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# Export-oriented Investment in Indonesia

## Indonesia Trade Assistance Project

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# **Export-oriented Investment in Indonesia**

## **Indonesia Trade Assistance Project (ITAP)**

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## **ACRONYMS**

ASEAN	Association of South-East Asian Nations
BKPM	Investment Coordinating Board
KADIN	Indonesian Chamber of Commerce and Industry
IFC	International Finance Corporation
IMF	International Monetary Fund
INPRES	Presidential Instruction
ITAP	Indonesia Trade Assistance Project
FDI	Foreign Direct Investment
IPR	Intellectual Property Right
KKPPI	Committee for the Acceleration of Infrastructure Reforms
MENCO	Coordinating Ministry for Economic Affairs
MNC	Multi-National Corporation
NAFED	National Agency for Export Development
NTB	Non-tariff Barrier
PEPI	National Committee on Export Promotion & Investment
PERPRES	Presidential Regulation
PPP	Public-Private Partnership
RMU	Risk Management Unit
SME	Small and Medium Sized Enterprise
SOE	State-Owned Enterprise
TREDA	Trade Research and Development Agency
USAID	United States Agency for International Development
WB	World Bank

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## **Executive Summary**

Over the last two decades, Indonesia has experienced sharply contrasting periods, one of dynamic trade and economic growth in the 1990s and one of economic depression in the wake of the Asian 1997-98 financial crisis. Since the mid-2000s, Indonesia's economy has been recovering well, due in large measure to sound macro-economic policies. However, Indonesia's trade performance has remained sluggish over recent years due to the impact of the crisis on Indonesian exporting companies and to lasting consequences of past protectionist policies. Those policies have left the country without well-established high-technology sectors, with poor infrastructure and with neglected labor-intensive industries. At the same time, countries competitive with Indonesia have emerged and established strong positions in world markets.

As Indonesia recovered from the 1997-98 crisis, its economy underwent significant structural changes. The role of trade and investment policies has evolved since that time in response to these changes. The Indonesian Government embarked into renewed trade liberalization policies, becoming a relatively low-tariff country by developing-country standards. The effective rate of protection also significantly fell over the past decade. However, a recent increase in non-tariff barriers has raised questions over the Government's commitment to sustained, comprehensive trade liberalization.

Analysis of Indonesia's trade performance over the last decades and of current trade patterns shows that much scope exists to use trade-related policies to further enhance growth in the Indonesian economy. External competitiveness and trade performance represents one of the major challenges to the realization of the country's full trade and economic potential.

In order to achieve the objective of sustained growth, Indonesia must identify strategies, including moving up the value chain, to better exploit comparative advantages and to use production factors more efficiently. The Indonesian economy also needs more dynamic and competitive support services that can integrate domestic firms in international production networks and boost the technological capacity of its enterprises.

Adopting a comprehensive approach will be key to boosting exports over the long run. Such an approach should encompass trade policy reform moving in tandem with reforms in other policy areas, in particular policies in industry, services and agriculture. A well-designed investment policy is needed as an important cross-cutting component of sector policies and as a keystone to any comprehensive strategy for economic expansion.

In accord with a widely-held view that is supported by documented evidence in numerous studies, FDI contributes to enhancing the competitiveness of host countries and therefore, contributes to the improvement of export performance by such countries. The role of multi-national corporations (MNCs) - a primary source of FDI in most economies - in expanding exports of host developing countries derives from the additional capital, technology and managerial know-how they provide, along with expanded access to global markets.

Indonesia's competitiveness has historically been driven, in substantial degree, by FDI as companies invested in by MNCs have generally demonstrated higher productivity than domestic firms. In many cases, increases in productivity have been transmitted to domestic firms via FDI-related productivity spillovers.

At present, Indonesia does not have specific policies to attract export-oriented FDI. The government's current strategy is to attract any kind of foreign investment whether its purpose may be to serve the domestic market or to support the supply of competitive products to international markets.

Indonesia's recent economic performance, particularly in terms of foreign investment, has been disappointing as the economy experienced practically no increase during 2006 and only a modest increase in 2007. Such poor FDI performance is due a number of well-known factors:

- a) weak overall management of investment climate reform,
- b) ineffective investment policy coordination.
- c) Cumbersome investment entry and facilitation procedures both at central and local government levels,
- d) weak legal certainty and law enforcement,
- e) public governance problems, especially in the customs and tax administrations,
- f) unattractive labor market conditions,
- g) neglected infrastructure,
- h) logistical constraints affecting the flow of goods,
- i) restricted access to credit, particularly for SMEs,
- j) vulnerability of the financial system to external shocks and
- k) a largely negative business image abroad that continues to be exacerbated by terrorist attacks and natural disasters.

Over the past few years, the Government has endeavoured to address the above issues and, in doing so, improve the investment climate. It has issued several Policy Packages aimed at enacting a new investment law, formulating a clear division of tasks between the central government and regional governments regarding investment matters, accelerating business licensing by reviewing licensing rules, simplifying the process of establishing a company and establishing an integrated service system for investment with a clear division of authority between the central and regional levels.

In 2007, Indonesia finally introduced a new investment policy package that consisted of the new Investment Law and several regulations, including the negative investment list, regulations on taxes and the establishment of Special Economic Zones. While the enactment of the new investment law was generally welcomed, the stipulations of the negative list restricting investment in many sectors – and significantly, its loopholes, particularly on the issues related to grandfathering – created further uncertainty for established companies and potential new investors. The Government has since revised the negative list twice, but without completely satisfying concerns of the private sector. A third and, hopefully, final version of the list is now waiting for the President's signature.

The new investment law constitutes a step in the right direction, but in itself is not sufficient to significantly improve Indonesia's investment climate. In the view of the domestic and foreign business communities, the Government should take decisive actions to enforce badly

needed reforms aimed at improving infrastructure, logistics, business licensing and other important areas such as labor regulations.

Coordination in the formulation and implementation of government policies is a cross-cutting issue that stands out in most of the identified problem areas affecting the investment climate in Indonesia. Numerous factors can be identified as possible causes of this syndrome of recurrent dysfunctioning in the Indonesian Government and bureaucratic systems. Any comprehensive strategy to promote FDI must address these factors.

At the executive level, conflicts and divisions often occur between ministries and agencies. In addition, the Government has created ad-hoc committees whose roles and missions have not always been clear and/or whose status and credibility have not been accepted by other government officials.

An important factor has been decentralization. There have been continued conflicts between the central government and local governments, in large measure because implementation of the institutional framework governing the division of roles, responsibilities and resources between the national and local governments remains incomplete.

Moreover, a large number of government agencies are fragmented and have overlapping authorities, thereby hampering efficient decision-making. Power has been dispersed to many actors without clarity as to their respective roles, responsibilities and authority and without recourse to adequate oversight or legal authority to address and resolve resulting conflicts, delayed decision-making and lack of required actions.

Indonesia's future success in realizing its economic potential will largely depend on its capacity to reform its public sector and to improve institutional effectiveness. The Government will need to address more effectively capacity weaknesses and fragmentation in Indonesia's relevant institutions in order to complete implementation of unfinished reforms in the trade and investment areas.

The capabilities of Indonesia's civil servants need improving in various areas to enable them to perform their functions effectively. To this end, the Government has initiated public sector reforms in selected ministries and agencies. The reforms involve strengthening human resources capacity, revising operating procedures, clarifying job descriptions and job grading, enhancing performance incentives through greater pay and promotion linkages, and improving human resource management functions. These reforms also seek to strengthen policy research and analysis within ministries and agencies and to increase overall professional capabilities.

In tandem with the bureaucratic reform, a major challenge will be to enhance the capacity of institutions across the country. To achieve this, the Government will need to address the following priority requirements: strengthen the legal and regulatory framework; strengthen organizational structures, management and information systems; and enhance implementation, technical and evaluation capacity. It will also need to strengthen operational, technical and administrative policies, procedures and standards, foster adequate planning and budgeting capacity and develop research and analytical capacity, including increased expertise in policy formulation.

## **Introduction**

Ten years ago, Indonesia was in the middle of a severe economic crisis and a difficult, challenging political transition. Today, Indonesia is a different country. It has embarked upon far-reaching institutional transformation and has become one of Southeast Asia's most vibrant democracies. Its political stability has recently been demonstrated by the recent Parliamentary and Presidential elections.

In economic terms, Indonesia has seen much progress over the past decade. Its real GDP has been growing at five to six percent annually since 2002. Prudent macro-economic management has resulted in a significant reduction in government debt levels. Inflation has largely been kept under control and Indonesia has a strong balance of payments. Indonesia's sizeable domestic market has allowed the country to weather the current global crisis better than most of its Asian neighbours.

Yet serious questions remain about Indonesia's capacity to decisively move up the development ladder and to reduce substantially or eliminate poverty. One of the most important challenges in this regard relates to Indonesia's capacity to reform its trade and investment climate in order to create a business climate that will foster investment and economic growth.

