This strategic toll road, which was long planned as a crucial link in reducing Jakarta's traffic congestion, had been delayed for 15 years due to the government's inability to acquire the necessary land. The delay, which created a huge opportunity cost for Jakarta's economy, was mainly caused by 153 families that rejected the government's proposal to acquire 2.8 hectares of land, effectively blocking the toll road development. Finally, then-Jakarta Governor Joko Widodo directed negotiations, the dispute was resolved and the road opened in July 2014.

Another example is the Batang PLTU power generation project in Central Java, which is targeted to produce 2,000 MW of much-needed electricity. This project has been delayed by almost three years due to a land acquisition problem. Although the investor has secured approximately 85 percent of the 250 hectares of land needed for the project, a few land owners have rejected offers to sell their land, blocking completion of the $2 billion project, which could play an important role in improving the country's electricity supply.

The aforementioned projects are only two examples of a long list of land acquisition problems in Indonesia. In response to the issue, the legislature ratified Law 2/2012 regarding Land Procurement for Development Purposes in the Public Interest, followed by the issuance of Presidential Regulation (PR) 71/2012 concerning the Administration of Land Procurement for Development Purposes in the Public Interest and National Land Authority (BPN) Regulation 5/2012 providing technical implementation guidelines and rules.

14 World Bank: Logistics Costs Reduce Economic Potential of Indonesia, http://www.indonesia-investments.com/

Land Acquisition for Infrastructure

Challenge	Impact	Recommendation
Despite the ratification of a law and regulation concerning land acquisition for public projects, the policy has not been fully implemented.	Delaying various strategic infrastructure and public-works projects.	▪ The government needs to build awareness among the business community and the general public about Law 2/2012, PR 71/2012, and BPN Regulation 5/2012; ▪ The government ensures the regulation is practically implemented by reviewing and incorporating best practices from successful projects; ▪ Strategic projects such as the PLTU power plant in Batang, Central Java and the Jakarta MRT, should be considered showcases for best practices on land acquisition.

Figure 7: Land Acquisition Process

Design Stage	Preparation Stage	Execution Stage
Parties that require land prepare a land acquisition plan in accordance with the regional land usage plan (RUTR) and development priorities stipulated in the mid-term strategic development plan of the institution.	Parties that require land, together with the provincial government, should: ▪ Announce the development plan to the public; ▪ Document the location of the development; ▪ Conduct public consultations. The entire process, including any legal dispute, should be finished within **238 working days**.	This consists of: ▪ Documenting the ownership, size and proposed use of land; ▪ Public consultations to determine the land price; ▪ Transfer of payment; ▪ Transfer of land. The entire process, including any possible legal dispute, should be finished within **190 working days**.

Under Law 2/2012, public interest is defined as the interest of the country, the nation and the public that should be prioritized by the government. The Law also defines a public development project as consisting of the following: (1) national security and defense; (2) public roads, toll roads, tunnels, railways, railway stations and railway facilities; (3) dams, irrigation projects, waste tunnels and sanitation; (4) ports, airports and terminals; (5) gas, oil and geothermal infrastructure; (6) power generation, electricity transmission, grid and distribution networks; (7) telecommunication networks; (8) public waste processing facilities; (9) public hospitals, (10) public security facilities; (11)

public cemeteries; (12) public social facilities and green spaces/parks; (13) historical sites, (14) housing for poor families; (15) schools and public education facilities; (16) public sports facilities; and, (17) public markets and parking facilities. The range of public interest projects is quite wide and should provide the flexibility needed to encourage infrastructure investment in Indonesia.

The rule clarifies the timing of the process and sets out clear procedures. It also enables the buyer and seller to meet and discuss price. If the parties cannot agree on the land price, then each party will appoint appraisers. These professionals then meet to discuss the price, and if they cannot agree, the court will determine a fair price. According to the regulation, land acquisition should be completed within 428 working days, including if there is any legal dispute.

The regulation provides certainty in the land acquisition process, and at the same time it provides the opportunity for landowners to receive fair payment. If it is implemented properly and transparently, it could potentially eliminate the role of rent seekers who try to profit from the process and unnecessarily make the acquisition process complicated and lengthy. The regulation has been utilized in some projects, including the South Sumatra Toll Road. Lessons from successful projects need to be effectively incorporated in other high profile projects as best practices.

Impact

The lack of effective implementation of the Land Law has delayed strategic projects in critical areas including transportation, electricity, geothermal, oil, gas, ports and agriculture.

Recommendation

The government should build awareness among the business community and the general public about Law 2/2012, PR 71/2012 and BPN Regulation 5/2012. The government should ensure that best practices from successfully completed projects are used as standard procedure for future development projects.

The problem with land acquisition is not so much with the law and regulations but rather with their effective implementation. 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

Labor wages are a sensitive issue in every country, including Indonesia. For US companies operating in Indonesia, minimum wages are not usually an issue since on average American companies pay significantly above the minimum wage. However, as this issue has a serious impact on the overall economy, US companies face an indirect impact through overall business uncertainty.

According to Labor Law 13/2003, minimum wages are to be determined by tri-partite meetings held every year between provincial governments, labor associations and the Employers Association. The minimum wage is to be considered against the cost of living (Kebutuhan Hidup Layak - KHL) as a reference. Currently, the regional minimum wage (UMP) is significantly below the cost of living. However, the UMP is to be adjusted to meet the KHL gradually over time. Indonesia does not wish to compete primarily as a "cheap labor" country so wages need to be increased but this should be determined by various factors including economic growth, inflation and labor productivity.

Ministry of Manpower and Transmigration (MoMT) Decree 7/2013 determined that the tri-partite meeting be held every year. But often during the time of the tri-partite meetings, labor unions stage protests and strikes as a means of bypassing the tri-partite negotiations. Such actions cause uncertainty among the business and investment community. Un-

Setting minimum wages

Challenge	Impact	Recommendation
The timing of tripartite wage negotiations leads to labor protests and abrupt raises in the minimum wage.	Creating business uncertainty and hindering employment.	Change tri-partite wage talks from annually to once every three years with increases based on an agreed formula in order to promote certainty for both labor and employers.

fortunately, many regional governments have the tendency to give in to such pressures. Such reactive responses are taken without factoring in other variables, such as labor productivity and the capability of employers, especially small and medium enterprises, to absorb the wage increases.

Although staged labor demonstrations that short-circuit the established tri-partite negotiating process may result in higher wages for employed union workers in the short-term, over the longer term it will constrain the hiring of new employees and contribute to unemployment. Companies that would otherwise hire more employees will shift labor-related expenditures toward capital-intensive investment requiring fewer employees or will hire labor through third parties under outsourcing schemes.

The decrease in labor creation in relation to GDP growth in recent years is a clear indication that abrupt increases in wages are causing a shift in industry away from hiring more employees. In short, the situation will tend to benefit those who already have jobs, but not job seekers, including young school graduates just entering the job market.

Impact

Labor protests and strikes, timed to coincide with tri-partite labor negotiations, are common in Indonesia. This planned unrest not only disrupts normal business operations but it also promotes greater business uncertainty, which is a hindrance to attracting more FDI, especially in labor-intensive manufacturing industries. These actions are not in line with government ambitions to create at least 3 million new jobs per annum to reduce unemployment and poverty.

Recommendation

To reduce business uncertainty due to labor unrest, we recommend revising MoMT Decree 7/2013 by requiring tri-partite negotiations to take place once every three years instead of annually. At the tri-partite meeting, parties can determine the minimum wage increase for a three-year period based on an agreed formula and mutually beneficial negotiations. In addition, increases should be clearly linked to improvements in labor productivity. In this context, the government and employers have the responsibility to improve labor productivity. The government should also consider introducing more attractive incentives for the private sector to increase labor productivity.

