

Investment

IMPROVING INDONESIA'S INVESTMENT CLIMATE

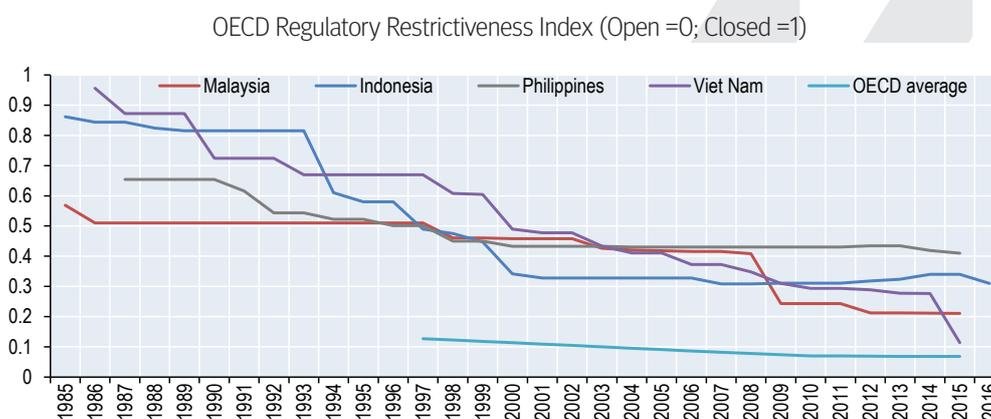
- ▶ Indonesia's wave of structural reforms in the late 1990s paved the way for its subsequent strong performance in terms of stable growth, enhanced investor confidence and increased FDI inflows.
- ▶ Indonesia nevertheless faces challenges in the current global economic climate. The end of the commodity super-cycle and China's slowdown will require new drivers of growth, notably in manufacturing and services.
- ▶ Foreign investment can be an important ally in supporting diversification and productivity growth, and greater efforts to strengthen the investment environment in Indonesia would likely yield substantial dividends.
- ▶ From a broad perspective, Indonesia has significantly liberalised restrictions on international investment over time but nevertheless still restricts FDI in many primary and service sectors.

What's the issue?

Located in a dynamic region, with a large internal market, a growing middle class and abundant natural resources, Indonesia has a natural appeal to foreign investors. The burst of reforms that followed the Asian Crisis of 1997-98, including important FDI liberalisation, paved the way for stable growth, enhanced investor confidence and renewed FDI inflows, as highlighted by the first *OECD Investment Policy Review of Indonesia* published in 2010. While the contribution of FDI to domestic capital formation in Indonesia has been relatively limited compared to ASEAN peers, it has brought important benefits in terms of employment generation, productivity growth and access to the global market.

By the end of the 2000s, reforms began to slow and so did growth. The new government has accelerated reform, launching 13 reform packages over the past year that have, in addition to liberalising FDI to some extent, aimed to improve the business environment. In particular the new Negative List on FDI issued in May 2016 is an important breakthrough in this respect. It signals a clearer positive attitude towards foreign investment, notably *inter alia* with the lifting of foreign ownership caps on 45 business lines (e.g. toll roads, tourism-related activities and e-commerce) and the easing of foreign equity restrictions in some other key service sectors (e.g. warehouse, distribution and transportation). Indonesia

Indonesia needs to continue its efforts to ease restrictions on FDI inflows



Note: The OECD FDI Regulatory Restrictiveness Index covers only statutory measures discriminating against foreign investors. Other important aspects of an investment climate (e.g. regulatory implementation and state monopolies) are not considered. The 2016 value is preliminary and refers to May 2016, taking into account Indonesia's new negative list (PN No. 44) enacted on 18 May 2016. Data for OECD countries exist for 1997, 2003, 2006 and 2010-2015. Data is linearly interpolated for the other years. The country composition slightly increases overtime due to information gaps for a few economies in earlier years. Source: OECD FDI Regulatory Restrictiveness Index database, <http://www.oecd.org/investment/fdiindex.htm>.

also strengthened policy predictability with a number of laws and regulations clarifying rules for investors, of which the Investment Law of 2007 was the most important.

But to some extent these reforms only serve to reverse the more protectionist trend observed in the recent past and much remains to be done to improve Indonesia's investment climate and sustainably attract productivity-enhancing investments. Many primary and service sectors remain partly off limits to foreign investors, holding back potential economy-wide productivity gains. Indonesia is more restrictive to foreign investors than many ASEAN peers (see Figure) and compared to the OECD average. The lasting effects of Indonesia's decentralisation programme still need to be addressed, including with regards to the ease of obtaining business licences and land titles from local authorities, which still varies greatly across the country. Moreover, the ore export ban and the accompanying smelter investment rules, enacted in the beginning of 2015, have damaged the investment climate in an important sector. Infrastructure gaps remain an issue, although recently issued regulations for land acquisition and improved infrastructure governance mechanisms should ease some of the issues that have hindered investments in the sector in the past. As in other ASEAN economies, Indonesia has experimented with a zone-based investment promotion strategy to attract and upgrade export activities. Nearly 7 years after the set-up of the SEZs legal and institutional framework and strategy, it is timely to take stock of the experience and review the evidence of such policies against set objectives in order to inform future investment policy and promotion strategies.

Why is this important for Indonesia?

The current global economic context, in particular the end of the commodity super-cycle and China's slowdown, pose new challenges for Indonesia. While the country is still a significant host of investment flowing into ASEAN, competition for FDI is fierce among member states, as well as from China and India. For some of the big investors in the region, such as Japan and Korea, the share of FDI flowing to Indonesia has declined vis-à-vis other Asian destinations. Other ASEAN member states are also continuing to improve their investment environment and securing privileged market opportunities for investors through regional trade agreements, including the Trans-Pacific Partnership. Greater efforts by Indonesia to revamp and revive structural reforms are therefore essential. Given the structure of Indonesian industry, where major resource projects feature prominently, access to foreign capital and expertise are critical. Moreover, as the country's own history shows, strengthening the investment climate can bring important benefits in terms of economic diversification.

What should policy makers do?

- ▶ Continue efforts to improve the investment climate, including simplifying business procedures and land titling from local authorities and harmonizing rules across the country.
- ▶ Raise spending on infrastructure, with a focus on transportation and logistics to support industry, and enhance the governance of investment projects.
- ▶ Strengthen local governments' capacity to deliver on investment projects with private sector participation.
- ▶ Review the impact of the zone-based investment promotion strategy and adjust its course and the associated legal and institutional framework as necessary to enhance its impact on development.
- ▶ Ease regulations in the labour market that are inhibiting employment growth and investment in skills and take measures to promote the formalisation of the workforce.



Further reading

OECD (2010), *OECD Investment Policy Reviews: Indonesia*, OECD Publishing. <https://www.oecd.org/investment/investmentfordevelopment/indonesia-investmentpolicyreview-oecd.htm>

OECD (2015), *Policy Framework for Investment: 2015 Edition*, OECD Publishing. <http://www.oecd.org/investment/pfi.htm>