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Foreword

This first Investment Policy Review of Indonesia assesses the development of Indonesia's investment environment on the basis of the Policy Framework for Investment. *It testifies to the growing ties between the OECD and Indonesia, both through the Enhanced Engagement process with key emerging economies and as part of the strategic partnership between Southeast Asia and the OECD.*

The Review describes the extensive reforms undertaken in Indonesia over the past decade to improve the climate for both domestic and foreign investment. It documents the rise in investor confidence, as seen in a resurgence of inflows of foreign direct investment, and highlights areas where further improvements in policies and practices could produce levels of investment commensurate with higher growth targets for the Indonesian economy.

The Review is based on a background report that facilitated a review by the OECD Investment Committee of Indonesia's investment policies in March 2010. The Indonesian delegation was led by Vice Minister of Trade, Mahendra Siregar. An early draft of the report was also discussed at a seminar organised by the Government of Indonesia in Jakarta in February 2010. The Government of Indonesia created a Task Force to prepare detailed answers to the questions in the Policy Framework for Investment *and to provide support to the process, including extensive comments on the draft report which have been incorporated in the Review. The OECD Investment Committee approved the report on 9 July 2010.*

The Review has been prepared by Stephen Thomsen and Kenneth Davies, Senior Economists, and Misuzu Otsuka, Economist, in the Investment Division, headed by Pierre Poret, of the OECD Directorate for Financial and Enterprise Affairs. Secretariat inputs were received from the Anti-Corruption, Competition, Financial and Corporate Affairs Divisions and from the Centre for Tax Policy and Administration. The report also benefited from the views of the Indonesian authorities and consultations with the private sector and other partners.

Table of Contents

Preface by Agus D. W. Martowardojo, Minister of Finance, Government of Indonesia 9

Preface by Angel Gurría, OECD Secretary General 11

List of Abbreviations 13

Executive Summary 19

Overview of Progress and Policy Challenges 23

1. Overview 24
2. Policy challenges and options to address them 30

Notes 37

Chapter 1. **Investment Policies and Trends Over Time** 39

1. The setting: economic reform 40
2. FDI trends 46

Notes 60

Chapter 2. **Investment Policy** 61

1. Laws and regulations 62
2. Effective land ownership registration 65
3. Intellectual property rights 67
4. Contract enforcement and dispute resolution 71
5. Expropriation procedures 74
6. The non-discrimination principle 75
7. Investment promotion and protection agreements 80
8. International arbitration instruments 81

Notes 82

Chapter 3. **Investment Promotion and Facilitation** 85

1. Investment promotion strategy 87
2. Investment promotion agencies 88
3. Monitoring IPA performance 90

4. Streamlining administrative procedures 92
5. Dialogue with investors 95
6. Investment incentives 96
7. Promotion of investment linkages 100
8. Drawing on international expertise 102

Notes 104

Chapter 4. **Competition Policy** 107

1. Transparency and non-discrimination 109
2. Implementation of competition laws 114
3. Anti-competitive practices 116
4. Policy evaluation and intra-governmental communication 117
5. Industrial policies 120
6. Competition aspects of privatisations 120
7. International co-operation 120

Notes 122

Chapter 5. **Infrastructure Development** 123

1. Setting infrastructure policy 127
2. A framework for private participation 129
3. Telecommunications 132
4. Electricity 137
5. Transport 140
6. Water 144

Notes 145

Chapter 6. **Financial Sector Development** 149

1. Financial sector regulation 151
2. Bankruptcy proceedings, collateral use and credit information . . 158

Notes 160

Chapter 7. **Public Governance** 165

1. Regulatory reform framework 167
2. Co-ordination across government 169
3. Regulatory impact assessments 172
4. Public consultation 172
5. Removing red tape 173
6. International anti-corruption and integrity standards 174
7. Enforcing anti-corruption laws and regulations 177
8. Reviewing the effectiveness of anti-corruption laws 183
9. International anti-corruption initiatives 184

Notes 185

Chapter 8. **Other Aspects of the Policy Framework for Investment** 189
1. Trade policy 190
2. Tax policy 195
3. Corporate governance 198
4. Policies for promoting responsible business conduct 208

Notes 224

Annex A. **Statistics** 227

Annex B. **Recent Intellectual Property Related Regulations** 231

Annex C. **Sectors where Foreign Investors Face Specific Restrictions** 232

Annex D. **Bilateral Investment Treaties Signed by Indonesia** 238

Annex E. **Bilateral Tax Treaties Concluded** 240

Annex F. **International Conventions Ratified by Indonesia** 242

Bibliography 245

Tables

1.1. A chronology of FDI liberalisation in Indonesia 45
1.2. The stock of OECD country FDI in Indonesia 54
1.3. Cumulative FDI in Indonesia by country 55
1.4. Top investor countries in Indonesia 57
2.1. International treaties and conventions on IPR signed by Indonesia 68
5.1. Recent sectoral laws relating to infrastructure 127
5.2. Telecommunications: subscribers/users per 100 inhabitants 133
A.1. FDI flows into Indonesia 227
A.2. FDI stocks in Indonesia 228
A.3. FDI flows by sector (share) 228
A.4. FDI flows by home country (share) 229
A.5. FDI flow by host region (share) 230

Figures

1.1. FDI liberalisation in Indonesia and the foreign investor response 44
1.2. FDI inflows in Indonesia 46
1.3. Recent FDI inflows into Indonesia 47
1.4. FDI statistics (BI versus BKPM) 48
1.5. FDI inflows in selected ASEAN economies 50

1.6. FDI reported by Indonesia and by OECD countries 51
1.7. The foreign share of realised BKPM-approved projects 52
1.8. Foreign capital flows to Indonesia by component 53
1.9. Japanese FDI in Indonesia 55
1.10. Distribution of FDI flows by region 57
1.11. FDI inflows by sector 57
1.12. Manufacturing exports as a share of total merchandise exports . . 59
5.1. Public-private partnerships in infrastructure, 1990-2008 125
5.2. The institutional framework for infrastructure 131
5.3. PPPs in the Indonesian electricity sector 138
6.1. Asset share of commercial banks, 2008 156
6.2. Listed companies in Indonesia, 1988-2009 156

Preface

by Agus D.W. Martowardojo, Minister of Finance, Government of Indonesia

Indonesia is a country with great opportunities. It is the world's third largest democracy offering stability and a large domestic market. Driving high potential growth rates is a young workforce, with those under thirty accounting for half of the productive population. With its potential of natural resources, Indonesia has significant industry and growing infrastructure. Economic growth has been sustained and GDP is expected to reach USD 1 trillion by 2014.

Indonesia knows well the need for proactive policy to realise this potential. The 1997-98 crisis was a watershed: the Indonesian economy, the rupiah and Indonesia's credit rating all plummeted; liquidations and bankruptcies were the order of the day; and debt had to be rescheduled with the Paris Club. The need to be proactive is an important lesson from this period. Priorities include strengthening regulatory and supervisory frameworks for financial markets, improving transparency and governance, strengthening risk assessment and management, and increasing co-operation in regional surveillance and financial market regulation.

Reflecting these policy efforts, the Indonesian economy has been buoyant during the global crisis. Macroeconomic and financial stability have been safeguarded and the economy grew by 4.5% in 2009, the third highest rate in the G20 after China and India. Inflation rates are on track. This success motivates confidence in continuing economic improvements. Consumer confidence remains high and the financial markets are among the top global performers. Indonesia's economic fundamentals are robust with a steady Bank Indonesia interest rate, expanding foreign exchange reserves, strong external accounts and a stable exchange rate against the US dollar. Our debt to GDP ratio has declined to less than 30%. Credit rating agencies are appropriately recognising this performance with improvements in our ratings.

The Government of Indonesia is committed to being pro-growth, pro-job creation and pro-poor. Hence, the development plan focuses on:

- Improving public welfare through poverty alleviation, greater access to quality education and health, family planning and the provision of basic

infrastructure such as clean water, communications, transport and housing.

- Increasing investment and improving the competitiveness of the real sector, improving food security and employment opportunities and increasing the capacity for climate change mitigation and adaption initiatives.
- Improving the quality of public service through encouraging public participation in the corruption eradication campaign, as well as improving the productivity and welfare of public service employees.

As one of the engines of economic development, investment policy and business climate improvements are a national priority. The enactment of a new Investment Law covering domestic and foreign investment, which provides for national treatment of foreign investment, improves the investment climate. The goals of the law have been supported by the establishment of new *Special Economic Zones* and the *Indonesian National Single Window (INSW)*. The INSW system, operating in five main ports/airports, will improve accountability and transparency in customs procedures as well as coordination with other government agencies in the import clearance process. Transparency has received a further boost by spelling out clearly the sectors that are closed to foreign and/or domestic investors.