Redundant permit processes

Challenge	Impact	Recommendation
Numerous and repetitive documents are needed to secure an Import Permit (PI).	Delays in the application process mean additional warehousing and holding costs. In the end, customers bear the burden of unnecessary costs.	Allow the digital submission of documents for each importer to maintain basic information in a docket. Eventually, a fully integrated on-line system can link ministries and permit applicants.

CHALLENGE 4: REDUNDANT PERMIT PROCESSES

There are numerous documents needed each time an Import Permit (PI) application is made. Some of these documents remain the same from application to application. For example, the appointment letter from the principle holder of the overseas brand. Each additional document entails additional time for review and processing of each application. The maximum permitted time that the Ministry of Trade (MoT) has for granting a PI is five working days but companies often encounter administrative delays (e.g., the absence of suitably appointed signatories from MoT to sign and issue the PI).

Impact

The delay in the PI permit process adds costs for companies, especially in terms of financing and logistics. Consumers eventually pay for the additional cost.

Recommendation

We recommend that the MoT improve the PI process by using an on-line system integrated with the Ministry of Industry (MoI) system. In the short term, before an on-line system is in place, we recommend that the MoT authorize the digital submission of documents and maintain a folio/docket for each importer that stores all the basic information and documents for the importer.

SECTOR-SPECIFIC RECOMMENDATIONS

1. OIL & GAS

Indonesia's oil and gas investment climate is highly unpredictable, with frequent changes occurring in exploration and exploitation policy. Oil and gas investment rules cannot be divorced from rules that apply to other sectors, as this creates burdens on producers to the serious detriment of investment in the sector and by extension to the Indonesian economy as a whole.

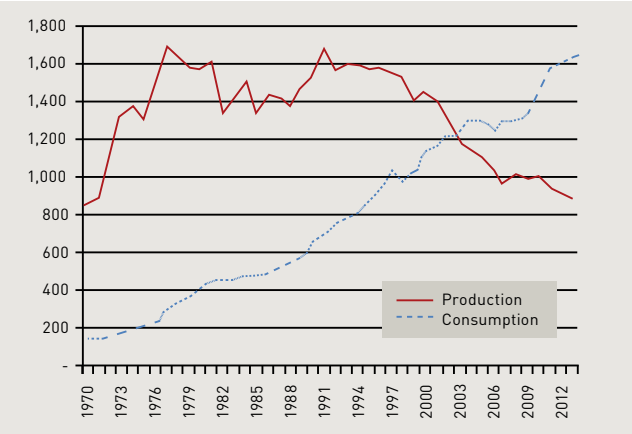
There are numerous policies, involving multiple stakeholders, that affect oil and gas investment activities including those that pertain to budget, taxes, implementation of contracts, labor, land and permit services.

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 has grown dramatically. 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 investment has two main characteristics: It requires huge investment both at the exploration and the exploitation stage and the investments have a very long-term payback period. In this regard, certainty is of critical importance for oil and gas investors.

The increasing lack of policy and regulatory certainty is discouraging investment in what is already a declining industry. Investors focus their attention on four issues within the scope of these basic points: First, multiple and conflicting interpretations of rules governing cost recovery, one example of which led to the case of Chevron facing criminal penalties in a civil dispute; second, government willingness to abide by the principle of binding Production Sharing Contracts (PSCs); third, the conflicting role of SKK Migas as both a regulator and a business counterpart of PSC holders; and, fourth, given that most current PSCs will expire in the next five years, any future significant capital investment will be contingent on the government's willingness to negotiate PSC extensions in short order and in good faith.

Figure 8: Oil Production & Consumption (Thousands of barrels per day)



Source: British Petroleum, Statistical Review of World Energy, 2014.

CHALLENGE 1: CONFUSION AND CRIMINALIZATION OVER COST RECOVERY

Cost recovery as part of a standard Production Sharing Contract is a mechanism between the government and oil and gas investors to repay costs associated with exploration. The state is responsible for the costs under the PSC but the 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. The principle difficulty comes when disputes arising from PSC project implementation are handled

Confusion and criminalization over cost recovery

Challenge	Impact	Recommendation
Multiple interpretations of cost recovery contracts among stakeholders.	Potential criminalization of PSC contractors.	▪ Avoid differing interpretations of cost recovery agreements. This should include a commitment to settle disputes under the terms of the PSC, which is based on civil law principles. ▪ Improve the monitoring process from project planning to implementation. ▪ Improve the business process at each of three critical stages: (1) pre-audit stage: (2) current audit, and (3) post audit.

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 despite both the previous regulator BPMIGAS and the Ministry of Environment saying no rules had been broken.[15]

Impact

Cost recovery rules that leave room for differing interpretations both in terms of philosophy and technicality may result in contradictory views among stakeholders. These varying interpretations relate to aspects of policy, the instrument for granting and refusing cost recovery and supervision.

Recommendation

Review relevant cost recovery regulations and procedures to avoid loop holes 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.

In addition, improve the monitoring process from project planning to implementation, as stipulated in the Authorization for Expenditure (AFE), to minimize legal issues during three stages:

- Pre-audit, consisting of the Plan of Development that determines the long term plan of a PSC contractor;
- Current audit, consisting of the preparation of the work plan and annual budget under the PSC;
- Post audit, following project completion.

15 The relevant laws and regulations concerning this issue are: Law 22/2001 on Oil and Gas; GR 79/2010 on Refundable Operating Costs and Income Tax Treatment in the Upstream Oil and Gas Industry; Ministry of Energy and Mineral Resources Regulation 22/2008 on Costs of Upstream Oil and Gas Activities that are not Restorable to PSC Contractors; Law 17/2003 on State Finance, article 11, paragraph (2), which states that the state budget is made up of the revenue, expenditure and financing budgets; and Law 1/2004 on the State Treasury: article 1, paragraph (22) on state losses as a result of conduct against the law; and article 41, paragraph (4) on investment management.

CHALLENGE 2: LEGALLY BINDING PRODUCTION SHARING CONTRACTS

Legal certainty and contract sanctity are two critical requirements for oil and gas investors. Adherence to the sanctity of contracts provides baseline certainty that promotes long-term investment.

The issuance of a number of regulations that threaten the principle of contract sanctity is a major concern for investors. One of these is GR 79/2010 on Refundable Operating Costs and Income Tax Treatment in the Upstream Oil and Gas Industry that presents the potential retroactive application of new regulations to existing contracts, meaning that contracts can be changed unilaterally. This is against the principle of binding contracts whereby all parties have to fulfill their agreements.[16] The binding power of a contract is clearly recognized in the Indonesian Civil Law Code (KUHPerdata), which states that all agreements legally made in accordance with existing law are binding.[17]

Legally binding Production Sharing Contracts

Challenge	Impact	Recommendation
The government often issues new policies that retroactively impact oil and gas operations.	Retroactivity creates uncertainty among oil and gas players and it makes investing in Indonesia less attractive relative to other countries.	New policies should not impact contracts that have already been signed by the government and PSC holders without mutual consent.

Impact

If the provisions of GR 79/2010 are retroactively enacted, the government may unilaterally amend contracts signed prior to the regulation being enacted. This will raise the risk of doing business in the sector, which will impact investors' desire to invest in the future.

Recommendation

Revise the retroactive provisions in GR 79/2010. Emphasize the fact that the government and the investor are in a parallel position and that the contract is regarded as binding and has to be upheld until the contract ends.