This report reviews Indonesia's trade performance over the last two decades and draws the conclusion that the country suffers from insufficient competitiveness. It examines the link between foreign direct investment, competitiveness and export development, drawing the conclusion that Indonesia suffers from an investment climate that remains poor, despite important efforts by the Government. The report further identifies weak coordination in the formulation and implementation of policies as one of the causes of the poor investment climate. It concludes by underlining the need to reform the country's public sector and to improve the capacity of its institutions as necessary steps to complete unfinished reforms in the trade and investment areas.

## **Chapter 1: Indonesia's trade performance**

The Asian financial crisis of 1997-98 interrupted the robust economic growth and trade performance that Indonesia had experienced in the 1990s. Regaining its previous position, let alone expanding in very competitive world markets, now seems a challenge.

Prior to the Asian crisis, trade had been an important driver of economic growth in Indonesia. On the demand side, net exports had been positively contributing to growth, while on the supply side, the expansion of production facilities for exports, due to a large extent to foreign direct investment, had boosted the expansion of the entire economy. The crisis damaged structural relationships across the economy and coupled with macroeconomic instability, Indonesian firms were adversely affected, diminishing their ability to trade. Alongside these developments, several competitors emerged on the world market, increasing economic pressure on Indonesian industries.

As Indonesia recovered from the 1997-98 crisis, its economy underwent significant structural changes in response to which the role of trade and investment policies has evolved. Much scope exists to use trade-related policies to further enhance growth in Indonesia. External competitiveness and trade performance represents one of the major challenges to realization of full trade and economic potential.

Indonesia's recovery has taken place in the face of several significant challenges, including the sharp depreciation of the rupiah in the wake of the Asian financial crisis, a strong rise in global oil prices, increases in interest rates and inflation, and the disastrous tsunami of December 2004. As a consequence, Indonesia's share of world trade in goods and services has not recovered to its pre-crisis level. This lag is related to the sluggish growth in exports and imports in the period since the crisis.

From 1994 to 2006, Indonesia's average annual growth rate of exports and imports in goods was below that of India, China, and other ASEAN economies, such as Singapore, Vietnam, and Thailand. In services, Indonesia ranks slightly higher in exports than imports, but growth rates lag behind China and India as well as those of its most important ASEAN neighbors.

Trade as a share of GDP in Indonesia fell markedly in 1998, the worst year of the crisis, resulting largely from the steep exchange rate depreciation and shrinking GDP. Since then, imports as a share of GDP have not returned to pre-crisis levels (about 25% in 2007), while exports have slightly exceeded pre-crisis levels and stood at about 29% of GDP in 2007.

The lag in recovery can be attributed largely to the severity of the crisis in Indonesia and to structural problems that are either a direct result of the crisis or have been exacerbated by policy responses taken in the aftermath. In the years immediately preceding the crisis, industrial policies intended to develop national champions resulted in excessive protection and decreased competitiveness of those industries.

However, while overall trade performance has been disappointing since the crisis, differences among sectors within the economy point to areas in which Indonesia can enhance its external competitiveness.

## **1.1 Trade liberalization**

Indonesia's relatively successful efforts at reaching and maintaining macroeconomic stability in the post-crisis years has laid the foundation for further realising its trade potential.

However, the transition from authoritarian rule to democracy that has taken place during the same period has created conditions that impede trade and exacerbate existing weaknesses in the trade policy environment. These impediments must be addressed if trade performance is to improve significantly.

Trade liberalization in Indonesia has progressed unevenly over time, beginning first in response to the economic woes that followed heavy state intervention and isolation under the Sukarno government. The 'New Order' government of President Suharto initially opened Indonesia's economy. It issued foreign and domestic investment laws aimed at attracting investors, simplified foreign trade procedures and significantly reduced tariffs.

However, the first global oil crisis in the 1970s changed the direction of Indonesia's trade policies. The oil revenue boom caused prices to increase, hence impeding development of the infant non-oil production sector. In an attempt to stop the decline of non-oil production, the government adopted protectionist policies aiming at nurturing infant industries such as textiles, food processing and engineering.

Dramatic changes in international oil prices during the 1980s again spurred trade liberalisation. As the second oil crisis ended and falling oil prices resulted in revenue losses, a further round of liberalisation was initiated. Beginning in 1986, several policy packages were introduced that reduced tariffs and dismantled non-tariff barriers, including the replacement of the export licensing system with a duty drawback system and the conversion of certain non-tariff barriers to tariff equivalents. These measures contributed to enhanced transparency and predictability of trade policies.

Deregulation coupled with sound macroeconomic management significantly contributed to upgrading the industrial and export structures during the period of the late 1980s. The composition of manufacturing exports, which represented an increasing share in export earnings, shifted from resource-based manufacturing toward low and medium-technology manufacturing products. The structural changes brought about by deregulation boosted the growth of productivity.

However, structural weaknesses that had been masked by strong economic growth became apparent. Export growth slowed in the years preceding the Asian crisis, a development that was not solely attributable to cyclical factors such as world prices or weakening demand in major markets. Incentives to import intermediate products needed for export outputs translated into heavily import-dependent export production.

One of the most damaging policies was the development of aircraft and shipbuilding industries which required a high level of protection. This protection, in turn, impeded competitiveness in related industries. The creation of monopolies and other similar practices to achieve the required protection also contributed to broader economic inefficiencies. Such practices continue to have repercussions until today. Over-emphasis on nurtured sectors has

left the country without well-established high-technology sectors and with neglected labor-intensive industries.

## **1.2 Tariff Liberalization**

Following the Asian financial crisis, Indonesia initiated a new trade liberalization drive under the Reform Era. It successfully liberalized tariffs, becoming a relatively low-tariff country by developing-country standards. The effective rate of protection also significantly fell over the past decade. Indonesia's MFN applied tariffs have been decreased sharply with the simple average applied tariff falling by two-thirds to 6.9% in 2007, a low figure by both developing country and Southeast Asian standards.

Partly in response to commitments made under the ASEAN Free Trade Area Agreement, Indonesia has revamped its tariff structure through a two-pronged tariff harmonization initiative. The initial phase culminated in Ministry of Finance Regulation 600/2004, which covered 1,964 tariff lines, primarily in the agriculture sector. The revised tariff schedule for these goods went into effect in the beginning of 2005. In the second phase, more than 9,100 tariff lines were revised via Regulation 132/2005 with the mandated changes coming into effect in early 2006. Overall, the tariff harmonization initiative has resulted in a 16% increase in the number of tariff lines and a small reduction in the simple average and maximum tariff rates.

At the end of the second phase of tariff harmonization, a medium-term plan was announced to cut tariffs between 2005 and 2010 as well as further alteration of the tariff structure. If fully implemented, this plan will ensure that 94% of Indonesia's tariff schedule will include rates in the range of 0-10% by 2010. The other 6% of tariff lines have been designated as special products and are slated for cuts in a similar rate range, but with an extended implementation deadline (2020). The medium-term plan seeks to convert existing non-tariff barriers (NTB) to tariff equivalents and to decrease the overall number of tariff bands in the schedule.

Effective rates of protection (ERP), which indicate how much protection is actually provided to the domestic processing of the import-competing product, have substantially fallen between 1995 and 2005. However, the overall reduction in ERP masks substantial differences across sectors. Sharp reductions in effective protection are evident, for instance, in motor vehicles and textiles and garments. But the extent of reduction of both nominal and effective protection has been much more limited in the iron and steel industry.

The motor vehicle sector was targeted to be one of the selected industries under the former national industrialization programme. Hence, it was one of the most protected industries with the objective of developing a national car, an objective that was never achieved. Learning from this failed approach, the government liberalized the industry with both nominal and effective rates of protection being substantially reduced between 1995 and 2005.

## **1.3 Non-tariff Barriers**

In 2007, the number of NTBs in Indonesia reached 353 and covered 60 out of the 79 two-digit HS product categories, greatly reducing the transparency of trade policies. A large number of NTBs in Indonesia concern agricultural products and chemicals, but there are also several important measures concerning electrical machinery and motor vehicles. Some of these

licences are so-called automatic licences, which are the most common and require only registration, while others aim at controlling import quantity or restricting importers to purchasing from producers that use specific commodities or components in their production process.

A lack of consistency and the absence of a single authority over trade policies have contributed to this proliferation of NTBs. While the Ministry of Finance sets tariffs, NTBs are under the authority of line ministries without consistent co-ordination or consideration given to their economy-wide impact. The increase in NTBs following the 2001 decentralization is in sharp contrast to the government's commitment to reduce tariffs and has sent contradictory signals to the outside world.

#### **1.4 Current trade patterns**

Trade policies have an important bearing on the formation of domestic prices and hence on the decision to produce or invest. Industries that are protected by tariffs, quantitative restrictions or subsidies do not face import competition and therefore, tend to orient their production toward the domestic market. Producing for a protected market will, in turn, reduce pressure to upgrade production or increase efficiency, resulting in a loss of competitiveness. The lack of coherence, both in the domestic dimension (with other policies that determine competitiveness) and in the international dimension (consistency with foreign direct investment policies) may send the wrong signal about the government's commitment to trade and investment reforms.