The Government of Indonesia has worked closely with the OECD in its first *Investment Policy Review of Indonesia*. The *Review* provides an opportunity for us to address priorities for further investment reform and also to gain international recognition for Indonesia's sustained efforts to improve the investment climate. I am highly appreciative and would like to congratulate the OECD Investment Committee and our Indonesian colleagues who have collaborated closely in carrying out this good job

Agus D.W. Martowardojo
Minister of Finance
Government of Indonesia

Preface

by Angel Gurria, Secretary-General, OECD

Indonesia has undertaken impressive reforms that have contributed to improve its investment climate. The country remained committed to reform throughout the challenging period of unprecedented economic crisis in 1997-98, severe natural disasters and its rapid transition to a democratic and decentralised system. The resilience that the Indonesian economy has shown during the recent global economic crisis illustrates the benefits of these years of reforms.

At the same time, Indonesia plays an increasingly important role in the global dialogue on economic policies. It actively participates in both G20 and APEC policy discussions and contributes to regional integration efforts in ASEAN. Since October 2009, the country has been a full participant in the Freedom of Investment Roundtables hosted by the OECD, where more than 50 governments work together to keep investment policies open, transparent and non-discriminatory.

This first OECD *Investment Policy Review* of Indonesia recognises Indonesia's major progress in improving its policy framework for investment. A landmark law on investment was enacted in 2007, providing national treatment and standard protection to investors. Indonesia has set up new institutions to promote competition, eliminate corruption, and regulate newly-liberalised sectors. Further liberalisation of investment policies is on track with the publication in June 2010 of a new list that further opens several sectors to FDI. While supporting the government's reform agenda, the Review also highlights important policy challenges as Indonesia strives to encourage more domestic and foreign investments and tries to unlock its full economic potential. The country needs to improve further its mechanism for evaluating and monitoring the development of laws and regulations relating to investment in order to avoid overlap, inconsistency and conflict among them. Simpler investment licensing procedures and more effective regulation of network sectors would also strengthen Indonesia's business climate.

This report is a product of the remarkable co-operation between Indonesia and the OECD. While the OECD is responsible for its contents, the report benefits from comprehensive inputs on the part of the Indonesian government as well as a peer review by the OECD and other partner countries. It also clearly shows that Indonesia has valuable experiences to share with others who wish to improve their investment policies.

Angel Gurria

List of Abbreviations

AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
ACIA	ASEAN Comprehensive Investment Agreement
ADB	Asian Development Bank
AGO	Attorney General's Office
APEC	Asia-Pacific Economic Co-operation
API	Indonesian Bank Architecture
APINDO	Employer's Association of Indonesia
ASEAN	Association of Southeast Asian Nations
ASEM	Asia Europe Meeting
BAKTI	Commodity Futures Trading Arbitration Body *Badan Arbritase Perdagangan Berjangka Komoditas*
BANI	Indonesian National Board of Arbitration *Badan Arbitrase Nasional Indonesia*
Bapedal	Environmental Impact and Management Agency
Bapenas	National Development Planning Agency
Bapepam-LK	Capital Market and Financial Institution Supervisory Agency
BAPMI	Indonesian Capital Market Arbitration Body
BI	Bank Indonesia *Bank Sentral Republik Indonesia*
BIT	Bilateral Investment Treaty
BKPM	Indonesian Investment Co-ordinating Board *Badan Koordinasi Penanaman Modal*
BOC	Board of commissioners
BOD	Board of directors
BPJT	Toll Road Regulatory Agency
BPK	Audit Board of the Republic of Indonesia *Badan Pemeriksa Keuangan*
BPKP	Financial and Development Supervision Body *Badan Pengawas Keuangan dan Pembangunan*
BPN	National Land Agency *Badan Pertanahan Nasional*
BPPMA	Foreign Capital Investment Advisory Board *Badan Pertimbangan Penanaman Modal Asing*
BPS	Central Statistics Agency

BRTI	Indonesia Telecommunications Regulatory Body *Badan Regulasi Telekomunikasi Indonesia*
CMEA	Co-ordinating Ministry for Economic Affairs
CSR	Corporate social responsibility
CTPA	Centre for Tax Policy and Administration
DGCE	Directorate General of Customs and Excise
DGIPR	Directorate General for Intellectual Property Rights
DGPT	Director General for Post and Telecommunications
DGT	Director General of Taxes
DPR	House of Representatives *Dewan Perwakilan Rakyat*
DSP	Priority List *Daftar Skala Prioritas*
EPL	Employment protection legislation
EPZ	Export Processing Zone
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
FSAP	Financial Services Assessment Programme
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GATS	General Agreement on Trade in Services
GCG	Good Corporate Governance
GDP	Gross Domestic Product
GeRAK	Network of NGOs for anti-corruption *Jaringan Nasional Gerakan Antikorupsi*
GRI	Global Reporting Initiative
GSM	General shareholders' meeting
IAP	Individual Action Plan
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information and communication technology
IDI	Individual Debtor Information
IDR	Indonesian Rupiah
IEA	International Energy Agency
IFC	International Finance Corporation
IICD	Indonesian Institute for Corporate Directorship
IICG	Indonesian Institute of Corporate Governance
IIFF	Indonesia Infrastructure Financing Facility
IIPA	International Intellectual Property Alliance
IKAI	*Ikatan Komite Audit Indonesia*
ILO	International Labour Organization
IMF	International Monetary Fund

INACA	Indonesian Airline Association
INATRADE	e-Licensing
INPRES	Presidential instruction
INSW	Indonesian National Single Window
IP	Intellectual Property
IPA	Investment promotion agency
IPO	Initial public offering
IPP	Independent power producers
IPR	Intellectual Property Right
ISICOM	Indonesian Society of Commissioners
IUT	Permanent business licence *Izin Usaha Teap*
Jamsostek	State Social Insurance Fund *Jaminan Sosial Tenaga Kerja*
JETRO	Japan External Trade Organization
JSE	Jakarta Stock Exchange
KADIN	Indonesian Chamber of Commerce and Industry *Kamar Dagang Dan Industri Indonesia*
KAPET	Integrated Economic Development Area
KKPPI	Policy Committee for the Acceleration of Infrastructure Provision *Komite Kebijakan Percepatan Penyediaan Infrastruktur*
KNKCG	National Committee on Corporate Governance Policy
KNKG	National Committee on Governance Policy
KON	National Ombudsman Commission *Komisi Ombudsman Nasional*
KPK	Corruption Eradication Commission *Komisi Pemberantasan Korupsi*
KPPBC	Mid-Level Service and Controlling Office *Kantor Pengawasan dan Pelayanan Bea dan Cukai*
KPPOD	Committee for the Monitoring of Regional Autonomy Implementation *Komite Pemantauan Pelaksanaan Otonomi Daerah*
KPPT	Integrated Customs Services Area *Kawasan Pelayanan Pabean Terpadu*
KPPU	Commission for the Supervision of Business Competition *Komisi Pengawas Persaingan Usaha*
KPU	Prime Service Office *Kantor Pelayanan Utama*
KUR	Small Business Credit Programme *Kredit Usaha Rakyat*
LAPPI	Advocacy and Protection Institute of Proxy Investors
LKDI	Indonesian Commissioners and Directors Institute

	Lembaga Komisaris dan Direksi Indonesia
LPEM-FEUI	Institute for Economic and Social Research, Faculty of Economics, University of Indonesia *Lembaga Penyelidikan Ekonomi dan Masyarakat, Fakultas Ekonomi, Universitas Indonesia*
LPS	Indonesian Deposit Insurance Corporation
MA	Supreme Court *Mahkamah Agung*
M&A	Merger and acquisition
MDG	Millennium Development Goal
MenPAN	Ministry of Administrative Reform
MK	Constitutional Court *Mahkamah Konstitusi*
MNE	Multinational Enterprise
MOF	Ministry of Finance
MoHA	Ministry of Home Affairs
MOT	Ministry of Trade
MOU	Memorandum of Understanding
MSME	Micro, small and medium-sized enterprise
NGO	Non-governmental organisation
NSPK	Norms, Standards, Procedures and Criteria
OECD	Organisation for Economic Co-operation and Development
OJK	Financial Services Authority *Otoritas Jasa Keuangan*
PDAM	Regional water enterprise
PEPI	National Team on Export and Investment Promotion
Perda	Regional regulations
PFI	Policy Framework for Investment
PKPS	Centre for Government-Private Co-operation
PLN	State-owned electricity company *Perusahaan Listrik Negara*
PMA	Foreign Capital Investment Company *Penama Modal Asing*
PPATK	Financial Transaction Reports Analysis Centre
PPP	Public-Private Partnership
PR	Presidential Regulation
Prolegnas	National Legislation Programme
PROPER	Programme for Pollution Control Evaluation and Rating
PSO	Public Service Obligation
PT	Limited Liability Company *Perseroan Terbatas*
PT KA	PT Kereta Api