16 GR 79/2010, article 38 (a) states that contracts made prior to this regulation must remain in force until they expire. However, article 38(b) lists a number of transitional provisions not specified in the contract that may have retroactive application.
17 Civil Law Code (KUHPerdata), article 1338, paragraph (1).

The conflicting Role of SKK Migas

Challenge	Impact	Recommendation
SKK Migas has a conflicting role. On the one hand, it is a regulatory body, and on the other hand, it is a counterpart for PSC contractors. In addition, it often involves itself in the day-to-day activities and responsibilities of contractors.	. SKK Migas's two-sided role means PSC holders are not operating on a level playing field; . SKK Migas focuses less on its main task of facilitating domestic exploration and production to the detriment of the industry.	. Revise PD 9/2013 to give SKK Migas more focus as a facilitator of upstream oil and gas business activities, and transfer its regulatory role to the energy ministry; . Ensure SKK Migas focuses on monitoring parameters of success rather than trying to manage the day-to-day activities of contractors.

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CHALLENGE 3: THE CONFLICTING ROLE OF SKK MIGAS

The Special Task Force for Upstream Oil and Gas Business Activities (SKK Migas) was established by the government under PD 9/2013, with the main task to oversee and execute the implementation of upstream oil and gas business activities based on PSCs. The role of SKK Migas is to facilitate the exploitation of oil and gas to optimize government revenue and to enhance the benefits for the people of Indonesia.

However, SKK Migas has a conflicting role. On the one hand, it is the counterpart of oil and gas PSC holders. On the other hand, it also plays the role of regulator. Often, SKK Migas is too involved in the day-to-day activities of oil and gas companies, such as expatriate hiring decisions and approval processes.

This current dual role creates a burden for SKK Migas to play its role optimally, and puts PSC contractors in an equally difficult situation with their day-to-day business activities being supervised by SKK Migas. This arrangement is a major handicap to creating a business environment that is optimal to encourage more FDI in the oil and gas sector.

Relevant regulations that need to be revised are: Law 22/2001, concerning oil and gas; GR 35/2004, concerning Upstream Business Activities in the Oil and Gas Sector and any relevant amendments; PD 95/2012, concerning Taking Over Duties, Functions, and Organization in the Implementation of the Upstream Oil and Gas Business; and, PD 9/2013, concerning Implementation of the Upstream Oil and Gas Business.

Impact

SKK Migas' conflicting role has made it more dominant than the PSC contractors. In short, the situation doesn't provide a level playing field for the parties involved.

In addition, SKK Migas's role as regulator is often more dominate than its role as a business counterpart. Consequently, it can have a negative impact on PSC contractors' operational activities and business performance, harming oil and gas production. This is not consistent with SKK Migas's assignment as stipulated in Law 22/2001, which is to increase government revenue from the oil and gas sector.

Recommendation

Revise PD 9/2013 to 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 regulations by transferring this role to the energy ministry.

Renewing Production Sharing Contracts

Challenge	Impact	Recommendation
23 major PSCs will expire from 2018 to 2021, and the government has not yet initiated discussions with PSC holders.	The uncertainty has potentially made contractors reluctant to invest, which could lead to a decrease in oil and gas production.	The government should decide how to proceed on the expiring contracts. The sooner the decision, the better to create business certainty in the oil and gas sector.

CHALLENGE 4: RENEWING PRODUCTION SHARING CONTRACTS

A long list of major PSC contracts between the government and contractors will expire within the next four to seven years. According to GR 35/2004, concerning upstream oil and gas business activities, contracts can be extended for a maximum of 20 years for each extension. Unfortunately, the government has not initiated discussions concerning the renewal or renegotiation of the contracts.

Currently, according to SKK Migas data, there are 23 contracts that will expire between 2018 and 2021. Foreign exploration and production companies are the primary participants in the oil and gas sector along with state-owned energy giant Pertamina and Medco Energi, the country's largest-listed oil company. [18]

Maturing production fields and declines in new exploration activity have contributed to the drop in oil production, which dipped to 942,000 bpd in 2011 and continues slipping to around 800,000 bpd currently. Because there is an increasing demand for crude oil, growing from 1.14 million bpd in 2001 to about 1.6 million bpd in 2013, imports must pick up the slack. Hence, it is a crucial moment for the government to improve the investment climate in the oil and gas sector.

Impact

Uncertainty concerning the extension of contracts has potentially made PSC holders reluctant to invest further, and this will likely have an adverse impact on oil and gas production. This uncertainty may also potentially cause oil and gas operators who manage existing blocks to disinvest.

Recommendation

The investment climate would be improved if the government decided on the future of the 23 contracts, whether to extend them or 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 would be optimized if it focused on the steps necessary to maximize the production and value of oil and gas assets within the PSC. Global and local expertise and knowledge must be considered when deciding the best scenario.

18 Contracts expiring in 2018: Tuban (JOB Pertamina-Petrochina); Ogan Komering (JOB Pertamina-Talisman); North Sumatera Offshore (NSO) B (ExxonMobil); Southeast Sumatera (CNOOC); Tengah (Total); NSO-NSO, Aceh Extent (ExxonMobil); Sanga-Sanga, Kalimantan Timur (VICO); W. Pasir and Attaka (Chevron Indonesia). Contracts expiring in 2019: Bula (Kalrez Petroleum); Seram-Non Bula (Citic); Pendaopo and Raja (JOB Pertamina-Golden Spike); Jambi Merang (JOB Pertamina-Hess). Contracts expiring in 2020: South Jambi B (ConocoPhillips); Selat Malaka (Kondur Petroleum); Brantas (Lapindo); Salawati (JOB Pertamina-Petrochina); Kepala Burung A (Petrochina International Bermuda); Sengkang (Energy Equity); Makassar Strait Offshore Area A (Chevron Indonesia). Contracts expiring in 2021: Rokan (Chevron Pacific Indonesia); Bentu Segat Kalila (Muriah Petronas); Selat Panjang (Petroselat Nwd).

2. EXTRACTIVE INDUSTRY

Natural resources, particularly minerals, have been an important component of Indonesia's economy, making a significant contribution to government revenue and foreign exchange earnings. Indonesia is the world's largest exporter of coal and tin. It is also a major producer of nickel (No. 2 globally), bauxite (No. 5), copper (No. 6) and gold (No. 9). Decreases in global commodity prices have a notable impact on Indonesia's economic performance.

Currently, mining represents about 16 percent of Indonesia's exports[19] and is a major source of tax revenue. Due to this important role and its non-renewable nature, public policy in the extractive industry needs to be based on reliable data and thorough study. Sound extractive policy can play a key role for the country to transform natural resources into prosperity.

Indonesia still has huge mining potential, as indicated by the Fraser Best Practices Mineral Potential Index. The index ranks Indonesia No. 20 in the world in terms of potential out of 112 jurisdictions surveyed. Presumably this means that if managed properly, Indonesia should rank No. 20 globally in term of investment attractiveness.

19 http://www.bps.go.id/brs_file/eksim_01juli14.pdf

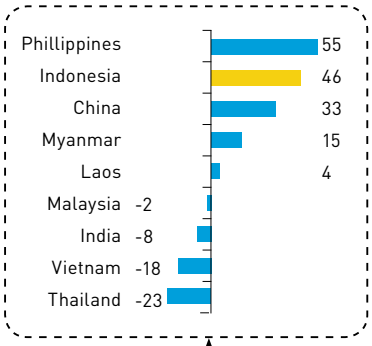
Unfortunately, extractive industry policies in Indonesia are perceived as far from ideal. The Fraser Policy Perception Index ranks Indonesia at No. 104 out of 112 jurisdictions in term of regulatory quality. In term of policy, Indonesia is grouped with countries like Ivory Coast, Argentina, Angola, Zimbabwe, the Philippines, Venezuela and Kyrgyzstan.[20] As a result, despite the great potential, Indonesia ranks No. 66 in terms of attractiveness for mining investors.