##### ***Energy still dominates trade patterns***

Indonesia's trade pattern in goods is dominated by the energy sector. In 2006, energy-related products accounted for 29% of exports and 37% of imports. Manufacturing also plays an important role in the pattern of goods trade. On the import side, for instance, machinery and equipment is the second largest import category at 18.5% of total imports. And on the export side, textiles, leather and footwear (11%) and processed foods, beverages and tobacco (10%) represent important export sectors.

These data underscore important changes that have occurred in the Indonesian economy. The non-agriculture primary sector clearly dominated Indonesia's exports in 2007. In 1995, in contrast, three out of the top ten exports were agriculture-related (shrimps and prawns, coffee, and crude palm oil), whereas in 2007 only palm oil remained in the top ten. Moreover, sports footwear fell out of the top ten ranking in 2007, leaving no manufacturing products that are not directly related to energy and non-energy-related mining (oil, coal, rubber, copper, nickel and tin).

While these broad trends in export values show important trade shifts, the relative ranking of particular products also points to interesting trends. The most dramatic change in exports of a particular product in the top 10 was copper cathodes, which moved from the 2,612<sup>nd</sup> most exported product in 1995 to 9<sup>th</sup> in 2007. Moving in the opposite direction was plywood, going from 10<sup>th</sup> place in 1995 to 2,149<sup>th</sup> place in 2007. These dramatic shifts can be partly explained by external factors, such as the large price rise for copper during the period, and partly by domestic factors, such as a shortage of raw materials and the surging growth of the plywood industry in China.

Indonesia lags behind its regional competitors in developing high-technology export sector. High technology sectors contribute to the economy by increasing the productivity of labor and capital; thus, they can play an important role in moving up the value chain. While Indonesia has experienced an increase in its high technology exports as a share of total goods exports in the 1990s, that share has steadily declined since. This decrease is in part attributable to low R&D and innovation intensity.

Indonesia's exports of high technology products have consistently lagged behind those of its ASEAN neighbors as well as those of China and Korea. In 2006, Malaysia, Singapore, Thailand, China, and Korea all recorded stronger high technology export shares than Indonesia. Only India posted a share lower than Indonesia's (4.9% in 2006). Indonesia's high technology sectors suffer from a lack of infrastructure support and a shortage of technical skills – two critically important factors for competitiveness in this sector.

### ***Comparative advantages***

Indonesia's comparative advantages in international trade are shifting. Measures of revealed comparative advantage (RCA), which are useful in assessing export performance, suggest that the past two decades have brought about substantial shifts in the pattern of comparative advantages. Over the past 10 years, RCA indexes have been increasing in the transport, metal and chemical goods sectors. In addition, between 1998 and 2007, Indonesia developed a measurable comparative advantage in five goods sectors: chemicals, pharmaceuticals, electrical machinery, motor vehicles, and railroad and transport equipment. In 2007, paper and printing registered the highest RCA index (2.1), followed by building and repairing of ships (1.9) and wood products (1.9).

In the same ten-year period, Indonesia experienced decreasing RCA indexes in the primary (basic resces), textile, energy-related, and high technology sectors. Moreover, from 1989 to 2007, RCA indexes fell dramatically in the energy-related mining and quarrying sectors (from 14.2 to 1.6) and the wood products sector (from 10.1 to 1.9), a shift related to structural reforms implemented in the mid-1980s. One of the most striking aspects of these RCA indexes is that values for high technology sectors are all well below 1, with the exception of the pharmaceuticals sector (1.5 with average annual growth of 17.9% during the period 1998-2007). Average annual growth values in the last ten years are negative for the high technology equipment and machinery sectors, but positive for the medical, precision and optical instruments sector which posted a growth rate of about 8.7%.

### ***Emerging patterns***

Analysis of export performance shows that iron and steel, as well as non-ferrous metal products, have been able to remain globally competitive in the world market during the period 1996-2006. On the other hand, mining and quarrying, coke and refined petroleum products and radio, television and communication equipment have been underachievers. This pattern shows that trade in mining products in particular represents an important share of Indonesia's overall exports while its comparatively poor performance reflects the aging infrastructure in these energy-related sectors.

Several of the high technology sectors (chemicals and office, computing and accounting machinery) are very near the average world growth rate of traded goods. Food, beverage and tobacco products, which represent one of the top export sectors has gained world

market share even as world trade in these products has declined. Paper and publishing, machinery and equipment, and the primary sectors also fall into this area.

Conversely, textiles, leather and footwear as well as wood products have been losing ground, suggesting that Indonesia may need to increase competitiveness in niche markets in these sectors in order to improve export performance. The evolution of textile and garment exports is of particular interest in light of recent global changes in the sector. Even though exporters in this sector have adopted specialisation strategies, in terms of products and markets and have cut costs to maintain their positions, these actions could not prevent losses in market shares.

Indonesia has strong positions in some products and markets, but it needs to further advance on the value chain and better exploit its endowments. The concentration in some product categories and the consolidation of markets have helped Indonesia to weather the phase-out of textile and garment quotas under the Multi-Fiber Arrangement (MFA) in 2005, but to remain competitive, this industry cannot lag behind other exporters in upgrading its technologies. Given its well-established, vertically integrated industrial structure and abundant labor pool, ample opportunity exists to expand medium to high-quality garment production. The 2002 decree that restricts textile imports, originally aimed at curbing illegal imports, actually impedes the upgrading of industrial structure by sheltering domestic firms from competition in the domestic market. The textile sector faces the risk of being further impacted by the competition of Chinese products that will be allowed to enter Indonesia in 2010, free of tariffs, as per the ASEAN-China Free Trade Agreement.

The emergence of Indonesia's motor vehicles industry is one of the success stories related to rapid liberalisation. After a long record of policy failures related to infant industry protection, the sector is now showing increasing signs of competitiveness. It is still small but is the fastest growing export sector. Effective protection of the industry has fallen substantially between 1995 and 2000 and an increasing share of inputs is sourced domestically, resulting in a domestic value-added share of nearly 64% in 2004, one of the highest. In addition, the increase in the domestic value-added share is the largest, from 40% in 1995. The motor vehicle industry is one of the few that has regained its pre-crisis level share of exports in production.

## **1.5 Conclusions**

In the evolving global trade environment, Indonesia needs to boost the competitiveness of its economy. It must identify strategies to remain competitive, including moving up the value chain, better exploiting comparative advantages and using production factors more efficiently.

Developing dynamic and competitive support services, integrating domestic firms in international production networks, and boosting technological capacity are all key elements of improving competitiveness in the medium to long term.

A comprehensive approach, involving trade policy reform moving in tandem with reforms in other policy areas, in particular policies in industry, services and agriculture, will be the key to boosting exports in the long run.

A well-designed investment policy is needed as an important cross-cutting component of sector policies.

## **Chapter 2: Foreign Direct Investment and Export Development**

### **2.1 The benefits of Foreign Direct Investment in enhancing export competitiveness**

Multi-national corporations (MNC) account for a substantial share of exports in a number of developing countries and their role spans all sectors. In the primary sector, besides oil and gas and minerals, MNCs contribute to the development of resource-based exports; for example, in food processing. In manufacturing, MNCs tend to be the leaders in export-oriented production and marketing, especially for the most dynamic products for which linking up to marketing and distribution networks is crucial. Their international production systems can take various forms, ranging from loose networks of independent suppliers to production-driven, FDI-based organisations involving networks of affiliated companies. The increased tradability of services also offers new opportunities for exports, such as service and R&D centres.

There is a widely held view, supported by documented evidence in numerous studies, that FDI contributes to enhancing the competitiveness of host countries and therefore, contributes to the improvement of export performance by such countries. The role of MNCs in expanding exports of host developing countries derives from the additional capital, technology and managerial know-how they bring, along with access to global as well as important home-country markets. MNCs' contributions in terms of resources and market access complement a host country's own resources and capabilities and usually provide important elements for greater competitiveness.

MNCs provide host countries with competitive assets for export-oriented production in technology-intensive, dynamic products in the world trade. Such assets are often firm-specific and therefore, are costly and difficult for domestic firms to acquire independently. The transfer of such assets by the MNCs to their foreign affiliates through training, skills development and knowledge diffusion opens up prospects for further dissemination to other enterprises and the economy at large. Thus more firms, including domestic companies, can develop their export capabilities, contributing to the establishment of factors that underlie competitiveness in the host country's economy.

FDI helps to promote the host country's exports by facilitating its access to new and larger markets. MNCs provide their affiliates in host countries with a privileged access, not only to their international production/market systems, but also to intra-firm markets and to the wider network of suppliers and other business partners.

MNCs further contribute to enhancing host countries' competitiveness and exports through spillover effects on local firms. These firms benefit from the improved infrastructure of transport and communications that may be brought about by MNC-driven increases in export activity. They also benefit from improved "soft" infrastructure, such as knowledge of and capacity in international standards compliance, better laboratories, and more capable export-quality institutions, better trade finance, and more sophisticated legal services.