PTSP	One stop integrated services centre *Pelayanan Terpadu Satu Pintu*
R&D	Research and development
RAN-PK	National Action Plan on the Eradication of Corruption
RBC	Responsible business conduct
RIA	Regulatory impact assessment
ROSC	Report on the Observance of Standards and Codes
RTRN	National Spatial Development Planning *Rencana Tata Ruang Nasional*
SEZ	Special Economic Zone
SME	Small and medium-sized enterprise
SMS	Short messages services
SOB	State-owned bank
SOE	State-owned enterprise
SPIPISE	Electronic system for information services and investment licensing *Sistem Pelayanan Informasi dan Perizinan Informasi Secara Elektronik*
SPP	Single Presence Policy
TFP	Total factor productivity
TRIPS	Trade-related aspects of Intellectual Property Rights
UNCAC	UN Convention against Corruption
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
UNIDROIT	International Institute for Unification of Private Law
UPP	Trade Service Unit
USD	United States Dollar
USO	Universal Service Obligation
VAT	Value added tax
WCED	World Commission on Environment and Development
WCO	World Customs Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

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Executive Summary

Indonesia has achieved impressive success in overcoming immense political and economic obstacles since the late 1990s. New economic laws and policies, based on an increasingly transparent and accountable political system, are bearing fruit in the form of stable growth and a renewed rise in inflows of foreign direct investment (FDI). At the same time, fixed investment, both domestic and foreign, remains inadequate to meet the country's requirements for basic infrastructure and higher productivity.

Indonesia has been opening to international investment since the mid-1980s, particularly since 1993 and immediately after the 1997-98 Asian financial crisis. Foreign investors have taken notice, although the upward trend in FDI inflows was temporarily reversed in the aftermath of the Asian crisis. Subsequent economic reforms, including a landmark Investment Law in 2007, have allowed FDI to recover to pre-1997 levels. As a demonstration of a new resilience to external shocks, FDI inflows have remain respectably high during the global economic crisis, while falling in absolute terms. Inflows in the first quarter of 2010 were at one of the highest levels achieved in the past decade.

FDI has historically contributed relatively little to fixed capital formation in Indonesia, but it has played a major role in raising employment and productivity and in generating exports. FDI has created nearly half the new jobs in recent years, and exports from foreign multinationals have accounted for an increasing share of Indonesia's exports since 1990. FDI in Indonesia has also generated productivity spillovers to domestic industries. While the sources of FDI in Indonesia have become more diversified, much of the investment comes from only a few countries and is concentrated in Java and Sumatra, particularly in manufacturing.

Economic policy certainty is improving, but some implementing regulations are lagging. Public consultation is becoming more institutionalised and the appeals process strengthened. Red tape remains an obstacle to business, though procedures are being simplified. The government is striving to register land and property and to protect intellectual property rights. Despite recent judicial reforms, enterprises often prefer alternative dispute resolution mechanisms. The 2007 Investment Law gives standard protection to investors against expropriation and enshrines national treatment.

Restrictions persist on foreign equity ownership. The provision of a Negative List of sectors where private investment is not permitted or where foreign investors are subject to restrictions has added to transparency, and the list has been streamlined. Indonesia has signed a number of bilateral and regional investment agreements and has ratified the ICSID Convention. Disputes between the government and foreign investors may be settled through international arbitration.

Indonesia is actively promoting investment and has worked to streamline investment approval procedures through a one-stop integrated service. Administration and promotion of investment is vested in the Indonesian Investment Co-ordination Board, while a National Team on Export and Investment Promotion has been formed to advance reforms. Local investment promotion agencies vary in capacity, and decentralisation of power has led to uneven policy implementation.

FDI incentives, which had been removed in 1984, were reintroduced on a non-discriminatory basis in the 1990s. The government has also pursued zone-based policies to accelerate investment, and a mechanism to evaluate investment incentives is being put in place. Strategies for promoting linkages between foreign and local businesses are evolving.

Other barriers to entry are also coming down, partly as a result of a Competition Law enacted in 1999, but regulations on merger review have not yet been issued. Transparent procedures for enforcement are set in the regulations. The competition regulatory authority enjoys operational independence and wide investigative powers and has a mandate to evaluate the effects of government policies on competition.

In infrastructure, public spending has not filled the gap left by the disappearance of public-private partnerships (PPPs) after the 1997-98 crisis, and, as a result, Indonesia lags behind its regional peers. Increasing infrastructure spending is a national priority: a new legislative framework has been put in place to accommodate PPPs, institutions created to mobilise private investment and share risks, and ambitious targets set for increasing infrastructure provision.

The government has taken steps to improve the performance of the financial sector in recent years. A major restructuring of the banking sector was triggered by the 1997-98 crisis. Banks have become more robust against shocks but have been slow to lend for investment. Indonesia's financial sector has been open to foreign investors for over 20 years. The insurance and pension sectors have not yet developed to channel long-term finance. Indonesia has no registry system for collateral, but a Credit Bureau has been established to facilitate information flows among financial institutions.

Regulatory reform has been limited in scope, although a comprehensive regulatory review is planned and some independent regulatory bodies have a mandate to review government regulations. Decentralisation initially complicated the regulatory environment due to the lack of capacity and awareness at local level and co-ordination between central and local governments, but these constraints have gradually been removed as the central government has further clarified the authority of local governments and provided more guidance. Business sector and civil society groups have been actively participating in these reform efforts.

Fighting corruption has been made a top priority of government, and the Corruption Eradication Commission established in 2003 has actively investigated and prosecuted corrupt public officials at all levels of government. To assist in this process, Indonesian legislation is being harmonised with the UN Convention against Corruption and co-operation with the OECD in fighting bribery is growing.

Trade policies have been liberalised unilaterally and through international agreements. The government has largely resisted protectionist responses in the current crisis, as shown in the OECD-UNCTAD-WTO monitoring reports to the G20. It has also reduced constraints on trade and streamlined border procedures, especially by reforming customs, and has launched an Indonesia National Single Window.

Foreign-owned companies incorporated in Indonesia receive the same tax treatment as domestic ones, but the proliferation of local taxes has added to the burden on investors. Tax administration has become more efficient, which has significantly raised revenues. Indonesia has concluded 59 bilateral tax treaties.

Corporate governance problems were a major contributor to Indonesia's economic collapse in 1997-98. Indonesia has since made progress in establishing a corporate governance framework, notably through the 2007 Company Law and corporate governance guidelines published in 2001.

The Indonesian government is encouraging responsible business conduct in various ways. The legal framework for human rights protection has been strengthened since 1998 and more players are now involved in enforcing human rights, though improvement is still needed, particularly in the judicial system.

This Review assesses the progress made by Indonesia in developing a policy framework for investment, describes remaining challenges and proposes policy options to address them. The OECD's main recommendation is that the Indonesian government persevere with its efforts to increase the transparency and accountability of this framework and continue to share experience of good practice in formulating and implementing investment-related policies.

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Overview of Progress and Policy Challenges

Indonesia has successfully overcome immense political and economic obstacles since the late 1990s. New economic laws and policies, based on an increasingly transparent and accountable political system, are bearing fruit in the form of stable growth and a renewed rise in inflows of foreign direct investment. Both domestic and foreign investment are nevertheless still inadequate to meet the country's requirements for basic infrastructure and higher productivity. This overview describes the tremendous political and institutional changes since the Asian financial crisis and suggests ways in which Indonesia's investment performance could be improved through further reforms.

This review presents the new institutional and legislative framework for investment in Indonesia. It describes progress so far and where further measures might help to encourage enterprises to invest in Indonesia. It looks both at investor perceptions and at actual policies – or their absence – and how these might affect investment. The review also considers the vital question of whether and how these policies are being implemented.

The investment climate in Indonesia is examined using the *Policy Framework for Investment* (PFI) developed at the OECD by participants from 60 countries. The PFI provides a checklist of important policy issues for consideration by any government interested in creating an environment that is attractive to all investors and in enhancing the development benefits of investment to society, especially the poor. It consists of a series of questions in ten policy chapters: investment; investment promotion and facilitation; trade; competition; tax; corporate governance; responsible business conduct; human resource development; infrastructure and financial sector development; and public governance.