The extractive industry operates under numerous regulations issued by many institutions including line ministries, the directorate general of taxes and local governments. The lack of coordination between these various bodies and their differences in goals has led to a lack of regulatory coherence and/or applicability. Policy makers need to improve the quality of regulations, otherwise Indonesia stands to miss many opportunities.

20 Fraser Institute, Annual Survey of Mining Companies, 2013.

Figure 9: Selected Countries: Potential vs. Attractiveness

Country	Best Practice	Policy Perception	Investment Attractiveness	Gap
Philippines	1	110	61	55
Indonesia	20	104	66	46
China	39	88	72	33
Myanmar	44	67	59	15
Malaysia	72	69	70	-2
India	82	63	74	-8
Vietnam	91	60	73	-18
Laos	96	95	100	4
Thailand	98	50	75	-23



Sources: Fraser Institute, 2014.

SECTOR-SPECIFIC RECOMMENDATIONS

Domestic ore processing: uncertainty and lost opportunity

Challenge	Impact	Recommendation
• Value-added policy for the downstream mining industry; • The intention in forcing investment in smelters is to create more value for the domestic economy; • Various studies highlight concerns over this initiative.	• The promotion of a domestic smelting industry impacts governments, business and miners; • The impact is felt in both fiscal and trade channels.	• Instead of issuing a one-size-fits-all policy, government should provide mining operators with several options to avoid decisions that negatively impact the industry. • A full study needs to be done to measure the profitability of smelting activities for various types of minerals. • Mining companies that find building smelters to be economically unfeasible, might be allowed to pay additional royalties.

CHALLENGE 1: DOMESTIC ORE PROCESSING: UNCERTAINTY AND LOST OPPORTUNITY

The policy to promote value-added downstream activities was introduced after Law 4/2009 on Mineral and Coal Mining was passed. The idea was not original as numerous countries have adopted such policies including Papua New Guinea (raw minerals, 2006), South Africa (raw minerals, 2006), Zambia (mineral products, 2005), Botswana (diamonds, 2006) and Australia (uranium, 2006).[21]

The intention behind promoting downstream industries, of course, is to create more value for the domestic economy. However, various studies, including those by Hausmann, Klinger and Lawrence, SEADI[22] and the World Bank[23] highlight concerns about this initiative. Mining beneficiation, as it is sometimes called, if not properly designed and executed can be counterproductive for the economy.

In Indonesia, downstream processing in the crude palm oil sector has benefited the economy. It was expected that the mining industry would have similar results. Unfortunately, mining and palm oil are not similar. Palm oil needs relatively low economies of scale and capital investment for downstream processing. Mining needs huge economies of scale and massive capital investment.

21 Hausmann, Klinger and Lawrence, 2008, Examining Beneficiation, CID, Harvard University.
22 SEADI, 2013, Economic Effect of Indonesia's Mineral Processing Requirement for Export, final report.
23 World Bank, Indonesian Economic Quarterly, March 2014, Investment in Flux: Some recent developments in the Indonesian Economy, page 31-29.

In addition, mining consists of a wide range of products, from coal and copper to tin, bauxite, nickel and gold. Each has a different characteristic, making a one-size-fits-all policy unproductive. For instance, investment in local smelters is profitable for bauxite and nickel, but not necessarily for copper and other minerals.

The rationale was to require mining operators to invest in smelting facilities in the hope that this would create more investment, jobs, refined products and government revenue. In this regard, the government fulfilled the 2009 Mining Law with its implementing regulations and decrees.

The key regulations are: Law 4/2009 on Mineral and Coal Mining, articles 3c, 103 (1) and 170; GR 1/2014 that obliges refining to be done in Indonesia. In addition, ministry regulations such as Ministry of Energy and Mineral Resources Regulation 1/2014 on the value added through mineral processing; MoF Regulation 6/2014 on mining export taxes and tax rates complete the picture, along with MoF Regulation 153/2014 on refining export taxes and the tax rate with regard to smelter commitments.

Impact

Mining policy impacts governments, labor and business through both fiscal and trade channels. In addition to the negative trade balance that has weakened the value of the rupiah, the policy has also hit government tax and royalty revenues, which may harm the government's fiscal position.

The policy has also had a medium-to-long-term impact in the form of deteriorating investor confidence in the industry, as depicted by the Fraser Institute. Last but not least, the government policy of value added in the mining industry has been seen by industry as inconsistent and sending mixed messages.

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. A full study needs to be done to measure the profitability of smelting activities for various types of minerals.

CHALLENGE 2: OVERLAPPING MINING PERMITS

Overlapping mining areas and overlaps between mining and forestry areas are common in Indonesia. This occurs largely due to a lack of coordination among the ministries of mining and forestry and local governments. The Ministry of Mining and Energy issues various licenses for mining and oil and gas. At the same time, the Ministry of Forestry has the authority to issue licenses for forest utilization for various business activities including palm oil plantations, pulp and paper forestry and mining exploration and production.

Overlapping mining permits

Challenge	Impact	Recommendation
• Overlaps between mining areas and between mining areas and forestry areas are a common phenomenon in Indonesia; • To reduce conflict, companies are obliged to get a clear and clean (CnC) status from the government.	• The CnC obligation has made the process of obtaining mining licenses more complicated and lengthy; • Most noticeably, certain mining activities and operations have been delayed or stopped.	• Develop one reliable national map for any permit activity to avoid conflicts. • The one-map policy is a strategy that needs support from all parties.

Several Presidential Instructions (PI) have already been issued to overcome the lack of coordination such as PI 41/2004 on licenses or agreements on mining areas inside forest land; and PI 10/2011 on improvement of natural forest governance on peat land and primary forest. The instructions have not proved to be breakthroughs. To make the situation more complicated, local governments also have the right to issue certain mining licenses, including for "type C" mining such as sand, stone and iron sands. There is a clear tendency for local governments to issue as many mining permits as they can in order to stimulate the economy and increase local government income. This has been a major factor in creating overlapping permits.

Not only is there difficulty with coordination among the various agencies involved but they also use different maps, a major factor in creating confusion. In addition, since many permits were not issued using proper procedures, overlapping occurred. A mining area may appear to be owned by more than one company, each citing different permits, a situation that has triggered disputes. One example is Churchill Mining Plc, which filed a request for arbitration against the Indonesian government due to a dispute between two companies, each claiming to have the right government-issued permit. [24]

In order to reduce conflict, companies are now obliged to get a clear and clean status (CnC) that shows their mining permit has no overlapping issues. For companies that have CnC status, the government will provide a CnC certificate provided that the mining company fulfills certain administrative, technical and financial conditions.

Impact

Unfortunately, the CnC obligation has made the process of obtaining mining permits more complicated and lengthy. This has created significant lost opportunities for the government, the business community and the people.

Recommendation

Ideally, both the central and local governments would use one reliable national map for any activity to avoid conflict. Currently, each province and city has its own map. Ministries have still other maps. The "One map policy" is a strategy that needs support from all parties. The President's Delivery Unit for Development Monitoring and Oversight (UKP4)[25] has initiated a one-map program that has shown encouraging progress. Ministries, public institutions and local governments need to use "one map" for any activities they may have. The new government needs to continue this initiative and ensure that it will be completed as planned.