Another factor is the influence of MNCs on the competitiveness of domestic firms' exports and the diffusion of new technologies. By bringing their advanced product-process technology, managerial and marketing skills, MNCs increase competition in host countries and force local firms to adopt more efficient methods.

## **2.2 Indonesia's case**

Indonesia's competitiveness has historically been driven, in substantial degree, by FDI as companies invested in by MNCs have generally demonstrated higher productivity than domestic firms. Productivity increases have been transmitted to domestic firms via FDI-related productivity spillovers.

At present, Indonesia does not have specific policies to attract export-oriented foreign direct investment. The government's strategy is to attract any kind of foreign investment, whether its purpose may be to serve the domestic market or to supply products to international markets. Therefore, current government policies primarily aim at improving the overall investment climate without specific market targets or focused development goals.

### ***Historical overview of FDI in Indonesia***

Indonesia first sought to attract FDI under President Soeharto's New Order regime as part of his policies to create a market environment conducive to the private sector. The Foreign Investment Law, enacted in 1967, contained various attractive incentives, including generous tax concessions and guarantees, the free transfer of profits, and a guarantee against arbitrary nationalisation of foreign enterprises. As a result, investment rose rapidly during the early 1970s as a number of domestic business groups, often in joint-ventures with foreign enterprises, created industries in a wide range of sectors including textiles, electronics, pharmaceuticals, food products and transport equipment.

However, these liberal trade and investment policies did not last long as the oil boom and increased revenues induced the government to embark in a new state-led, import-substituting industrialization drive that involved the establishment of large scale, state-owned basic industries. The government also reversed its foreign investment policy in response to rising economic nationalism, in part aimed at the so-called "over-presence" of Japanese investors. This attitude was reflected in the requirement that new foreign investment projects would only be allowed in the form of joint-ventures with Indonesian partners holding a majority of the company's share capital. Another development was the establishment of "strategic industries" in the late 1970s, such as an aircraft assembling company, a shipbuilding company and other state-owned enterprises.

The end of the oil boom in 1982 forced the government to shift back to a more liberal trade and investment regime, including a series of trade reforms aimed at reducing the "anti-export" bias of its protectionist regime. These trade reforms were intended to move from the import-substituting pattern of industrialization to an export-promoting one. The aim was to generate an expanding stream of non-oil and gas exports to reduce the country's dependence energy imports.

As a result, export-oriented investment rose rapidly since the late 1980s. Most of the FDI inflows came from the newly-industrialized countries of Asia. This investment boom occurred in two waves: the first came in 1988-90 when Indonesia's textile sector received large amounts of export-oriented FDI from East-Asian countries and the second from 1994 until the Asian financial crisis in 1997. The second wave was triggered by the significant liberalization of the foreign investment regime that took place in June 1994 and that aimed at attracting more export-oriented FDI to sustain the growth of manufactured exports.

After the Asian crisis, domestic and foreign investment declined steeply due to the deteriorated investment environment. Since 2004, investment indicators have improved again due to Indonesia's political stability and the marked improvement in its macro-economic situation. However, new productive FDI has remained sluggish due to a number of factors that have kept Indonesia's investment climate less attractive than that of some of its Asian neighbors and rivals.

In 2007, foreign investment, with a share of 15.8% of capital formation, constituted a key component in Indonesia's gross domestic capital formation. This share was roughly in line with that in 1997 (16.5%), the first year of the crisis, suggesting that foreign investment was once again playing a significant role in the economy. However it is likely that new FDI has been decreasing again since the onslaught of the current global financial and economic crisis.

Over recent years, most FDI flows have been into manufacturing, in particular the chemical, pharmaceutical, and paper and printing industries. There have also been substantial inflows into the food, metal, machinery and electronics industries as well. In services, the biggest inflows were recorded in the transport and telecommunications sectors, largely as a result of the privatization of telecommunications firms that had been nationalized in the wake of the Asian crisis. There have also been sizeable inflows into banks, utilities, construction and real estate and business services.

Indonesia does not publish data on FDI stocks, but the total from the International Financial Statistics database and bilateral data suggest that Japan, Singapore and the United States make up about two-thirds of FDI stocks in Indonesia with Canada, Germany, Netherlands and the UK having a combined share of 20% in 2005. The three major investors specialize in three different sectors. Japan's investments are mainly flowing to the manufacturing sector, making it the biggest foreign manufacturer in Indonesia. Over 95% of Singapore's investment is in services, in particular finance and telecommunications while almost two-thirds of US investment is in mining. The US also made substantial investments in chemicals, metals and other industries.

### **2.3 Improving the investment climate**

Investment is one of the key factors that could increase current economic growth rates, but its recent performance, particularly foreign investment, has been disappointing, having experienced practically no increase during 2006 and only a modest increase in 2007. Such poor FDI performance is due a number of well-known factors:

- a) weak overall management of investment climate reform,
- b) ineffective investment policy co-ordination.
- c) Cumbersome investment entry and facilitation procedures both at central and local government levels,
- d) weak legal certainty and law enforcement,
- e) public governance problems, especially in the customs and tax administrations,
- f) unattractive labor market conditions,

- g) neglected infrastructure,
- h) logistical constraints affecting the flow of goods,
- i) restricted access to credit, particularly for SMEs,
- j) vulnerability of the financial system to external shocks and
- k) a still-negative image abroad, exacerbated by terrorist attacks and natural disasters.

### ***Policy Packages***

Over the last three years, the Government has issued, in the form of Presidential Instructions, successive Policy Packages aimed at improving the trade and investment climate. These Policy Packages, prepared by the Coordinating Ministry for Economic Affairs (MENCO), have set out annual plans of actions to be implemented by all Ministries and Agencies concerned with trade and investment.

The first Policy Package for the Improvement of the Investment Climate, INPRES 3/2006, issued at the beginning of 2006, stipulated the following main objectives:

- Enact a new Investment Law.
- Revise the regulations related to investment, including a new list of sectors closed for investment and sectors open with special conditions (“negative list”).
- Formulate a clear division of tasks between the central government and regional governments regarding investment matters by revising Government Regulation 25/2000.
- Revitalize the National Team for the Enhancement of Exports and Investment (PEPI).
- Accelerate business licensing by reviewing licensing rules, simplifying the process of establishing a company and establishing an integrated service system for investment with a clear division of authority between the central and regional levels.
- Synchronize central and regional regulations.

A similar Policy Package was issued in June 2007 (INPRES 6/2007) and in May 2008, a new Policy Package (INPRES 5/2008), entitled "Focus of the Economic Programme 2008-2009" was issued by the government. In the latter package, the government attempted to complete various reform programs and agendas that had not been implemented in the 2006 and 2007 packages. The new package included programs in the fields of general investment climate, infrastructure, macroeconomic and finance policy as well as SME development. It also introduced new actions concerning energy sustainability, natural resources, environment and agriculture as well as the implementation of commitments undertaken as part of the ASEAN Economic Community.

The contents of the most important programs are outlined below:

- **Improving the investment climate** – This programme set out actions ranging from implementation of one-stop investment services and simplification of

business licensing procedures to the gradual implementation of the National Single Window.

- **Macroeconomic and finance policy** – Most actions of this programme were a direct continuation of previous packages and contained items to further strengthen the banking system and capital markets, including sector supervision (along with development of a market for shariah-based financing), improving the quality of credit information, and efforts in combating money laundering. Other actions are aimed at increasing access to capital for entrepreneurs by strengthening the venture capital market while at the same time enhancing supervision of finance companies. With regard to state-owned enterprises (SOEs), the package stipulated a goal of reduction to 87 SOEs from the current 139 in accord with a moving time line.
- **Infrastructure** – Contrary to the 2006 and 2007 packages, this program contained little policy actions, reflecting the lack of progress on infrastructure projects under public-private partnership schemes. The stipulated actions mostly concerned specific projects such as the construction of roads, bridges, airports, railways to airports and waste treatment plants.

### ***The new investment law***

In 2007, Indonesia introduced a new investment policy package that consisted of the new Investment Law (Law 25/2007) and several regulations, including the negative investment list (Presidential Regulation 77/2007), regulations on taxes, and the establishment of Special Economic Zones. The new law enshrines the principles of national treatment and transparency; it also provides for both dispute settlement using international investment laws as well as protection against expropriation. Importantly, the law also makes a clearer distinction between the responsibilities of sub-national and national authorities, particularly with respect to the ability to impose trade-related taxes.

The new law narrows disparities in the treatment of foreign and domestic firms. Now, both domestic and foreign firms benefit from the same incentives if they invest in infrastructure, labor-intensive industries, projects involving significant technology transfer or development of rural areas, or joint ventures with small and medium-sized enterprises. For certain types of investments, fiscal incentives have also been introduced in the form of tax and import duty reductions and accelerated rates of depreciation and amortisation among others.

The Investment Coordinating Board (BKPM) is given a new role with a specific mandate to coordinate investment policy implementation. The Board is to oversee the establishment of one-stop shops to facilitate and speed up investment licensing with the aim of reducing the time needed to process investment applications from 90 to 30 days.