Through this review, conducted in close collaboration with the Government of Indonesia, the OECD can provide an objective assessment of progress in Indonesia and the reform challenges that remain. It can share the experience of how OECD and partner countries have tackled the same problems, and it can help to benchmark Indonesia's performance against these countries. At the same time, the Government of Indonesia can also use the PFI assessment exercise to help build consensus and capacity within government and to foster a whole-of-government approach to investment climate reform.

1. Overview

Indonesia has achieved impressive success in overcoming immense political and economic obstacles since the late 1990s. New economic laws and policies, based on an increasingly transparent and accountable political system, are bearing fruit in the form of stable growth and a renewed rise in inflows of foreign direct investment (FDI). Both domestic and foreign investment are nevertheless inadequate to meet the country's requirements for basic infrastructure and higher productivity.

With its large internal market, abundant natural resources and location within a dynamic region, Indonesia has a natural appeal to foreign investors.

The economy has exhibited periods of rapid growth in FDI inflows in response to policy reforms, as in the early 1970s and the years before the Asian financial crisis. On this basis, the prospects for future inward investment are good. Investor responses in the aftermath of the 1997-1998 crisis were muted by slow recovery and political uncertainty, but after years of reforms the government may now have accumulated a critical mass of legislation to rekindle investor interest. The payoff from addressing remaining policy challenges to promoting foreign and domestic investment as described in this review could be immense.

Political reforms have strengthened democracy and local autonomy

Political reforms over the past decade have provided a firm basis on which to develop economic policies that have increased the resilience of the Indonesian economy and enabled the government to make further progress in creating an enabling climate for investment. Since the end of the Suharto regime in 1998, Indonesia has put in place a democratic, transparent and accountable form of government. Power has been democratised and decentralised. Policy making is now shared vertically between central and local governments as well as horizontally among the executive, legislature and judiciary. A Regional Representatives Council covers regional issues, together with regional governments. Civil society is flourishing in this new environment.

Amendments to the Constitution and changes in the political environment since 1998 have caused a major reduction in the president's executive powers. The president has overall responsibility for organising the administration of the state to implement policies which foster national development. The president also has emergency law-making powers, but any presidential laws may be recalled by the legislature.

Legislative power rests with the Parliament, although laws must also have presidential approval. The Parliament has three main functions: legislative, budgeting and oversight. It draws up and passes laws and discusses and approves government regulations in lieu of laws and proposals. A National Legislation Programme provides drafting guidelines mandating stakeholder consultations at every step to ensure transparent law-making by government agencies. The public has a legal right to comment on draft laws and draft local regulations. Government officials receive training in the formulation and design of laws and regulations. A guidebook for drafting local regulations is also available for local governments.

The Constitution provides that judicial power is exercised by the Supreme Court and subordinate judicial institutions in the form of public courts, religious affairs courts, military tribunals and state administrative

courts, as well as by the Constitutional Court. Judicial appointments and supervision of judges are now conducted by a newly-established Judicial Commission, freeing the judiciary from political interference.

Several measures have been taken to promote government integrity and transparency. In 2008 an ombudsman was established to hear complaints against government agencies alleged not to be satisfying minimum service standards. Several government bodies have adopted codes of conduct for their staff and strengthened control mechanisms. Transparency with regard to government actions has been improved by a Law on Freedom of Information passed in 2008.

Human rights protection has been strengthened since the end of the Suharto regime in 1998. The government strengthened the existing National Commission on Human Rights and granted it independence in 1999. In the same year it passed a law guaranteeing freedom of speech. NGOs and academic institutions have sprung up in recent years to voice public concerns, providing a civil society sounding board to comment on government actions.

Labour rights have been strengthened since 1998. In 2000 Indonesia became the first country in Asia to ratify all core ILO conventions. In that year, it enacted a law on labour unions to guarantee the right to form a union. A 2003 Manpower Law consolidated labour regulations and further strengthened labour protection in many areas.

The government gives high priority to fighting corruption. The 2001 Law on Eradicating Corruption is stronger than its predecessors and was modified after Indonesia ratified the UN Convention Against Corruption in 2006. Laws have recently been passed to provide greater protection for witnesses and victims and to set up a corruption court. Other laws are in preparation. A Corruption Eradication Commission was formed in 2003 and given wide-ranging powers to investigate corruption which it has used to great effect. Whistleblower protection is available under a law that became operational in 2009. High-ranking government officials are required to report their assets; compliance is increasing. The public procurement system has been reformed to eliminate bribes. A specialised centre has been set up to eradicate money laundering and Indonesia was removed from the Financial Action Task Force's blacklist in 2006.

Indonesia has made progress in developing a corporate governance framework based on its concept of Good Corporate Governance (GCG). Since corporate governance problems were a major factor in the economic collapse of the late 1990s, commitments to improve performance in this area were included in the conditionalities of IMF rescue loans. As a result, the first corporate governance guidelines were published in 2001. GCG principles are also embodied in the 2007 Company Law. Shareholders are now entitled to

legal redress if their rights are violated and they have the right to obtain information.

This transition process has not always been smooth. Indonesian laws tend to leave specific details to implementing regulations, which adds further delays. Even when these regulations have eventually been put in place, government officials may not always have the incentive and the capacity to fulfil them. Capacity shortages are particularly acute at local government level. New institutions also require time to establish their independence and overcome resistance from other parts of government. The work of the Corruption Eradication Commission, for example, could clearly benefit from establishing a *modus operandi* with the Attorney General's Office and the Police. These conflicts are not unique to Indonesia, but the extent and rapidity of institutional change makes them more acute.

The government has persisted with economic reform, despite crises…

Democratic political reform and institution-building have provided an increasingly firm basis for continuing economic reform and macroeconomic stability, creating a virtuous circle where a more stable economy can help reinforce the legitimacy of the new polity.

Since the late 1990s, the government has pressed on with economic reforms and has not resorted to protectionist responses to either the 1997-1998 crisis or the current global economic crisis. In the aftermath of the Asian crisis, multilateral and regional obligations restricted the range of possible policy responses, but the trend towards greater openness was not solely a result of these obligations.

Three packages of economic reforms have addressed a wide range of policy areas, including: macroeconomic and financial policies; infrastructure development; investment regulations and the investment climate; customs; taxation; manpower; financial institutions; small business development; energy security; natural resources; environment; agriculture; labour and transmigration.

The new policies have taken shape in a vast project of law and institution building. The number of laws introduced since 1998 has been unprecedented. Beyond those covering regional autonomy, new laws now exist in almost all areas of economic activity, including: investment (replacing foreign and domestic investment laws from the 1960s), labour, arbitration, bankruptcy, company law, competition, tax administration, human rights, mining, oil and gas, geothermal and other energy, and in other infrastructure sectors.

Indonesia is now a signatory to almost all conventions or treaties covering intellectual property rights. The government has also demonstrated leadership in contributing to the transition to a low carbon economy, with

President Yudhoyono announcing a target for Indonesia to reduce greenhouse gas emissions by 26% by 2020 compared to expected levels – or up to 41% if international support is forthcoming to assist the abatement effort.

Indonesia has also created new institutions, such as the Commercial and Constitutional Courts, as well as several other specialised courts, sectoral regulators and numerous task forces designed to improve implementation, including the National Task Force for Intellectual Property Rights Violation Prevention. New agencies have also been created to combat corruption or anti-competitive practices, and national teams have been formed to enhance exports and investment and to expand private participation in infrastructure. A National Council for Climate Change has been established.

... providing a foundation for improving the investment environment

Economic reforms are starting to bear fruit. Macroeconomic stability, once a major worry for investors, has been re-established and has so far survived the global economic crisis relatively unscathed. The economy is growing steadily, although not rapidly enough fully to address problems of unemployment or poverty. Foreign investors have returned, though they remain cautious, and exports were also growing before the recent crisis, albeit insufficiently in labour-intensive sectors.

Economic policy certainty has increased, providing the predictability needed for long-term investments. A landmark Investment Law passed in 2007 covers both domestic and foreign investment, stipulating national treatment for foreign investment. It has also increased the transparency of Indonesia's policy framework for investment, in particular by clarifying which sectors are closed to foreign and/or domestic investors.