24 http://www.thejakartapost.com/news/2014/02/28/indonesia-should-learn-churchill-case-analysts.html

25 UKP4's role is to ensure the president's policies have been delivered and monitored well.

SECTOR-SPECIFIC RECOMMENDATIONS

Proposed environmental waste regulation

Challenge	Impact	Recommendation
• The Ministry of Environment has proposed a new regulation on waste that has a very vague definition of toxic and hazardous waste (B3) that is subject to many interpretations; • The proposed regulation is different from Extended Producer Responsibility (EPR), which was enacted in 2012.	The draft government regulation on waste could be misused to criminalize corporate policy.	The proposed regulation should describe clearly what is meant by hazardous and toxic material to avoid misunderstandings and criminalizing corporate policy.

CHALLENGE 3: PROPOSED ENVIRONMENTAL WASTE REGULATION

Sustainability is a major issue, and combining economic progress and environmental preservation has become a key development theme. The terms green energy, green building, green technology and the like have become very popular.

In line with this emphasis, the Indonesian government through the Ministry of Environment has proposed a new draft regulation on the management of hazardous and toxic waste, or what is commonly called B3 waste. It will revise GR 74/2001 regarding hazardous and toxic material, and the older GR 18/1999 and GR 85/1999 on B3 waste management.

The proposed GR has a very vague definition of B3, which can have various interpretations. B3 is defined as "Substances, energy and/or other components which due to its characteristics and concentration and/or quantity, both directly or indirectly, could pollute the environment, destroy the environment and/or endanger the environment, health and lives of human beings and other creatures."

Impact

Objections to the definition of B3 have been raised by the Indonesian Mining Association, the Iron and Steel Industry Association and other business groups. The simplification of environmental permits proposed by the ministry was appreciated, but concerns were raised because authority may be granted to regional governments to assess the handling of B3 waste in the process. In addition to concerns about local government capacity to assess the feasibility of a permit, the legal umbrella for the permit-granting authority is also not clear.

The proposed regulation could potentially improve environmental quality, however, the vague definition of B3 could be misused to criminalize corporate policy, similar to the Chevron bioremediation case in Riau. This is a significant potential drawback for business.

The regulation is still in the drafting stage and is scheduled to be issued soon. Public consultations were held in February but fundamental questions were left unanswered.

Recommendation

The proposed regulation should describe 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 mining and other hazardous waste.

3. INFORMATION TECHNOLOGY

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. [26]

But Indonesia must move beyond where it is today and make more substantial investments in technology so that the sector can develop in more meaningful and profitable ways.

Cloud computing remains limited in Indonesia, which has a lot to do with geographical realities in the country. Internet penetration is low at about 22 percent. When users are connected, often they do not have access to adequate broadband speed and the cost can be prohibitive. Government efforts to improve basic infrastructure also have not gone as planned. The Palapa Ring, a fibre-optic backbone that was to cover the main regions of the archipelago, is behind schedule and does not yet cover eastern Indonesia.[27]

Another problem is cyber security as a bottleneck to the wider deployment of cloud computing. 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. Cyber security is a major issue causing economic losses and concerns for citizens.

The government is currently implementing a number of e-government initiatives. The best known are the e-procurement and e-KTP programs. E-procurement is designed to reduce corruption and waste by creating a secure Internet-based bidding system for government procurement. The e-KTP involves heavy government IT spending to create a single identity system for Indonesians (See Finance Industry section). It has been more than 10 years in the making, aiming to register the entire population and issue an identity card to each person.

There are challenges in the IT sector that need special attention from the new government on localization of data centers and the right way to build an IT hardware industry. We are also encouraged by the government's recently unveiled Indonesia Broadband Plan 2014-2019, which is a positive sign for the future.

26 Business Monitoring International, 2014.
27 Oxford Businesss Group, The Report: Indonesia 2013.

Localization of data centers

Challenge	Impact	Recommendation
• GR 82/2012 requires "public service" companies to localize their data centers. There are multiple interpretation of what is meant by "public service." • To what extent does Indonesia have the infrastructure for large data centers? • A bigger issue is cyber security, where Indonesia is notoriously weak.	• Increased cost for businesses including SMEs; • Different industries have different needs and levels of readiness to adopt the new policy.	• The government should clarify what is meant by "public service" in GR 82/2012. • The government should create a regulatory body for the sector (akin to OJK for the financial industry) to act in accord with the complexities and needs of the IT sector.

CHALLENGE 1: LOCALIZATION OF DATA CENTERS

The push for data centers came with the issuance of GR 82/2012 on the management of electronic transactions and systems. The regulation mandates Indonesian businesses and others conducting electronic transactions to set up data centers in the country. GR 82/2012 is the implementing regulation for Law 11/2008 on Information and Electronic Transactions.

GR 82/2012 seemingly makes it obligatory for companies that provide any kind of electronic systems to put their data centers and disaster recovery centers inside the country. The law has been widely criticized by businesses as impractical. The term "public service" (pelayanan publik) in the law is vague and can be interpreted as "service to the public" or "service by government institutions." There is no additional explanation of the term "public service" in GR 82/2012.

Impact

The localization of data centers has an impact across many industries. If any business

that serves "the public" has to localize its data centers this would cut across 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.

Beside cost considerations and infrastructure issues, the discussion also touches on basic questions of cyber security. For example in the banking sector, the challenge is dealing with regulating non-physical banks. Bank Indonesia (BI) already has a policy of applying risk management in IT by public banks under Bank Indonesia Regulation (PBI) 9/2007, article 19, which requires banks to station data centers and disaster recovery centers in the country. If a bank wishes to put its data center and recover center abroad, it has to seek approval from BI and meet several requirements. This regulation was issued five years before GR 82/2012.

Recommendation

We recommend that the government clarify the meaning of "public service" in GR 82/2012. Ideally, the term public service means services done by government institutions only, 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 Ministry of Trade (MoT) issued regulation 82/2012 on Import Certification of Cellular Telephones, Handheld Computers and Computer Tablets and a subsequent amendment, MoT 38/2013, while the Ministry of Industry (MoI) issued regulation 108/2012 on the Registration of Cellular Phones and Handheld Computers. Both regulations require the holder of an import permit (PI), who has been appointed by an overseas manufacturer, to "establish an industry of mobile phones, handheld computers, and tablet computers" in Indonesia. This must be done within three years of becoming a registered importer. It has resulted in confusion among business players over what will need to be done to satisfy the requirement.

The government wants growth in domestic manufacturing especially in the tech sector but developing manufacturing by decree in this fashion could harm investment. Multiple interpretations of the policy also add to continuing business uncertainty.

The government understandably wants growth in domestic manufacturing especially in the tech sector. Progress in the local manufacture of technologically advanced products and software has been slow and inconsistent over the years. And with tariff barriers steadily dropping to near zero, Indonesia has seen a flood of low-priced goods from China and elsewhere enter the market. The goal of creating an IT industry is worthwhile but the government needs to create an ecosystem for IT and creative industry to flourish because Indonesia is not yet part of the global supply chain for the IT industry.

In addition, under article 24A of MoT regulations 82/2012 and 38/2013 there is room for an exemption from the regulation. It is unclear, however, what factors the ministry will consider in granting exemptions.

Establishing a local IT 'industry'

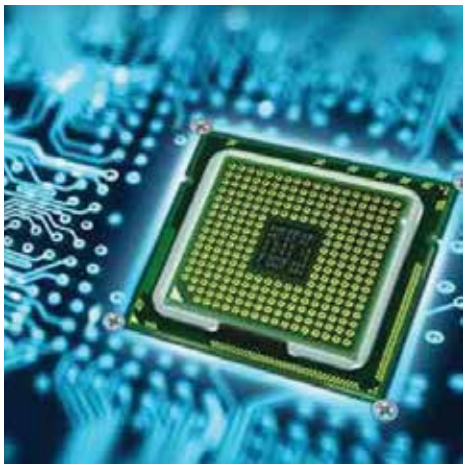
Challenge	Impact	Recommendation
▪ Requirement for companies to establish an "industry" within three years of registering as a device importer. The definition of "industry" is unclear; ▪ Exemptions can be granted, however, it is not clear how to qualify.	▪ Multiple interpretations of the policy raise uncertainty about the broader regulation; ▪ This may impact the need for a level playing field in the industry.	▪ We recommend that the MoT clarify the term "establish an industry." ▪ We also recommend MoT issue guidelines on exemptions.