The new law also sets out a new negative list of restricted and prohibited sectors for domestic and foreign investors. While 25 sectors were completely closed to investment, there was a long list of restricted sectors. According to the law's provisions, the following significant restrictions are applied:

- Twenty-one sectors are limited to co-operatives and micro, small and medium-sized enterprises (construction and the other business activities sectors are particularly affected),

- partnerships are required for 18 sectors (especially forestry and fisheries)
- limits on the percentage of capital ownership are imposed in 25 sectors (primarily construction, architecture and engineering services, transportation, and to a lesser extent, insurance services),
- special permits are needed in 14 industry sectors, and
- a requirement of 100% domestic capital is mandated for 19 sectors, mostly in retail trade.

While the enactment of the new investment law was generally welcomed, the stipulations of the negative list restricting investment in many sectors – and significantly, its loopholes, particularly on the issues related to grandfathering – created further uncertainty for established companies and potential new investors. The government has since made two revisions of the negative list without completely satisfying concerns of the private sector. A third and, hopefully, final version of the list is now waiting for the President's signature.

The new investment law constitutes a step in the right direction, but in itself it is not sufficient to significantly improve Indonesia's investment climate. The following elements are seen by the domestic and foreign business communities to have decisive effects on the investment climate:

- **Poor infrastructure** – In the mid-1990s, Indonesia was at the forefront of infrastructure development with more than 6% of its GDP invested in infrastructure projects by both the public and private sectors. However, following the Asian financial crisis, the difficulties linked to political reform and the economic slump led to a steep decline in overall development spending, particularly infrastructure investments. Today, Indonesia is only spending about 2% of its GDP on infrastructure and ranks below most of its Southeast Asian neighbors on key infrastructure indicators. About 90 million people live without electricity, 50 million have no access to treated water and close to 200 million people have no direct access to a phone or sewage network.

Poor infrastructure issue is repeatedly identified in various surveys as one of the most important constraints on the investment climate in the country. Infrastructure inadequacies bear directly on the costs associated with trading goods and services and consequently, adversely affect Indonesia's competitiveness. The country's overall economic development is handicapped by this deficiency.

A major increase in infrastructure investment and spending is essential to achieve the economic growth required to create jobs. The government has declared improvement of the overall investment climate and improvement of infrastructure provision to be major objectives in order to enhance Indonesia's international competitiveness, increase productivity and generate employment.

- **The Government's infrastructure strategy and the role of public-private-partnerships** – Realising the need to attract capital and expertise from the private sector, the Government announced an ambitious agenda to carry out policy, institutional and regulatory reforms aimed at fostering public and private sector

cooperation in the provision of infrastructure at a high-profile Infrastructure Summit in January 2005. The principal vehicle through which this cooperation was to be accomplished was to be public-private partnerships (PPP).

At the Summit, requirements for infrastructure investment amounting to US\$65 billion over the next five years were announced. These needs were to be financed by the government budget up to US\$25 billion, by the domestic financial system up to US\$14 billion, by international development financial institutions up to US\$10 billion, and by private investors up to US\$16 billion.

The Summit created considerable initial enthusiasm among potential investors; however, they were quickly disappointed as the 91 projects offered were not well-prepared and the necessary policy and regulatory framework was not put in place. A subsequent Infrastructure Conference was held in November 2006 at which the Government reiterated its commitment to establish firm policies and a regulatory framework conducive to PPPs. A new list of 10 “model projects” was submitted to potential investors, but these projects also proved not to be well prepared.

Subsequent to these initiatives, the Government’s fiscal position improved, due to favorable macro-economic conditions, and budget allocations for public infrastructure investment increased. At the same time, however, the economic pressure to attract private investment lessened.

- **Policy and regulatory reforms** – At the Infrastructure Summit, the government announced an ambitious agenda to carry out policy and regulatory changes aimed at fostering public-private cooperation in the provision of infrastructure. The Government’s reform package included commitments to offer policy certainty and guarantee a stable macro-economic environment, to ensure predictability in rules and policies (including with regard to tariffs and market arrangements) to provide appropriate support and risk-sharing for essential investments. The Government also committed to liberalize access to infrastructure provision, to introduce fair competition and to establish regulatory bodies that would oversee a fair process of tariff determination.

Regarding legal and regulatory reforms, the key issue was to establish a framework for private participation in infrastructure by revising outdated laws and regulations. Substantial progress has been achieved on creating the main pillars of a comprehensive legal and regulatory framework for PPP and several important sector laws (for instance the law on railways) have been passed by Parliament, but most of the implementation regulations are still pending.

a) *Perpres 67* – In November 2005, the Government enacted Presidential Regulation 67/2005 (*Perpres 67*) to provide a comprehensive legal framework for Public-Private Partnerships. The regulation defined the main rules and procedures for the bidding process:

- PPP projects may be identified and prepared either by the Government or the private sector, but the sponsors must be selected through open and transparent bidding.

- Tariffs must be set at full cost recovery levels and if tariffs exceed consumers' ability to pay, the difference could be compensated by a government subsidy.
- Decisions on financial support from the Government are to be managed by the Risk Management Unit (RMU) of the Ministry of Finance (note discussion below).
- Government support is only to be provided to projects that comply with the terms of Perpres 67.

However, the drafting of Perpres 67 was unclear in various respects. It was not clear whether Perpres 67 was intended to apply to projects promoted by SOEs or sub-national entities. There were questions about the application of Perpres 67 to projects for which calls for proposals had been issued prior adoption of this Perpres.

Perpres 67 also required that projects achieve financial closure within 12 months of project award. This requirement would be an important mechanism to ensure that concessionaires that cannot perform would not be able to block infrastructure development projects. But there was ambiguity about which projects were subject to this clause as well as the definition of "financial closure". These legal ambiguities encouraged project proponents to seek Government support outside the requirements of Perpres 67.

Realizing these shortcomings, the Government announced a revision of Perpres 67 in order to bring more clarity on the definition of contracting agencies, and to stipulate the modalities of government support for regional projects and project procurement procedures. However, this revision has not yet been enacted by the Government.

- b) *KKPPI and Institutional Challenges to Effective PPP Projects* - The government established the KKPPI (Committee for the Acceleration of Reforms in Infrastructure) to facilitate the creation and use of PPP. Its primary role is the evaluation of PPP projects submitted by ministries, agencies or regional governments. Procedures and criteria for prioritizing such projects and for evaluating projects that require government support were spelled out in the regulations establishing the KKPPI. The RMU was established to manage the provision of government support, including guarantees.

Development of a comprehensive institutional framework to steer implementation of good quality PPP projects has been the primary challenge. While a framework has been adopted, it has been largely non-functional and PPP projects have failed to develop. Nonetheless, a review of the current framework and the problems that have beset it provides useful indicators for developing a productive way forward.

KKPPI was meant to be the central agency in the PPP process and was given the key tasks of establishing standards of good practice, independently reviewing projects and recommending government support to the RMU,

assisting ministries and agencies in developing projects, and establishing a tendering process that is comparable to international standards in terms of content, clarity and selection procedures. Since its establishment, KKPPI has done substantial work. However, it has never been given sufficient means and authority and has consequently been bypassed by line Ministries that have taken projects directly to the Ministry of Finance for approval.

The Project Development Facility (PDF) was established to fund and support the technical preparation of projects, in particular projects originated at local government level. However, it has not yet been able to function effectively due to inter-agency implementation difficulties. In similar fashion, “model projects” that were meant to be showcases of good practices in PPP development have been *de facto* abandoned with only one of them (the coal-fired Central Java power plant) having now reached the stage where it can be presented to potential investors.

- c) *Government support* – In May 2006, the Ministry of Finance issued Decree 38/2006 on Technical Directives for Controlling and Managing Risks of Infrastructure Development that defined the terms and conditions of government support for PPP projects.

The decree stipulates that government guarantees may be used in the financing of PPP projects. Some level of direct financial support from the Government may also be required, particularly where infrastructure projects have large public externalities.

The RMU would determine the type and level of government support for PPP projects. It would review PPP project proposals to determine whether the proposed contract represents an appropriate allocation of risk between the Government and private investors. The RMU would also be responsible for managing the Government’s exposure to contingent liabilities.

- d) *Preparation of projects* – The Government announced the establishment of a Project Development Facility (PDF) aimed at improving the preparation of projects. This facility was first used to prepare ten model projects that were presented at the Infrastructure Conference in November 2006.
- e) *Indonesia Infrastructure Fund* – The Government established the Indonesian Infrastructure Fund (IIF) to address weaknesses in the domestic capital market. Indonesian banks have limited experience in complex project appraisal, risk assessment for structured financings and, in particular, management of construction risk. Even the most experienced local banks possess only limited exposure to infrastructure projects – for example, providing 3-5 years corporate finance loans to infrastructure companies. Despite the attraction of long-term infrastructure investments for pension funds and insurance companies, current regulations largely restrict their long-term assets to bond issues with 1-10 year maturities (shorter than the life of most infrastructure projects). Although institutional investors control assets worth more than 7% of GDP, over half are invested in bank deposits.