In line with the political reforms alluded to above, there is also greater transparency in making and implementing economic laws and regulations. For example, the government actively consulted foreign investors when preparing the 2007 Investment Law. Decisions on investment projects can now be challenged in the courts. The government is also striving to increase the transparency of its investment regime by slashing red tape, especially by streamlining the investment project approval process and implementing one-stop integrated services for investors.

These efforts to improve transparency are not just paper commitments. The central government is actively encouraging streamlining of licensing and other local level investment procedures by giving investment awards to local governments offering good investor services and by providing a wide range of relevant capacity building courses at local level.

Fiscal incentives do not discriminate between domestic and foreign investors. The government now has in place an organisation, the National

Team on Export and Investment Promotion (PEPI) whose brief explicitly includes conducting cost-benefit analyses of such incentives and, where necessary, proposing changes in the level of incentives and sometimes revoking them.

The Indonesian government is making strenuous efforts to curb intellectual property rights (IPR) violations. These efforts can help provide a more attractive investment environment for firms considering bringing in new technology. Consistent with the many international treaties and conventions on IPR that it has signed, Indonesia has put in place and updated IPR legislation to bring it closer to internationally-recognised standards. Concrete steps have been taken to strengthen enforcement of these laws, while also raising public awareness and building institutional capacity to handle complaints. Applying for IPR protection has been made easier.

The competitive environment for investors has improved since the enactment of a Competition Law in 1999 and the establishment of a Commission for the Supervision of Business Competition (KPPU) in 2000. KPPU is an independent body reporting directly to the President; it has a separate budget from the rest of government. The government is preparing to issue regulations on merger and acquisition review. During the 2000s, KPPU has become increasingly active. As well has handling cases referred to it, KPPU conducts competition impact assessments of government policies and regulations. KPPU co-operates actively with international and regional bodies, potentially facilitating its work on cases involving foreign parties, which are explicitly within its jurisdiction.

Acknowledging the country's infrastructure weaknesses, the Indonesian government has put in place a major programme of infrastructure construction that allows for greater private participation and a reduced, more accountable, role for state-owned enterprises. This Review examines the programmes to address deficiencies in telecommunications, electricity supply and transport facilities, including measures to facilitate and encourage public-private participation projects.

Marked improvements have taken place in the financial sector. The banking system has been restructured in recent years, enabling it to weather the current global economic crisis far better than it did the 1997-1998 crisis. The government has granted independence to the central bank and strengthened its supervisory powers while partially divesting the government's own shares in local banks. Prudential regulations have been improved, as has co-ordination between the central bank and the Ministry of Finance. Commercial banks have been strengthened by increasing capital requirements and promoting consolidation. Lending has been facilitated by the recent establishment of a Credit Bureau to provide debtor information.

Measures have been taken to strengthen the expanding capital market, in which foreign investors play a major role.

Indonesia's trade policies have been liberalised in recent years. Border procedures have been streamlined, as the Indonesian customs have been reformed to increase transparency and accountability and the Indonesian National Single Window launched in 2007 to handle export-import licences, data and information related to customs documents and the release of goods. The government is committed to reducing uncertainty with regard to trade policy and minimising regulatory changes. Domestic and foreign chambers of commerce are involved in trade policy formulation as part of the process of stakeholder consultation. The fruits of economic reform are stable growth and rising FDI inflows

2. Policy challenges and options to address them

The achievements outlined above demonstrate the tremendous efforts the Indonesian government has made to improve the investment environment, which have already achieved impressive results. However, Indonesia inevitably faces continuing challenges which need to be analysed and addressed.

Indonesia's impressive investment performance could be improved further

Although it has improved markedly in recent years, the business climate still lacks dynamism and attractiveness, as attested by many global indicators. These indicators can be criticised, with some justification, for presenting only a partial image of the complex array of factors which shape a business climate. Methodologically, they also tend to capture established perceptions rather than changes on the ground. But at the same time, the fact that Indonesia lags behind some of its regional peers in a number of international surveys of the business climate suggests that there is scope for improvement.

The *Doing Business* indicators of the World Bank, for example, rank Indonesia 122nd out of 183, only slightly worse than Indonesia's ranking in the Corruption Perceptions Index of Transparency International (111/180). Indonesia nevertheless outperforms Vietnam and the Philippines on corruption perceptions and is ahead of Brazil, India and the Philippines in terms of *Doing Business*. Indonesia was also the star reformer in Asia in the most recent *Doing Business* survey which, if sustained, will help to turn perceptions around. Indonesia also performs much better in some other surveys, such as the World Economic Forum's Global Competitiveness Index (54/133) and the World Competitiveness Index of the International Institute for Management and Development where it ranked 42 most recently, up from

51 in 2008. Indonesia is expected to continue at 61st of the 82 economies covered by the Economist Intelligence Unit's business environment rankings, though it is forecast to improve its absolute score over the next five years.

Another test of the investment climate is how much investment is actually undertaken. A decade of legislative reform seems to be paying off in terms of promoting domestic investment and attracting foreign investors. Total fixed investment as a proportion of current-price GDP is on a steadily rising trend, reaching nearly 25% in 2007 compared with 19.5% in 2003 – though this is well below the rates achieved by faster-growing economies in Asia. Recent FDI inflows have returned to pre-crisis levels, with strong growth in mining investment in 2007. But Indonesia still lags behind many of its peers in the region in attracting FDI relative to the size of its economy and given its rich natural resources. A comparison of FDI inflows and policy changes in Indonesia over four decades suggests a high degree of elasticity in terms of investor responses to policy changes, which should encourage reformers.

The challenges Indonesia faces can be seen in inter-related areas which tell much the same story. Export performance has lagged regional peers since the 1997-98 crisis. This can be seen in declining market shares in goods and services in world markets (now at 1% of world trade) and in the low share of high-technology exports within total exports, which are still dominated by the energy sector.[1] Most of the post-crisis expansion in exports has occurred outside the manufacturing sector and has been more from price gains than volume growth.[2]

The weak export performance and the relative scarcity of export-oriented FDI projects are both cause and consequence of weak productivity growth in Indonesia in the post-crisis period. The OECD's *Economic Assessment of Indonesia* (2008a, p. 21) concludes on the basis of available evidence that "input accumulation, rather than productivity enhancement, has been the main driver of growth in Indonesia".[3] This trend started in the early 1990s and is not solely a result of the crisis. Recent empirical analysis has nevertheless emphasised a recovery in total factor productivity in recent years.

Overall productivity can be improved by increasing the productivity of individual sectors (with more productive firms displacing weaker rivals) and by reallocating resources from less to more productive sectors. Either outcome will depend on increasing the levels of investment, including foreign investment, in the economy and on allowing capital to flow to where it can be used most productively. This will depend in turn on efforts to improve the climate for business in Indonesia.

The new era of political and macroeconomic stability offers a propitious time to discuss how further reforms and improved governance can build on the progress achieved so far to address the weaknesses in the business

climate described above and thereby to propel the Indonesian economy onto a new growth trajectory as seen in other Asian economies.

Inadequate infrastructure in Indonesia's geographically challenging archipelago has slowed the country's progress in joining the rank of the world's economic powerhouses such as China and India. The years after the Asian financial crisis witnessed very little of either public or private investment in most infrastructure sectors. Filling this infrastructure gap cannot be financed exclusively by the public purse. In line with the experience in a large number of OECD and other countries, Indonesia has made efforts to incorporate private participation in infrastructure to boost both the coverage and efficiency of infrastructure services.

The experience with public-private partnerships in Indonesia in the 1990s, in keeping with that in much of the rest of the developing world, was not always a favourable one. The goal of ensuring financial sustainability while at the same time meeting user needs and social objectives has often proved elusive. The OECD *Principles for Private Sector Participation in Infrastructure* could be useful in this context. They are intended to assist governments seeking private sector involvement in infrastructure development, in attracting investment and mobilising resources for the benefit of society and achieving sustainable development.

Investment promotion needs to be focused

In terms of investment promotion, the focus of the Investment Co-ordinating Board (BKPM) has been shifting more towards investor services, policy formulation and co-ordination as investment administration responsibilities are further delegated to local level. Performance indicators for BKPM are being adjusted to reflect its evolving focus.

The new Special Economic Zones being set up in Indonesia may go some way in addressing many investor concerns, but care needs to be taken in ensuring that incentives provide value for money. The OECD *Checklist for Foreign Direct Investment Incentive Policies* helps governments to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to warn against the pitfalls and risks of excessive reliance on incentive-based strategies. The National Team on Export and Investment Promotion (PEPI) may be well placed to conduct such reviews.