Impact

The government wants growth in domestic manufacturing especially in the tech sector but developing manufacturing by decree in this fashion could harm investment. Multiple interpretations of the policy also add to continuing business uncertainty.

Recommendation

We recommend that the MoT clarify the term "establish an industry" under MoT regulations 82/2012 and 38/2013. Ideally, it should be realistic and not create additional burdens for industry players. We also recommend that the trade ministry issue guidelines on exemptions that are mentioned in Article 24A of the regulation but are not spelled out.



Indonesia Broadband Plan 2014-2019

Challenge	Impact	Recommendation
Under Presidential Decree No. 96/2014 an Indonesia Broadband Plan 2014-2019 has been launched.	The Broadband Plan was developed after extensive consultations and should guide the development of Indonesia's IT ecosystem in coming years.	The new government is encouraged to support and continue the Indonesia Broadband Plan, which has wide support from stakeholders in the IT community and beyond.

CHALLENGE 3: INDONESIA BROADBAND PLAN 2014-2019

The Indonesia Broadband Plan 2014-2019, implemented under Presidential Decree 96/2014, was developed after more than two years of consultations and discussions with stakeholders in government, industry, user groups and academe. It is Indonesia's IT blue print and was spearheaded by the government in coordination with the Ministry of Planning, the Coordinating Ministry for the Economy and the communications ministry. Business groups like Mastel and Kadin also contributed to the plan. There are five project priorities within the plan: E-govt, E-edu, E-logistics, E-procurement and E-health.

Impact

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. 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. As stated by the UN's Broadband Commission for Digital Development, all countries should have a broadband plan in place by 2015 and the Indonesia Broadband 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. As consumer purchasing power has increased, fast moving consumer goods have become a major driver of the economy. Currently, with an average per capita income of almost $4,000 per year, Indonesia's 250 million people constitute a great market and a major draw for investors in consumer goods and health care products. It will only get better with the growing Indonesian middle class predicted to reach 85 million people by 2020.[28]

But there are also challenges, which include rising wages, higher energy prices, electricity rate increases, the shifting value of the rupiah, dependence on imported raw materials and lack of integration across sectors especially among small businesses. For health care products, consumer food and beverages and cosmetic products the recently passed Halal Law is a significant challenge.

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

The extensive decentralization process that was ushered in by the political reforms that began in 1998 is widely seen to have had a positive impact on Indonesia's economy in many ways. 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 not

28 Mc Kinsey Global Institute, The Archipelago Economy: Unleashing Indonesia's Potential, 2012.

aligned with laws and regulations issued by the central government.

Law 28/2009 on Regional Taxes and User Charges, for example, allows local governments to tax a wide range of areas. Article 43-5 of Law 28/2009 regulates taxes on advertising media. Local governments can add excise taxes, payment procedures and locations on their own authority. Article 150 of Law 28/2009 gives local government the room to initiate and add taxes to collect more revenue. Each region has a different tariff level. There are also various requirements regarding the size and design of advertising material, for example, and thus local tax authorities may have differing formulas to calculate a tax on billboards for companies that operate nationally and therefore use outdoor advertising in many regions.

Harmonization of local government regulations

Challenge	Impact	Recommendation
Decentralization has had an adverse impact on the investment climate by increasing business regulations issued by local governments.	This has meant increased costs for companies operating across Indonesia.	The government can expedite the harmonization of local and national regulations concerning consumer goods and heath care products nationwide to promote efficiency and growth.

Impact

The direct impact of various local business regulations is often to increase costs for companies that operate nationwide; in the end, increased costs are passed on to the consumer. In addition, the complex rules potentially increase incidences of corruption in local government.

Recommendation

We recommend that the government expedite the harmonization of rules issued by regional administrations with national laws. The reference for formulating regional regulations is already stipulated in Law 10/2004 on Law Formation and Law 32/2004 on Local Government. The central government should provide standards and procedures to guide regional regulations to promote efficiency and benefit industry and consumers.

CHALLENGE 2: HALAL REQUIREMENTS

The Indonesian Council of Ulama (MUI) has been the formal institution that grants halal certification. Under the just-passed Halal Product Guarantee 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.

According to the Law, Halal certification will be mandatory for all food, beverage, drugs, cosmetics, chemicals (used for human consumption), organic and genetically modified products sold in Indonesia as well as for the machinery and equipment involved in processing these products. Companies will have at least three years before the new Halal certifying and auditing agencies are up and running. The new law also covers imports.

With an estimated 85 percent of the country's population being Muslim, the demand for halal-certified products is very high. This creates a unique opportunity for food exporters from countries with established halal food-processing sectors.

Impact

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. As a result, the additional cost will likely be transferred to consumers.

Halal requirements

Challenge	Impact	Recommendation
• 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 Law covers the food, beverage, cosmetics and pharmaceutical sectors including imports.	• Indonesia does not recognize halal certification from other countries, which may result in redundant processes for imports. • The addition of more agencies will possibly make the process more costly.	• The government should harmonize Indonesian halal requirements with common practices in the region. • The government should provide one-stop services for businesses applying for halal certification and labeling.

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.

Mandatory extended producer responsibility

Challenge	Impact	Recommendation
In order to implement Extended Producer Responsibility (EPR), access to large amounts of capital will be needed to upgrade capacity.	The process of implementing EPR will put additional burdens on producers. Ultimately, the consumer will face higher costs.	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 3: MANDATORY EXTENDED PRODUCER RESPONSIBILITY

Extended producer responsibility (EPR) is a principle to improve environmental standards and practices in waste management. Enhanced EPR is mandated under the Solid Waste Management Law, 18/2008, which requires companies, individuals and communities to take responsibility for solid waste recovery through reuse, recycling and recovery. The law also insists that manufacturers be responsible for their own packaging. It will be the manufacturer's responsibility to recover waste not consumers. The cost of implementation will go directly to companies that are obliged to make changes to reduce the environmental impact of their products. Care must be taken because implementing EPR requires large amounts of capital to upgrade various activities.

The concept of EPR comes from Sweden and was adopted by Indonesia in 2008. Business areas involved include residential, commercial and industrial developments; heritage sites and national parks and public facilities. Manufacturers are obliged to put labels related to waste handling on their packaging; to establish recycling channels for the materials they sell; and to use materials that can be re-used, re-cycled or easily decomposed.

Law 32/2009 on Environmental Protection and Management is enforced by GR

The process of implementing extended EPR will put additional burdens on producers. Ultimately, the final consumer will bear rising costs. Products could also become less competitive due to the cost adjustment of EPR. This will be a disadvantage for companies as they will also be responsible for consumers' waste.

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81/2012. GR 81/2012, which relates to the implementation of the handling of Household and Household-type Waste under the law. The Ministry of Environment has announced that local governments will also have to change the open dumping system into more environment-friendly dumping.

Impact

The process of implementing extended EPR will put additional burdens on producers. Ultimately, the final consumer will bear rising costs. Products could also become less competitive due to the cost adjustment of EPR. This will be a disadvantage for companies as they will also be responsible for consumers' waste. It will become even more complicated if companies have distributed their products throughout Indonesia and then have to somehow collect and manage the waste.