The IIF can mobilize local currency financing for PPP projects by intermediating in the local bank and capital markets and providing a vehicle for institutional investors who could not invest directly in projects. The IIF will be a financial institution with minority government participation and leveraged by private resources.

- f) *Land acquisition* – One of the most serious obstacles to infrastructure development lies in land acquisition. The main issues are inconsistencies in land acquisition practices and implementation procedures, lack of a fair and independent mechanism for the valuation of land, and the absence of land records.

Land acquisition procedures originate in the Home Affairs Ministerial regulation No.15, 1975 concerning “Land Acquisition Procedure”; No 2, 1976 concerning “Land Acquisition Procedure for Public Purpose by Private Sector”; and No 2, 1985 concerning “Land Acquisition Procedure for Development Project in Sub-District Area”. These regulations were enacted to facilitate private investments, in particular real estate development.

In response to dissatisfaction among affected land owners, the Government issued Presidential Decree 55/1993, the key features of which were to limit the definition of public purpose and to use the Assessment of Price for Land Tax (NJOP) as a basis for compensation. The decree was made general in order to give flexibility to local governments in its implementation. As a consequence of this flexibility, however, different interpretations were possible, depending upon the capacity and intentions of the implementing authority.

Presidential Decree 55/1993 also re-emphasized the eminent domain powers of the President under the Law 20/1961 which stipulates that only the President can compel people to relocate. The Law 20/1961 concerning Expropriation Right on Land and Other Assets is still valid.

Presidential Decree 55/1993 was succeeded by Presidential Regulation (Perpres) 36/2005 which shifted responsibility for land acquisition to higher-level entities and provided for direct negotiations on compensation to affected owners. Perpres 36/2005 was further amended by Perpres 65/2006 which aimed to provide clearer guidelines on land acquisition. The key provisions included compensation based on market price, dissemination of information to the affected communities concerning the land in question and potential impacts of the proposed project. Perpres 65/2006 also confirmed the President’s powers with regard to expropriation of land under Law 20/1961.

The provisions of Perpres 36/2005 and Perpres 65/2006 remain too general and consequently provide scope to varying interpretations. Furthermore, their provisions are not always consistent with other regulations and operational guidelines prepared by different ministries. In May 2007, the National Land Agency (Badan Pertanahan Nasional or BPN) issued a decree on implementation provisions of PerPres 36/2005 and Perpres 65/2006. How the BPN decree will actually be implemented remains to be seen.

The Government also established an inter-ministerial Land Working Group to oversee and coordinate further reforms, in particular the issue of the delegation of the President's role in land expropriation. The working group will determine the legal instrument required to achieve this objective and determine whether Law 20/1961 needs to be amended or replaced. The working group will also evaluate the feasibility of allowing construction of projects to start before negotiations on land acquisition are completed. This would be accomplished by placing compensation funds in escrow accounts, a practice used in many countries.

- g) *Land acquisition fund* – A land acquisition revolving fund (BLU) was established within the Ministry of Public Works to implement land acquisition. The government allocated Rp600 billion (about US\$65 million) to the fund under the 2006 budget.
- h) *Property rights* – Prior to the implementation of the new investment law, land titles were offered to foreign firms for relatively short durations (*e.g.* 20 years with the ability to extend for another equally short time period). Leases and extensions are now combined into periods of 95 years for agriculture and plantation investments; 80 years for construction on land purchased by the investor; and 70 years for the right to use land for any purpose. However, it should be noted that recent legal challenges have questioned whether the longer land-use rights will be upheld.

### ***The way forward***

After the strong drive of the 2005-2007 period, the reform process appears to have lost considerable momentum. In the latest Policy Package, infrastructure policies were hardly mentioned. Some progress has been achieved, but most of the work remains to be done on the key policy issues, primarily (1) the development of a clear policy and strategy for infrastructure development, including well-defined roles for central and sub-national levels of government and for the private sector, and (2) the development of a comprehensive master plan for each main sector of infrastructure. Moreover, the role of State-owned Enterprises (SOEs) still remains to be clarified.

In order to return private provision of infrastructure to a central position in infrastructure development, the credibility of the PPP agenda needs to be restored. To achieve this, credibility and capacity of PPP-related institutions must be established, primarily the KKPPi and PPP nodes in ministries and possibly in the regions. The land acquisition question will also have to be tackled with decisiveness and financial means. Finally, private investors will expect financial closure on the first model project, the Central Java power plant, in order to determine whether PPPs are likely to be viable investment vehicles.

- **Poor logistics** – Poor logistics constitute another area of weakness affecting Indonesia's competitiveness and investment climate. The performance of the logistics sector is adversely affected by Indonesia's geographical factors, poor infrastructure and relatively low efficiency of operators, both public and private.

Indonesia's sizeable geographical distance from the major centres of economic activity is hampering its competitive edge. Because the country is spread across 17,000 islands covering over 5,000 km, internal distances pose trade-related infrastructure challenges.

Compared to other countries in the region, the maritime transport costs of a 20-foot container to Yokohama in Japan are substantially higher from Tanjung Priok in Indonesia – almost 50% higher than from Manila, 10% higher than from Singapore and 20% higher than from Malaysia. Inefficient transport links impose material costs as well as costs associated with extended transportation time. From Tanjung Priok, the closest port to Jakarta and one of Indonesia's major ports, a ship takes 21 days to reach Europe or the west coast of the United States. Most ships heading for Europe or America travel via Singapore, a trip that takes about a 2-3 day trip from Tanjung Priok, but may take as long as 4-5 days if containers need to be reloaded onto another ship. Ships heading for Yokohama often call at Shenzhen or Manila; the trip, therefore, takes about 11 days, a duration about 50% longer than from Malaysia, Singapore and Vietnam and about double the time from South China or the Philippines.

Port congestion, lengthy clearing processes and high charges add to these transport costs. Congestion is partly due to port design and partly to time-consuming handling procedures. In Tanjung Priok, the proximity of the container depot to the port appears to contribute to congestion. In an attempt to rationalize the clearing process and handle exports and imports in a more efficient way, the Government reduced the number of ports that are authorized to handle foreign trade from 141 to 25. This streamlining is expected to make the process more efficient.

Distribution costs (including procurement, the intra-firm movement and distribution of goods) represent 14.1% of production costs (this share is only 8.4% in the US and 4.9% in Japan) with terminal handling charges, trucking, documentation and service charges making up 90% of these costs. The largest single component is terminal handling charges with a 48% share.

Trucking costs, at 25% of distribution costs, are also high, especially in comparison with other countries in the region such as Malaysia or Thailand. A recently published survey on the per kilometre cost of moving goods by truck showed that it is 50% higher in Indonesia than the Asian average. The largest component, not surprisingly, is fuel, but legal and illegal levies also make up an amount roughly equal to the compensation of drivers. These levies comprise transit fees (46%), weigh stations fees (32%) and bribes to police and local groups for protection. Sizeable maintenance costs due to the poor condition of trucks, coupled with dilapidated roads, encourage overloading.

Weigh stations, designed to serve the public policy goals of road safety and the preservation of road quality by imposing fines on overloaded trucks, are governed by regulations of the Ministry of Transportation, but are operated by sub-national governments. Only overweight trucks are supposed to pay a fine (20% actually do), but given that the majority of trucks are overloaded, 84% of drivers pay bribes to avoid fines. Closer oversight by the Ministry of Transportation is needed to stop abusive practices at these facilities by sub-national governments. Such oversight could curb illegal fees and bribes, thus reducing transportation costs.

There is much less room to reduce regular operating costs as the trucking market appears competitive, albeit enjoying fuel subsidies. Curbing levies on truck transport would also provide room to phase-out fuel subsidies without triggering too much resistance by industry associations.

In 2008, the Coordinating Ministry for Economic Affairs took the initiative to set up a national logistics team charged with drafting a logistics blueprint and improving the regulatory framework. The blueprint, issued at the end of 2008, was entitled “Vision 2025: Locally Integrated, Globally Connected Logistics for National Competitiveness.

The blueprint summarizes the logistics strategy as (i) ensuring capacity and quality of services; (ii) promoting domestic freight transport; (iii) facilitating bi-national and regional transport; (iv) supporting SMEs and logistics operators; and (v) speeding up of foreign trade documentation and inspection processes. It blueprint sets out both long-term objectives and a number of immediate actions, such as improving infrastructure in several priority areas (for example, Tanjung Priok) and creating access roads. The long-term plan envisions an integrated network with international gateways and domestic nodes.

Regarding seaports, the logistics blueprint admits the current weak state of port management and states that Indonesia must rely until 2014 on Singapore and Malaysia as international hub ports. The blueprint aims at Indonesia developing its own hub ports by 2025. On air transport, the priority recommendation is to improve cargo facilities at the international airports of Jakarta and Bali. The blueprint also envisions railways becoming the main mode for cargo transport within Indonesia.