More could also be done to promote development of investment linkages between foreign affiliates and local enterprises. A broad policy to build the capacity of local enterprises to profit from business opportunities with foreign affiliates has been important, along with the government's role in facilitating business matching. Capacity development programmes for local firms could be offered in close partnership with the foreign investors.

Investment restrictions have been declining with few interruptions since 1985

Indonesia has been liberalising its investment regime through various rounds of reforms beginning in the mid-1980s. Unlike in earlier periods when abundant oil revenues led to more inward-looking development strategies, the past 25 years have seen very little backtracking. The Asian financial crisis led to substantial liberalisation, particularly in the banking sector and for acquisitions of local firms, but seen from a longer term perspective the crisis merely served to speed up a process which was already under way. More recently, the government has largely resisted protectionist responses in the current global crisis, as shown in the OECD-UNCTAD-WTO monitoring report to the G20.

Indonesia now has no general approval process for investment which might discriminate against foreign investors. In many sectors, particularly in services, foreign investors face a limit on the share of foreign equity, but in many cases foreigners are allowed to hold a majority stake. The Negative List of sectors where foreign investors face equity or other restrictions appears to be long in comparison with other countries and indeed even with earlier lists published by the government, but this is partly a consequence of its transparency.

… but foreign equity limits remain at the sectoral level

The pervasiveness of foreign equity restrictions in numerous sectors nevertheless makes Indonesia much more restrictive towards FDI than the average in OECD countries, according to the OECD *FDI Restrictiveness Index*. At the same time, Indonesia is not an outlier within its own peer group of major emerging economies and is less restrictive than China based on this measure. A useful future exercise in benchmarking might be with other economies within Southeast Asia.

While foreign equity limits by themselves are not likely to pose a serious obstacle to foreign investment in Indonesia, depending on their levels, these measures could be reassessed in light of the policy objectives they are intended to achieve. Performing regulatory impact analysis on existing restrictions and any proposed new ones when they arise should help to find non-discriminatory alternatives to meet policy objectives and improve the investment climate. At the very least, it will make sudden changes to the *status quo* by line ministries less common and hence add to predictability.

Other entry barriers exist for both domestic and foreign investors

State-owned enterprises (SOEs) operate in many sectors in Indonesia, although their number has gradually declined over the years. In some

nationally strategic sectors, such as electricity, railways and gas, SOEs continue to have a monopoly or market dominance. Policy changes concerning both competition and corporate governance move in the right direction, but recent institutional innovations still need time to become established. In this context, the government might consider reviewing certain provisions of the Competition Law with due regard to the development of Indonesia's industrial structure. The government is currently preparing regulations to allow the Competition Commission to review anti-competitive mergers and acquisitions.

Judicial reform has not yet provided the expected benefits

The judicial system is asserting its independence, after being tightly controlled by the Ministry of Justice under the New Order regime. A Constitutional Court and a Commercial Court have been created, among others, but capacity building remains a priority. Judicial activism has delayed new legislation in some cases, and investors complain about the lengthy and inefficient process of settling disputes through the local courts.

Decentralisation has created an urgent need for capacity building

The policy of decentralisation has an inherent logic in a country as geographically dispersed and ethnically diverse as Indonesia. But after four decades in which all major decisions were made by the president, the transfer of competence in a number of areas to the local level has not proceeded evenly. Some regions have progressed much better than others. Capacity building is already undertaken by a number of agencies and non-governmental organisations.

The government is complementing capacity building by further efforts to streamline the regulatory environment, including by further rationalising licensing requirements and implementing one-stop integrated services at both the central and local levels. The allocation of licensing authorities among ministries as well as between central and local governments has been clarified in various regulations and decrees. The strong commitment of the government leadership and careful planning of implementing steps, in consultation with stakeholders, are required in order to provide more efficient and predictable investment administration services

Implementing the new initiative targeted at improving the investment climate as outlined in the Medium-Term Development Plan of 2010-14 systematically to inventory, review and simplify laws and regulations at both central and local government levels, supported by stakeholder consultations and awareness campaigns, would help alleviate some of the administrative burden on local government.

There is also room for improvement in policy areas related to the investment environment

This Review explains how improvements are being made in policy areas that impinge on investment, including financial market regulation, competition, corporate governance, tax policy and policies for promoting responsible business conduct. For example, difficulties with implementing existing legislation relating to common business practices such as debt collection or winding up a business need to be remedied to ensure the predictability that investors prize above all else.

Enterprises are being encouraged to embrace principles of responsible business conduct in their core corporate strategy and investment. Reform efforts here should be deepened and business awareness that adoption of responsible business conduct is more than an additional cost to comply with laws and regulations needs to be increased. This can also support the government's efforts to improve corporate conduct in areas such as core labour standards and environmental protection by providing an impetus for companies to comply not only with applicable law but also with societal expectations expressed in other ways than through law.

Co-operation with the OECD has begun in investment policies, including the OECD's Freedom of Investment project, and also in other policy areas that relate to the overall environment for investment, such as competition policy and corporate governance. Indonesia can benefit from developing and deepening this co-operation to share experience with its peers and to exert influence on international rule-making to the benefit of its own people.

Policy options to address the challenges

The Indonesian government is strongly encouraged to:

- *Persist with efforts to ensure greater consistency in policies and laws*. The recent initiative systematically to inventory, review and simplify laws and regulations at all levels of government constitutes a major step in the right direction. These laws also need to be accompanied by the prompt creation of implementing regulations.
- *Continue to relax restrictions on foreign investment*. Current efforts to harmonise the bewildering array of foreign equity limits and introduce cost-benefit analysis are to be encouraged as part of broader reforms to fulfil public interest objectives through non-discriminatory means.
- *Continue to streamline business licensing*, as foreseen in the 2010-2014 Medium-Term Development Plan. A timely review of this streamlining showing progress in, for example, eliminating unnecessary licences and overlaps in information collection, would be welcome at an appropriate time.

- *Expand the role of BKPM to include a consolidated programme of consultations with investors and local IPAs leading to recommendations to government.* The BKPM could implement a consolidated programme of annual consultations and dialogue with investors. Problems and grievances brought up in such consultations could be shared with local IPAs and these in turn could notify BKPM of problems met with at local level. Based on the outcome of this process, BKPM could produce a set of recommendations to the government.
- *Improve the BKPM website.* A user survey on BKPM's online services could indicate specific areas for improvement. The BKPM website could be expanded to include a complete set of laws and regulations affecting investors, and to publicise other already available promotional materials; the site could also be updated more regularly.
- *Develop policies to facilitate and encourage the development of backward linkages and spillovers from FDI to the local economy.* These could, for example, include: capacity-building for local suppliers, including micro, small and medium-sized enterprises, provided by the government or the private sector; a cluster-based approach to investment attraction, based on existing local competitive advantage in terms of the resource base, including skills; and the publication of a user-friendly business directory to facilitate business matching between domestic and foreign-invested enterprises.
- *Strengthen the regulation of network sectors.* As the role of the state diminishes over time in these sectors, regulatory structures need to be strengthened to ensure adequate competition
- *Ensure that investment incentives are non-distorting, transparent and broad-based.* Indonesia lags behind many other countries in the region in terms of its participation in global supply chains. The creation of special economic zones to boost labour-intensive, export-oriented manufacturing might help in this area, but care needs to be taken to ensure that any incentives offered are transparent and based on a clear assessment of the likely costs and benefits.
- *Reinforce* ad hoc *institutional arrangements to promote co-ordination and further reform.* Many teams and task forces have been created to address specific problems, such as the National Team on Export and Investment Promotion (PEPI). These teams can supplement government capacity by drawing from the pool of high quality local experts and can become advocates for reform within the government. These *ad hoc* arrangements require political support at the highest level in order to overcome resistance in other parts of government and also need to have clear roles and missions, adequate resources and qualified staff.
- *Improve reporting of foreign investment in Indonesia.* Adequate information on the activities of foreign firms is important both for policy formulation and

for targeted investment promotion. Statistics on FDI inflows into Indonesia need to be improved and aligned with international standards such as the *OECD Benchmark Definition of FDI* to provide a clear picture of trends and patterns, concerning both the sector and the country of origin.

- *Review arrangements for handling bankruptcies* with a view to creating a credible and efficient mechanism that can be resorted to when out-of-court negotiations between creditors and debtors break down.
- *Consider the establishment of a centralised registry system for collateral*. This can reduce existing fragmentation, dispersal and incompleteness of collateral recording that makes it difficult and time-consuming for lenders to recover collateral when a borrower defaults.
- *Encourage domestic and foreign-invested enterprises to comply with standards of responsible business conduct* compatible with internationally-recognised instruments such as the OECD *Guidelines for Multinational Enteprises*. Indonesia is invited to participate actively in consultations regarding the 2011 revision of the OECD *Guidelines* to help ensure that this process can take full account of the needs and interests of developing countries.
- *Conduct an in-depth assessment of Indonesia's competition policy in co-operation with the OECD*. This can help record progress in opening markets to competition and develop policy options to address remaining challenges.