Recommendation

The government may consider revising the regulation, GR 81/2012 article 13 (1 c), 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 have been 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.

Impact

There is a lack of scientific evidence that the decree will have a positive impact on NCD in Indonesia. In addition, the decree will set a labeling precedent in one country that may increase costs substantially for both producers and importers and could potentially act as a barrier to trade in ASEAN, since other countries apparently intend to act on a voluntary basis and invest more in consumer education.

Recommendation

The government might consider revising the decree on the basis of scientific evidence. It also could take into consideration the implementation of the ASEAN Economic Community in 2015 to align Indonesia with the other members of the association.

Mandatory food labeling

Challenge	Impact	Recommendation
Mandatory health messages related to sugar, salt and fat content in packaged and processed foods have been introduced by a Ministry of Health decree as a tool to prevent the rise of non-communicable diseases (NCD) such as diabetes and hypertension.	. Industry supports improved nutritional literacy but there is a lack of scientific evidence that the measure will prevent the rise of NCD in Indonesia. . It also sets up labeling requirements in Indonesia that may be out of step with the rest of ASEAN.	The government might consider revising the decree on the basis of scientific evidence and also in light of the ASEAN Economic Community in 2015.

Mandatory health messages related to sugar, salt and fat content in packaged and processed foods have been introduced as a tool to prevent the rise of non-communicable diseases. The industry supports improved nutritional literacy and greater health awareness, but significant concerns remain toward the approach suggested in the decree.

SECTOR-SPECIFIC RECOMMENDATIONS

5. AGRICULTURE

The Indonesian agricultural sector is also "home" to the nation's poverty with almost 40 percent of the nation's work force employed in agriculture, which represents just 13 percent of the economy and grows at a rate about 2 percent slower than GDP. In short, the sector is not only underrepresented in the economy, it is also slow to expand. 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.

In addition, for a country with more than 250 million people, food security is a sensitive and a strategic issue. President

Joko Widodo and Vice President Jusuf Kalla have made food security one of the most important issues facing their government, in addition to energy security, education and promoting economic competitiveness.

In line with the challenge, attracting more FDI inflows to agriculture is a strategic move for the government in order to increase output and produce high value-added agricultural products. Currently, FDI in the sector is relatively weak compared to other sectors, despite the fact that agriculture has the advantage of being labor intensive, and thus a good way to reduce unemployment, and have high investment efficiency.

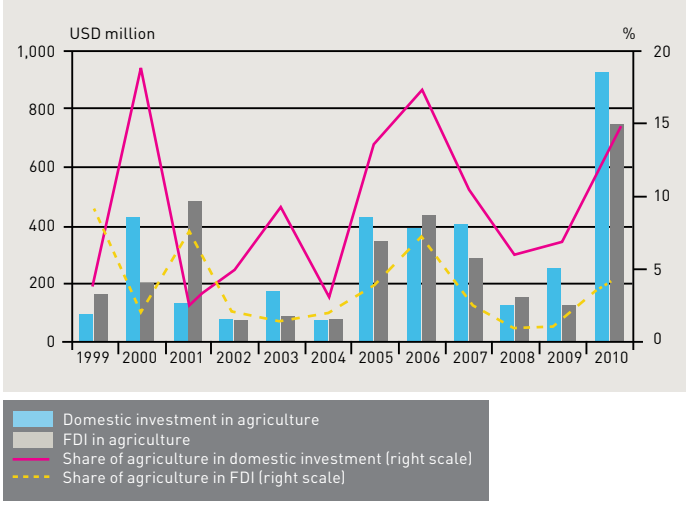
Agriculture has a low Incremental Output Ratio (ICOR), meaning that relatively low investment is needed to enable economic output to increase. Agriculture is the most efficient way for Indonesia to promote GDP growth and reduce inequality and poverty.

Investment in agriculture offers great potential for investors because it is highly labor-intensive and makes little use of capital investment. Indonesia, however, remains restrictive towards FDI in the sector with the upper limits for foreign equity in food crops decreasing from 95 percent in 2007 to 49 percent in 2010.

To overcome this problem, the government has various policies to assist and empower farmers. These policy objectives use output and input subsidies, and payments for the provision of services to agriculture generally. On the other side, there is also the massive rice-for-the-poor (Raskin) scheme to support poor consumers. Raskin, however, has also drawn the attention of anti-corruption investigators who have said it is prone to misuse.

Indonesian agriculture policy is dominated by a desire for food self-sufficiency, an objective that creates conflicts with other goals. The challenge for the new government will be to keep the balance while supporting producers and ensuring that prices for essential food items remain affordable for poor households. This is where FDI has the potential to support food security in Indonesia.

Figure 10: FDI in Agriculture Sector



The Indonesian agricultural sector is also 'home' to the nation's poverty with almost 40 percent of the nation's work force employed in agriculture, which represents just 13 percent of the economy and grows at a rate about 2 percent slower than GDP. In short, the sector is not only underrepresented in the economy, it is also slow to expand.

SECTOR-SPECIFIC RECOMMENDATIONS

CHALLENGE 1: THE FOOD SECURITY AGENCY & DATA RELIABILITY

Law 18/2012 on food was introduced to strengthen the principles of food sovereignty (kedaulatan pangan) and food self-reliance (kemandirian pangan). Article 126-128 in the new law mandates the establishment of an institution to report directly to the president, which is underway. This new Food Security Agency is intended to play a major role in managing supply and demand for food products. Article 36 specifies that "food imports can only be implemented if domestic food production is not sufficient and/or cannot be produced domestically."

The Food Security Agency & data reliability

Challenge	Impact	Recommendation
• The urgent establishment of a strategic institution to fulfill its objectives in less than one year; • The Food Security Agency needs reliable data on which to base decisions or bad policies may result.	• Potential disruption in the market if the agency is not fully capable. • Unreliable data could lead to weak policies, potentially deteriorating food security.	• Government should issue implementation guidelines for the Food Security Agency and build capacity within the organization. • The Ministry of Agriculture and the new food agency should share data to come up with reliable data. • The Food Security Agency should consider market-friendly policies that give wide benefit to farmers and consumers.

The institution has the task of carrying out government orders with regard to "production, procurement, storing and/or distribution of staple food and other food that has been determined by the government." What the law calls a "super agency," the food security body must be in place three years after the promulgation of the law or by the end of 2015. It takes time to build capacity in a new organization. If it is not well prepared, there is potential for a negative impact on the food industry.

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 as a means to achieve food security could ultimately hinder the competitiveness of the agricultural sector.

Given its vast authority, the new agency must ensure that it uses robust methodology to collect data. Law 18/2012 article 113-115 mandates the establishment of a Food Information System. There are great risks here. For example, total corn production was 18.5 million tons for 2013 based on Indonesian Central Bureau of Statistics (BPS) data. The Ministry of Agriculture (MoA) is using the same BPS number for 2013. However, based on our interviews with companies, total corn production for 2013 is predicted to be not more than 8 million tons. Hence, there is a huge discrepancy in the data between government and industry.

Impact

There could be potential disruption in important food products if the Food Security Agency is not well established within the next year. Because the new agency has vast authority over food imports, there could be market problems if it 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 and guidance. Because the law mandates the establishment of a reliable food information system for the agency, the agriculture ministry might consider sharing 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.

Unattractive investment environment

Challenge	Impact	Recommendation
Government limitations on FDI in the agriculture sector.	• No incentive to invest without a majority of equity. • Limited potential to tap the benefits from foreign investment.	Government should relax the maximum investment ceiling for FDI in agriculture.