With regard to the regulatory framework, the blueprint calls for speedy issuance of implementation regulations for the Law on Shipping, promulgation of a new regulation to create a railway freight operation, and adoption of standard regulations on private participation in logistic services.

On the institutional front, the blueprint recommends establishment of a National Logistics Council or Committee that would be responsible for overseeing regulatory reform, conducting further sector studies and coordinating all government projects. The Council would be chaired by Indonesia’s President or Vice President and would have a wide membership drawn from ministries, government agencies and the private sector.

- **Licensing** – Investors and businesses in Indonesia frequently complain about both excessive bureaucratic red tape and lack of clarity regarding licenses and prerequisites required during each step of the business start-up process. Reflecting, in part, these complaints, the *Doing Business Report 2009* produced by the International Finance Corporation (IFC) ranks Indonesia 129 out of 181 countries surveyed, down from the previous year’s 123rd position out of 181 countries. Despite an improvement over the figures from previous years, 76 days are still required to start a business in Indonesia. The process involves numerous agencies at the central government level and subsequent procedures to obtain construction and other permits at regional and local levels.

Following decentralization in 2000/2001, the authority to issue many licenses was transferred to local governments. However, while local governments may actually

issue licenses, most licenses are created and regulated by the central government or are legally based on central government regulations.

Many local business licenses are overlapping, duplicative or conflicting – a situation that constitutes one of the main challenges to simplifying business procedures and requirements. This situation exists in part because different central government agencies issue regulations for their own area of authority without sufficient inter-agency coordination. Local taxation is a similarly confused situation. Despite the prerogative of the central government to issue guidelines for the creation of local taxes and user charges and to approve their implementation, scrutiny and evaluation all of them is very difficult.

The Decree from the Ministry of Home Affairs of July 2007 instructed the municipalities and regencies (460 in all) to set up one-stop shops to facilitate investment projects. The implementation of this massive initiative is still under way and even though there are some encouraging success stories in some local governments, there is little agreement as to what model is most effective at serving the business community.

The streamlining of the business licensing process is a priority for the Government's investment climate reform agenda, and as such has been included in the May 2008 Policy Package. In response to the findings of the *Doing Business Report 2009*, the Government reiterated its objective to reduce the duration of this process to 20 days. Instrumental for the achievement of this objective will be the establishment of an online investment licensing system and an integrated one-stop investment service, both of which are under the responsibility of BKPM. However, successful simplification of business licensing at the local level and improvement in the performance of one-stop shops require simplification and harmonization of central government regulations.

- **Intellectual Property Rights** – While Indonesia has a credible intellectual property rights (IPR) regime, more far-reaching and effective enforcement would create a more predictable environment for foreign investors. During the Reform Era, Indonesia overhauled its intellectual property regime to bring it in line with the WTO and other international agreements. There are seven primary intellectual property laws in Indonesia: Laws 30/2000 (trade secrets); 31/2000 (industrial design); 32/2000 (lay-out design and integrated circuits); 14/2001 (patents); 15/2001 (trademarks); 19/2002 (copyrights); and 29/2000 (plant variety).
- Indonesia's IPR regime recognizes copyrights through a copyright law that came into effect in 2003 and provides 50-year protection for copyrighted materials. Importantly, this law establishes the right to license, produce, rent or broadcast audiovisual, cinematographic and computer software. Additional laws enacted in 2004 and 2005 govern copyrights for optical discs and related machinery. Penalties for end-user piracy are in effect as well as copyright holders' ability to request civil injunctions against pirates. Importers are also required to register the origin, type, quantity and destination of all optical discs and optical-disc machinery.

- The law on trademarks that was enacted in 2001 raised the maximum fine for violations to US\$120,000, but reduced prison sentences. Trademark rights are determined by registration rather than commercial use and the new law requires that all trademarks be registered. However, the registration requirement may run contradictory to both the Paris Convention and the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS). Complaints about trademark usage may only be made through the court system within five years from the registration date.
- The 2001 patent law provides for 20-year patent protection with a possible 2-year extension. It also establishes an independent commission to hear patent disputes and increased the maximum fine for violation to US\$60,000. Yet an inventor must produce or utilize a product or process in Indonesia (“physical presence”) to be able to patent their invention. Some experts argue that the law’s exclusion of patents that are contrary to the public interest appears to be stricter than as provided for in TRIPS. The law establishes an alternative mechanism for dispute settlement via arbitration and grants the courts authority to issue an injunction to prevent infringement. Some experts have asserted that Indonesia’s IPR regime represents the best compliance with TRIPS by any Southeast Asian WTO member.
- While the overhaul of the intellectual property regime has been welcomed by foreigners, the new laws sit less comfortably with ordinary Indonesians. The Indonesian custom of *adat* (norms that do not recognize individual ownership of intellectual inventions or works) is still prevalent in many parts of Indonesia, making enforcement of intellectual property rights challenging. Pirated optical media (recorded music and movies) is widespread and the capacity of the authorities to combat piracy is limited.
- Street vendors who sell pirated goods are often poor and crackdowns on such vendors have sparked backlashes against law enforcement officials in the past. In 2000, for instance, rioting broke out in the Glodok shopping area of West Jakarta when police raided street vendors in the area. Progress has certainly been made and Indonesian authorities recognize that improving enforcement is an important element of improving the business environment and encouraging badly needed investment in many sectors of the economy.
- **Labor market conditions** – The *Doing Business Report 2009* also ranks Indonesia poorly in terms of the easiness of employing workers. Indonesia's high severance costs and minimum wage provisions have an important effect on this assessment and place the country at a disadvantage vis-à-vis their neighboring countries when it comes to attracting foreign investment. In addition, these policies perpetuate segmentation in the labor market in a country where informality is already widespread. To be sure, dismissal procedures and flexibility measures are not the only issues affecting the labor market. Reform in this instance should accompany measures to ensure social protection.

The current labor market rigidity is largely a result of the 2003 Manpower Law. This Law was reviewed in 2005, but street protests by labor unions made the Government withdraw any revision. Central to obtaining a consensual revision of the law is the strengthening of the consultation and dialogue between the main social actors, the

Government, trade unions and employers' associations. The Ministry of Manpower and Transmigration has, in fact, developed a Decent Work Country Programme 2006-2010 which has as one its priorities the "Social Dialogue for economic growth and principles and rights at work".

As expressed by representatives of trade unions interviewed for this report, capacity building and knowledge of best practices applied in other countries is needed for them to be able to engage in informed discussions in this dialogue. In addition, analysis and public dissemination of the impacts of such rigid labor practices on overall employment levels and equality would be helpful in order to mobilize the public opinion in favor of a revision of the law.

- **State-owned Enterprises (SOEs)** – Reducing the influence of SOEs in the economy would make markets more competitive and would encourage new private investment. Despite progress in decreasing government involvement in the economy, SOEs continue to play a dominant role. In 2007, 139 SOEs represented 45% of GDP. Government participation in the economy via these SOEs continues to support domestic production as well as distort trade in several important sectors, such as energy, steel, cement, mining, transportation, and banking.
- **The new Mining Law** – New investment in the important mining sector has decreased significantly since the Asian crisis. Spending on mining exploration has decreased 90% since 1997. This decrease is, in part, a consequence of decentralization which transferred some, but not all, authority over mining rights to sub-national governments. This transfer of power created a conflict between the laws on mining and decentralization, generating legal uncertainty and confusion among foreign investors.

After more than three years of debate, the Parliament enacted a new mining law in January 2009 (Law 4/2009). The new law eliminates the mining contract scheme and establishes instead a mining license scheme. The new law restricts individual new mining areas to 100.000 hectares each, and it restricts the duration of mining licenses to 20 years instead of 70 years previously. Further, it requires operators to process the ore in Indonesia. Also, the new law requires operators to obtain separate permits for each phase of mining activity (surveys, exploration, Construction, mining, etc.).

A survey conducted by an international consulting firm among mining companies showed that the international mining community is not convinced that the new law will attract large investments back into Indonesia, due to its more restrictive provisions.

### **Chapter 3: Inter-Agency Coordination Issues**

As can be seen from much of the discussion above, a cross-cutting issue that stands out in most of the problem areas affecting the investment climate in Indonesia is the issue of coordination in the formulation and implementation of government policies.

For instance, the design and effective implementation of PPP schemes in infrastructure development has been hampered, among other reasons, by a lack of coordination between the agencies designated to implement the stipulated procedures and the line ministries such as the Ministry of Public Works or the Ministry of Transportation. Another example is the fact that issuance of implementing regulations for provisions in the investment law, such as the negative list, has not yet taken place, more than two years after the law was enacted, due to protracted disagreements between line Ministries, the Coordinating Ministry for Economic Affairs and BKPM. Similarly, the complexity of the business licensing process is due, to a large extent, to a lack of coordination and harmonization between regulations issued by different central government agencies and also between central government regulations and regulations issued by local authorities.

#### **3.1 Factors**

Numerous factors can be identified as possible causes of this syndrome of recurrent dysfunctioning in the government and bureaucratic systems.