Notes

1. Molnar and Lesher (2008), p. 5.
2. OECD (2008), p. 18.
3. For a more complete discussion, see OECD (2008), pp. 21-26.

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Chapter 1

Investment Policies and Trends Over Time

This chapter charts how much progress Indonesia has made in reforming its investment climate, encompassing the post-independence era, the New Order regime and the Reformasi period. The Asian economic crisis of 1997/98 damaged the country's economic and political stability, causing many foreign investors to withdraw their capital, and new foreign investment was slow to come back to the country. The chapter describes the government's policies to improve its investment climate, including the enactment of the new Investment Law of 2007, while transforming the country into a democratic and decentralised state with a more transparent governance structure. It also demonstrates how FDI flows have responded to policy changes over time and highlights contributions of foreign investment to Indonesia's economy.

1. The setting: economic reform

With a large domestic market and abundant natural resources, Indonesia has relied less than its regional peers on export-led development orchestrated in part by foreign multinational enterprises (MNEs). Investment policy has been influenced in the past by oil prices, with periods of low prices characterised by relative openness towards foreign investors. The 1997-98 Asian financial crisis added urgency to the need to attract capital, not only as a source of investment but also for technology transfer and access to global markets.

Indonesia's post-independence economic development

Early policies in the post-colonial period[1] favoured small-scale industry under *pribumi* (indigenous) ownership. Beginning in the late 1950s, the government shifted towards an emphasis on heavy industry relying on state ownership. Almost all foreign property was nationalised, beginning with Dutch-owned enterprises in 1957. The management of these nationalised enterprises was entrusted to senior military officers while the government sought to build a national industry led by state-owned enterprises (SOEs). By the end of this period, SOEs dominated the economy and there was little FDI outside the oil sector. By the time the New Order government assumed power under President Suharto in 1967, the economy was suffering from high inflation, budget and trade deficits and a strong need to attract foreign capital.[2]

To counter the economic crisis, the new government ushered in a period of economic liberalisation, including the Foreign Capital Investment Act of 1967 which continued to provide the basic legislative framework covering FDI for the next 40 years in spite of amendments. The framework was liberal compared to many other developing countries at that time. The import licensing system was also abolished and some nationalised enterprises returned to their owners. These moves were accompanied by foreign investment promotion through generous tax concessions and investment protection. The government also made it easier to secure approval for foreign investment projects by clarifying administrative procedures. The 1968 Law on Domestic Investment also reversed the Sukarno-era restrictions on domestic private investment.

Buoyed by a strong economic performance, vastly increased oil revenues and the boom in commodity prices after 1973, together with rising nationalism as seen in riots during a visit by the Japanese prime minister, policies became

more restrictive. The government adopted an ambitious policy of state-led industrialisation backed by an import substitution strategy as SOEs were set up to produce fertiliser, steel, cement, paper and petrochemicals. The Investment Co-ordinating Board was established in 1973 to issue investment licences to domestic and foreign firms in all sectors except oil, banking and the forestry sector. In sectors permitting majority foreign ownership, new investment regulations stipulated that the foreign share was to be diluted progressively over ten years until it became a minority share and new foreign investments were to be minority joint ventures. The dominance of SOEs supported by government policies crowded out private investment including FDI in certain sectors. Provisions concerning key personnel were also tightened. More sectors were closed to FDI following the 1979 oil price rise.[3]

Sharp declines in oil prices in the 1980s, a deteriorating balance of payments and large budget deficits then shifted the policy mix towards promoting exports and FDI. A series of reforms in the 1980s eased regulations covering investment, opened more sectors to foreign participation and consolidated and clarified FDI regulations through the introduction of a negative list of industry sectors where FDI was either restricted or prohibited. Foreign ownership restrictions and divestment requirements were relaxed for export-oriented investments and projects located in bonded zones in 1985-1986. The joint-venture requirement on foreign investors was lifted and 100% foreign ownership and less stringent divestment requirements were allowed for investments greater than USD 50 million or those located outside Java and in bonded zones in 1992. The same policy was extended to all investments greater than USD 2 million in the supply industry in 1993.

The lack of strong investor response to these changes led to further, wide ranging reforms from 1994 through 1996. Full foreign ownership was permitted under certain conditions, the minimum divestment requirement was removed and nine "strategic" sectors were opened for the first time to participation by foreign investors: ports, the energy sector, telecommunications, shipping, civil aviation, water supply, railways, nuclear power and the media. Only a nominal 5% Indonesian holding was still required, although in some cases the state still played a dominant role in the sector. Investors could also take advantage of various fiscal and regulatory concessions, including accelerated depreciation and amortisation and a duty drawback scheme on imported capital goods and raw materials for export oriented firms.

In parallel with this liberalisation, the state continued to promote several indigenous industries. Eight high-technology industries were promoted in the 1990s, together with the "national car" project, and various other sectors received special tax and customs treatment, as well as credit privileges. As a result, not only did public enterprises dominate strategic industries, but the state was also the dominant producer of petroleum, cement, steel, aircraft,

ships, chemicals, fertilisers and paper, as well as rubber, palm oil, tea and other cash crops.

Strong economic growth following from reform beginning in 1985 was accompanied by a surge of FDI inflows between 1986 and 1996, especially after the major policy liberalisation in 1994. As Indonesia's industrial policy became more investor friendly, foreign investors responded by increasing investments in Indonesia. Export-oriented policies from the mid-1980s, along with deregulation and liberalisation of trade and investment policies, promoted FDI in export-oriented industries.

The Asian financial crisis

The Asian financial crisis was an economic and political watershed, and FDI inflows were no exception: record inflows prior to the crisis gave way to a sustained period of net outflows. Policy uncertainty and economic collapse no doubt greatly contributed to this situation, but even without the crisis the country's economic policies would eventually have proved unsustainable. Industrial policies in key sectors were proliferating, often involving the family or entourage of President Suharto. On top of this cronyism and nepotism, reform fatigue had set in after almost a decade of sporadic deregulation.

The crisis resulted in 50% devaluation of the rupiah in real terms in 1997 and a collapse in Indonesia's GDP which returned large numbers of Indonesians to abject poverty. This led to the reappraisal of many existing policies and to the enactment, largely supported by the IMF, of reforms which constituted a major step towards a more open environment for both foreign and domestic investment.[4]

As a result of successive agreements with the IMF, imports of sugar, wheat, soybeans and garlic were no longer to be controlled by Bulog, the state food logistics agency. Bulog's monopoly was limited solely to rice. Tariffs were cut on chemicals (previously excluded from the liberalisation move to protect the Chandra Asri petrochemical plant), metals and fish. Export taxes for metal ores and rattan were also cancelled. Restrictive marketing arrangements for cement, paper and plywood were eliminated in February 1998 while price controls on cement were abolished as early as November 1997.

Domestic trade in all agricultural products was also fully deregulated and the Clove Marketing Board was eliminated in June 1998. Budgetary and extragovernmentbudgetary support and credit privileges granted to projects in the aircraft industry were discontinued in January 1998. Lastly, all special tax, customs and credit privileges for the national car project were revoked. Parliament also passed a law in October 1998 allowing full foreign ownership in the banking sector, and the ban on foreign ownership in the retail sector, mining, palm oil and other plantation industries was also partially lifted.[5]

Post-crisis economic reform

Economic reforms since the Asian financial crisis have taken place against a backdrop of democratisation and decentralisation. President Suharto resigned in May 1998 and direct presidential elections were held in 2004 and in 2009. At the same time, power has been devolved towards both Parliament and the regions. A "big bang" decentralisation launched in 1999 resulted in the transfer of control of large amounts of public expenditure and service delivery from the central government to 33 provinces, 398 regencies/ districts and 93 cities.[6]

Reform of the investment climate is a key priority of the Indonesian government. In 2003 it issued an Investment Policies Statement which set out the importance of private investment in sustainable development. Under President Yudhoyono's administration starting from 2004, the government has been an even more energetic reformer. The stage was set via the government's medium-term goals, stated in its Medium-Term Development Plan for 2004-2009; then the government implemented three economic reform packages[7] (as Presidential Instructions), including measures to improve the investment climate, from 2006 to 2008. The Plan was also supported by the annual budget process.