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. There is untapped potential in the sector for investors.

The government is actively promoting large-scale investment in agriculture with public spending targets aimed mainly at food crops, while most private investment is channeled to perennial crops. Investment in palm oil plantations by large private companies has increased greatly over the last decade. However, even though total investment in agriculture has grown, the share of agriculture as a percentage of total realized investment remains much lower than the share of the sector itself in GDP, imports, exports and employment.

Constraints on increasing investment in agriculture have remained about the same for the last decade. Getting secure land rights is a challenge as is poor-quality infrastructure. To its credit, the government is continuously simplifying and speeding up business licensing and investment procedures in a bid to attract more FDI.

The latest revision of the so-called Negative Investment List (DNI), PR 39/2014, specifies restrictions on foreign investment and equity ownership. Agriculture is one of the sectors in which restrictions increased in the 2014 DNI list as compared with the 2010 list. For example, the maximum share of foreign ownership in main crops (corn, soy, peanuts, green beans, rice, cassava, sweet potato, etc.) had been 49 percent without any restrictions on the size of the farmed area. The 2014 list limited foreign ownership to 49 percent if the size of the area is more than 25 hectares. The investment also now must receive a required recommendation from the MoA.

Furthermore, Law 13/2010 on horticulture reduced foreign equity in horticulture businesses, or food crops, from 95 percent to 30 percent. The Law does not include a grandfather clause for existing businesses 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. By the end of 2014, all foreign companies will have to comply with the regulation.

Impact

There is little incentive for FDI to enter Indonesia if companies cannot have majority equity stakes in exchange for significant investments. This ceiling seems likely to hamper the investment climate and 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.

SECTOR-SPECIFIC RECOMMENDATIONS

6. FINANCIAL SECTOR

The Indonesian financial sector is relatively small compared with other countries in the region and dominated by banks. Long term financing is still limited and institutional investors have not yet become a source of long-term capital. The government continuously promotes financial market diversification, developing the bond market and strengthening the capacity of institutional investors.

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 the 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 of an independent Financial Service Authority (OJK) that has taken over monitoring and supervision responsibilities from BI.

Insurance is the second largest financial sector after banking. Total assets of insurance companies accounted for about 5 percent of GDP in 2008. The foreign equity ownership ceiling is currently set at 80 percent for insurance companies. The insurance sector has lagged behind the banking sector in terms of consolidation and capitalization.

CHALLENGE 1: POTENTIAL LIMITATIONS ON FOREIGN OWNERSHIP IN INSURANCE

GR 73/1992 on insurance was enacted soon after the Law 2/1992 was promulgated. The regulation's article 6 limits foreign ownership in insurance to 80 percent, which is much higher that that of other countries in the region. On Sept. 15, 2014 the House of Representatives approved an insurance bill to replace Law 2/1992. The new Law does not specify foreign ownership limitations. A new GR will set out implementation guidelines for the new law and may adjust the percentage. Under existing rules, a foreign investor may acquire up to 80 percent of ownership and may only increase the percentage if Indonesian shareholders cannot contribute the required capital.

Potential limitations on foreign ownership in insurance

Challenge	Impact	Recommendation
The recently passed Law on Insurance does not specify a ceiling on foreign ownership. The next step is issuing a GR as an implementation guideline for the Law.	• Even though Indonesia is relatively open compared with the region, market penetration remains low despite rapid GDP growth. • Greater ownership limitations could negatively affect investor sentiment.	We recommend that the government carefully assess limits on foreign ownership in insurance. Any adjustment on ownership limits should ensure the attractiveness of the industry for foreign companies and should not be retroactive.

Even though Indonesia is relatively open, the insurance penetration rate is very low. With strong prospects for growth, foreign investors are eyeing Indonesia's insurance market. Higher caps on foreign ownership would add to the appeal.

Impact

If there is a policy change to limit foreign ownership, the new law should include a grandfather clause so that it does not impact existing businesses. Unpredictable regulatory changes have hampered foreign investment.

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. If there is any decrease in foreign ownership limits the rule should not be retroactive.

CHALLENGE 2 : BENEFITS FROM FEES PAID TO OJK

OJK relies on fees from financial companies to run its operations, as stipulated by Law 21/2011, article 37 (1), with GR 11/2014 on fee collection. If the fees received during the year exceed the OJK budget for the next fiscal year, the excess is remitted to the state treasury. Unfortunately, there is a lack of clarity on the budget allocation restrictions. From the stakeholders' perspective, the fee

Benefits from fees paid to OJK

Challenge	Impact	Recommendation
Companies want to know what benefits they derive from the fees paid to OJK to fund its operations. The establishing regulation only stated that the fee is allocated for operations, administration, procurement and other support activities.	The fee is assessed based on assets and is seen as a new tax burden by companies.	OJK should set rules that restrict the fee to specific activities and clarify the benefits that stakeholders get in return. Concerns from stakeholders need to be considered.

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 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.

Impact

The fee is based on the asset value of an institution and is generally seen as a new tax burden on companies that will be transferred to consumers. The lack of clarity on the fee collection and usage mechanisms will potentially create governance and accountability problems for OJK in the future.

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

Indonesia does not have a single identity system for citizens. Government institutions use various sources of information to track individuals. For example, the Directorate General of Taxes uses 28 unique data sets to track individuals. For the financial sector, this increases credit risk and eventually the cost of financing. The availability of reliable credit information is needed to facilitate credit expansion. The existing debtor information system under BI is helpful, but it is not enough.

The e-KTP initiative is a step toward creating a reliable identity system. 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 patterns and history could potentially be established by banks and financial institutions. Therefore, a payments-enabled e-KTP could not only contribute to financial inclusion but also result in increased efficiency in government disbursements.

Impact

The delay in full implementation of the e-KTP has consequences for both the government and the private sector. For the financial industry, the BI's debtor information system is an important stepping stone to reduce credit risk. However, without a single ID, the system will be less efective. In addition, the single ID is crucial for the financial industry to expand to new markets and create more financial inclusion.

Recommendation

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

Expediting the single identity system

Challenge	Impact	Recommendation
Indonesia does not have a single identity card for citizens. Both government and the private sector utilize various sources of data to track personal identity. The e-KTP system is intended to address this.	The direct impact for business is inefficiency, specifically for the financial industry due to increased credit risk and slow credit expansion.	The new government needs to take the lead in pushing ahead with the e-KTP project to ensure the target is achieved.

NEXT STEPS

Foreign investors stand ready to help Indonesia meet the new government's goal of 7 percent GDP growth and poverty eradication. A robust business environment and a spirit of partnership can go a long way to mobilizing the resources that can help turn dreams into realities. We believe the recommendations in this report should be seen in light of a genuine desire to move forward together.

There is much to be done. All of it is possible. Regulatory and contract certainty are crucial factors in urging both domestic and foreign investors to get off the sidelines. FDI has become a competitive marketplace in which countries compete to attract the high quality FDI that creates value-added for host economies. We think our recommendations can help Indonesia compete and add positive ideas to an ongoing national debate.

Indonesia has made a lot of progress in promoting a better business environment in recent years but it still lags behind its main competitors for FDI. In short, Indonesia has not realized its full potential. Indonesia has a long list of benefits other countries cannot offer in terms of natural resources, a massive market, vast human resources, a strategic location and stable politics. Better policy can complete the picture.

The policy recommendations in this report can be a starting point. The new government appears to have the courage and determination to promote policy reforms and to improve regulations to facilitate investment. This is in line with the needs of investors, the government and the long-term interests of the Indonesian people.

We want to work hand in hand with the government to reach our mutual goals in terms of policy and growth. The dialogue has begun. The challenge is ahead of us.

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