At the executive level, conflicts and divisions have often occurred between ministries and agencies, sometimes due to political rivalry between ministers belonging to different parties, at other times due to disagreements over policies. In addition, there has been a tendency for the government, even at the highest levels, to create ad-hoc committees whose roles and missions have not always been made sufficiently clear and/or whose status and credibility have not been accepted by other government officials. Consequently, these committees are generally not able to support effective coordination in keeping with their purposes.

Another important factor has been decentralization. Sub-national governments have now become major players in service delivery. Their role in public investment and economic development is increasing. Indonesia's almost 500 provincial, district and city governments now undertake nearly 40% of public spending. However, there have been continued conflicts between the central government and local governments.

Many of the gaps in the provision of public services are due to the difficulties in rebalancing the roles of provincial and district level governments and in shifting the public's sector role from a provider to a regulator. Indonesia faces a difficult challenge in that a large number of government agencies are fragmented and have overlapping authorities, thereby hampering efficient decision-making. The implementation of the institutional framework governing the division of roles, responsibilities and resources between the national and local governments remains incomplete. Power has been dispersed to many actors without clarity as to their respective roles, responsibilities and authority.

An example of the fragmentation and overlapping responsibilities can be found in the area of trade and investment climate where at least three ministries, agencies and committees play important roles that are discussed below.

### **3.2 The Coordinating Ministry for Economic Affairs (Menco)**

Menco is responsible for the co-ordination of investment policy among and between central government agencies, including the Central Bank, and between the central government and regional authorities. Menco has issued the successive trade and investment Policy Packages and has endeavored to facilitate the effective implementation of the planned actions by the concerned ministries and agencies.

Menco is tasked to coordinate the work of line Ministries in the important horizontal areas and to facilitate the search for solutions in the numerous cases of inter-ministerial conflicts. Menco is not expected to provide strategic policy formulation, for instance, in the development of economic sectors. Its role mainly lies in the implementation of policies within the framework of long-term plans developed by Bappenas and in yearly plans and budgets set out by the line ministries.

In addition to the Secretary General, the Minister has six Deputy Ministers, in charge of sectors: macro-economy, agriculture, energy, trade and investment, infrastructure and international cooperation. Each Deputy Minister has four or five assistants, under whom there could be also three or four staffers. Altogether, Menco has a professional staff of about 70 people. Its overall effectiveness has been limited by insufficient resources, mostly in terms of qualified staff.

### **3.3 The National Team for the Enhancement of Exports and Investment, known as Timnas (PEPI)**

PEPI is a high level policy making body led by the President of Indonesia and chaired on a working basis by the Coordinating Minister for Economic Affairs. Timnas PEPI was established in its current form by Presidential Decree No. 3 of 2006 and later revised by Presidential Decree No. 8 of 2008. Its missions are to develop policies to increase exports and investment, to facilitate policy implementation, to resolve obstacles to exports and investment, and to undertake economic deregulation and debureaucratization.

PEPI consists of the Ministers in the areas concerned. At the working level, it is composed of three working groups, each chaired by a minister and vice-chaired by another minister or agency head. Working Group I, chaired by the Minister of Trade, is responsible for policy formulation, research and monitoring. Working Group II is responsible for implementation and problem solving. Working Group III is responsible for promotion. A fourth working group on tax and non-tax investment incentives is under preparation.

Timnas PEPI and the ministerial working groups are supported by a full-time Secretariat whose duties are to undertake policy research, make recommendations to the Ministers, and monitor implementation of trade and investment policies. At present, the Secretariat only has two permanent senior personnel, the Secretary and a deputy. It operates mostly on an ad-hoc basis for specific projects and working through staff that is seconded from research institutes, universities or other organisations. The current personnel are composed of young economists. At present, there are eight such people working in the Secretariat. Given PEPI's broad mandate and considering in particular its mission to make strategic policy recommendations, the Secretariat is not adequately staffed to perform the assigned missions effectively.

### **3.4 Indonesia's Investment Coordinating Board, Badan Koordinasi Penanaman Modal (BKPM)**

BKPM, Indonesia's Investment Coordinating Board, was established in 1973 to serve essentially as a screening and authorizing agency for foreign investment. This role derived from the investment screening and approval system put in place by the issuance of the 1967 investment law. In 2007, after several years of drafting and debates, the Parliament enacted a new investment law which stipulates BKPM's new mandates:

- Design investment policies, including the identification of potential investment opportunities.
- Define norms, regulations, standards and procedures for investment services.
- Coordinate the implementation of investment policies both in terms of sectoral relations and relations between the central and regional governments.
- Promote investment in Indonesia.
- Facilitate solutions to problems faced by investors.

As part of its mandate, BKPM has been also tasked to set out standards for the one-stop shops and to establish an on-line system for investment licensing. One-stop shops have been mandated by law for each of Indonesia's municipalities and regencies; by the end of 2007, more than half had one-stop shops, some of them with successful operations. However, local government approaches to one-stop shops have differed and there is little agreement as to what model is most effective at serving the business community.

## **Chapter 4: The need to reform the public sector and to improve institutional capacity**

### **4.1 Public sector reform**

The capabilities of Indonesia's civil servants need improving in various areas to enable them to perform their functions effectively. To this end, the Government has initiated public sector reforms in selected ministries and agencies. The reforms involve strengthening human resources capacity, revising operating procedures, clarifying job descriptions and job grading, enhancing performance incentives through greater pay and promotion linkages, and improving human resource management functions. These reforms also seek to strengthen policy research and analysis within ministries and agencies and to increase overall professional capabilities.

#### ***Example: The Ministry of Trade***

In achieving its mission to formulate and implement well-designed trade policies, the Ministry of Trade (MoT) faces constraints in terms of its organization and the capacity of its personnel. At present, the Ministry does not have the required human resources or an appropriate organizational structure so as to be able to meet its mandate effectively and efficiently.

The main structural issues and challenges of the MoT can be identified as follows:

- The organizational structure of the Ministry, like all Indonesian Ministries, is not aligned according to identified needs, missions and desired outcomes.
- Overall effectiveness and efficiency is hampered by the Government's lack of overall strategic planning and poor coordination.
- Human resources management needs to be better aligned with the mission and objectives of the Ministry.
- In the area of international cooperation, human resources are insufficient to meet expanding requirements.
- There is a general insufficiency in the number of qualified lawyers, economists, policy analysts and regulatory specialists on staff.
- There is a generation gap between a large group of senior staff, in their 50s and above, and a growing group of staff in the 25-35 year age range. Coupled with a significant number of senior staff is expected to retire in the next two years, the MoT faces a major shortfall in staff capabilities.

The MoT has launched a bureaucratic reform plan that is aimed at implementing a profound transition from a traditional government organization to a modern institution with a clear definition of mission and strategic objectives and with a well-designed, appropriate organizational structure to be staffed with adequately trained and competent personnel. This plan is mandated by and consistent with the larger reform campaign of the Government.

Law 17/2007 on the National Long Term Development Strategy 2005-2025 stipulates that all government institutions (ministries and agencies) should have implemented the

Bureaucratic Reform Initiative before the end of 2011. This ambitious programme is overseen by the Ministry of State Apparatus (MenPAN) in conjunction with the Commission for Eradication of Corruption (KPK). The key principles of the reform process are stated as:

- Application of Good Governance,
- Enhanced Supervision and Accountability of State Apparatus,
- Restructuring of Institutions and Management,
- Enhancement of HR Management, and
- Enhancement of Public Service Quality.

Overall, MoT commands a real capacity to formulate well-conceived trade policies. Its senior staff is aware of the need to thoroughly research subject matters, which is largely done by TREDATA, and to seek advice and inputs from concerned stakeholders such as other ministries and agencies, the private sector and civil society, in particular consumers associations. MoT's main constraint is insufficient capacity to institutionalize consultation process adequately due to insufficient human resources and probably to established practices in the MoT and other institutions that consist in addressing issues on an ad hoc basis, rather than in a well planned and coordinated manner. Furthermore, the MoT lacks sufficient staff capacity to develop thorough evaluation of the impact of policies on a sustained basis. This capacity would greatly enhance MoT's credibility with its stakeholders and improve its tactical position in future trade negotiations.

#### **4.2 Strengthening institutional capacity**

The MoT's requirements in strengthen institutional capacity are but one example of a wider need. Indonesia's future success in realising its economic potential will largely depend on its capacity to improve institutional effectiveness. The Government will need to effectively address capacity weaknesses and fragmentation in Indonesia's institutions in order to complete implementation of unfinished reforms in the trade and investment areas.

In order to enhance institutional capacity, the Government, possibly with the assistance of international donors, will need to address the following priorities:

- Strengthening the legal and regulatory framework,
- Strengthening organizational structures, including clarity in the definition of roles and responsibilities,
- Strengthening management, information and evaluation systems and enhancing implementation, technical and evaluation capacity,
- Strengthening the operational, technical and administrative policies, procedures and standards,
- Evaluating and enhancing planning and budgeting capacity, and
- Building research and analytical capacity, including increased support for policy formulation.