In early 2006, a new investment policy package was announced which included the submission of a new investment law, a revised negative list, new regulations covering taxes on investment, free trade zones and the division of government authority. Investment and customs regulations were also to be streamlined. These initiatives were complemented by an Infrastructure Reform Package and by reforms of the judiciary and the civil service.

The Investment Law 25/2007, passed by Parliament in March 2007, provides national treatment for established enterprises, in contrast to the separate treatment for foreign and domestic firms in earlier laws. Compared to the earlier legislation it also offers greater transparency in terms of the sectors covered, more extensive land use rights and a reduction in administrative burdens through the creation of an integrated service facility and longer work permits for key personnel.

The reform packages became increasingly expansive. The third package, issued in May 2008, covered: the investment climate; macroeconomic and financial policies; energy security; natural resources, environment and agriculture; micro, small and medium enterprises; implementation of the commitments to ASEAN Economic Community; infrastructure; and labour and transmigration. All three packages were part of an overall drive to improve business and investment conditions in the Indonesian economy. The process did not present a quick fix; rather it was designed to improve business and investment conditions progressively by generating a virtuous circle of reforms

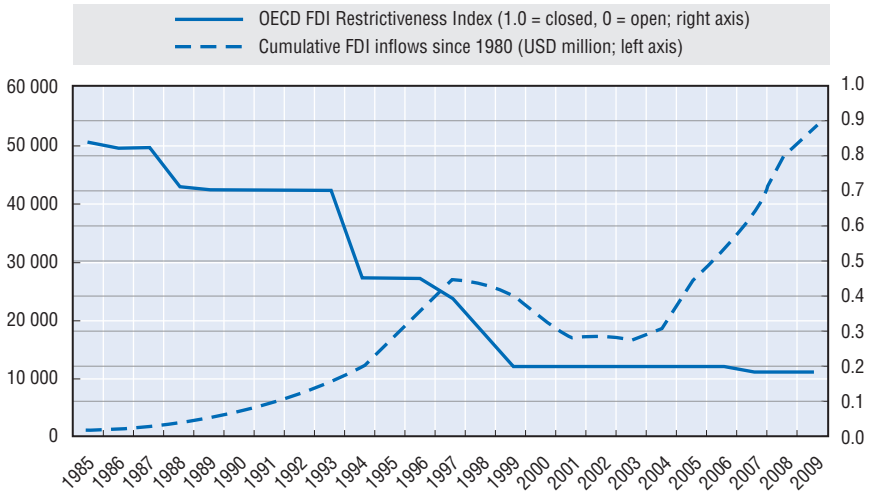
which would make the regulatory environment and government practices more business friendly. Ultimately, the better business environment is expected to encourage more and better quality investment and to create jobs.

While the government understands that the reform process did not produce dramatic changes, it believes that the general direction of the process was highly positive. An increasing number of institutions praised the process and recognised the positive impact of the reform, including the World Bank and international credit rating agencies. For example, Indonesia's credit ratings were progressively upgraded in recent years by three major credit rating agencies.[8] The Chairman of the International Chamber of Commerce and Industry in Indonesia commented in 2008 that the government, through its policy packages, had addressed the areas under its direct control that are critical to the economy, namely infrastructure development, investment regulations, customs, taxation, manpower, financial institutions and small business development, though the improvement was not yet widespread.

Measuring Indonesia's investment reform since 1985

Indonesia's liberalisation path in its FDI regime through various rounds of reforms beginning in the mid-1980s can be measured by a simplified *OECD FDI Restrictiveness Index* (Figure 1.1). The *Index* captures both horizontal restrictions covering almost all sectors, particularly manufacturing, and specific restrictions in three key sectors: banking, distribution and infrastructure.[9] The *Index* measures only statutory restrictions and excludes both implementation

Figure 1.1. **FDI liberalisation in Indonesia and the foreign investor response**



Source: OECD and Bank Indonesia.

and other potential entry barriers. Key reforms reflected in the *Index* construction are listed in Table 1.1. Unlike in earlier periods when abundant oil revenues led to more inward-looking development strategies, the past 25 years have seen very little backtracking.

The Asian financial crisis led to substantial liberalisation, particularly in the banking sector and for acquisitions of local firms, but seen from a longer term perspective the crisis merely served to continue a process which had begun over a decade earlier. The lack of a strong downward trend since 1999 does not imply either that no reforms have been undertaken or that the government has been inactive in this area. A number of sub-sectors have been removed from the Negative List over this period but are not included in Figure 1.1. Furthermore, the emphasis of the government has been more on legislative and institutional reform than on liberalisation *per se*. These reforms have served to improve policy implementation which had been a frequent complaint of investors in the past. The best measure of the effectiveness of these improvements is the substantial rise in FDI inflows in past few years compared to the previous period.

Table 1.1. **A chronology of FDI liberalisation in Indonesia**
1986-2010

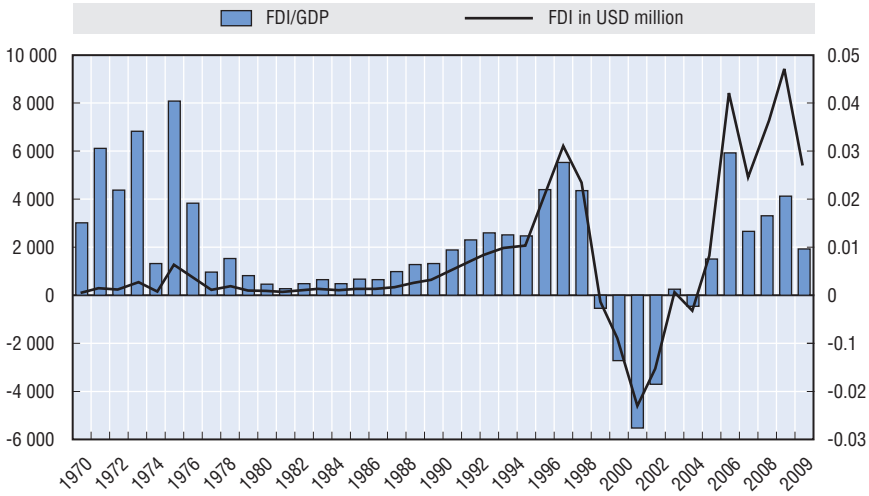
1986	• Relaxation of limits of foreign ownership for export-oriented firms • Several sectors previously closed to FDI are opened, including retail trade
1987	• Foreign investors allowed on stock exchange
1988	• 16-year ban on new foreign bank entry removed • Joint ventures allowed to distribute their products locally
1989	• Switch from Positive to Negative List, with hundreds of sectors opened to foreign investment under certain conditions (*e.g.* export requirement, co-operation with SMEs) • Foreigners allowed to purchase 49% of shares of listed companies
1994	• Minimum capital requirement for foreign investment eliminated • Nine strategic sectors opened to 95% foreign ownership • Up to 100% foreign ownership permitted throughout Indonesia (80% previously) • Divestiture requirement reduced to only a token amount of local equity • Domestic partnership requirements relaxed
1995	• Ten sectors removed from Negative List, including motor vehicles
1997	• Presidential Decree removes 49% foreign equity limit on purchases of listed shares
1998	• Full foreign ownership allowed in banking
1999	• BKPM no longer requires Presidential signature for approvals • Local content programme for motor vehicles phased out • Full foreign ownership of holding companies allowed, including through acquisitions • Several sectors opened further to FDI, including retail, general importing, palm oil plantations, broadcasting and downstream operations in the oil sector.
2007	• Investment Law does away with general divestiture requirements • New Negative List opens some sectors to greater foreign participation
2009	• Mining Law allows foreign ownership of concessions • Electricity Law allows for private operators in areas not served by PLN
2010	• New Negative List opens some sectors to greater foreign participation

2. FDI trends

Flows into Indonesia have returned to pre-1997 levels

The trend in FDI inflows since the late 1960s has followed closely policy changes over time, albeit sometimes with a lag. The peaks in FDI as a share of GDP in Figure 1.2 correspond to the periods of greatest openness towards foreign investors: in the early 1970s, the mid-1990s and in the past five years.[10] Early liberalisation was quickly tempered by the oil and commodity boom after 1973 which led to greater restrictions on foreign investors. This policy phase continued until the collapse in oil prices in the mid-1980s, with negligible FDI inflows in the early 1980s.

Figure 1.2. **FDI inflows in Indonesia**



Note: FDI values (dotted line) are measured on the left axis and FDI/GDP ratios (continuous line) on the right axis.

Source: Bank Indonesia.

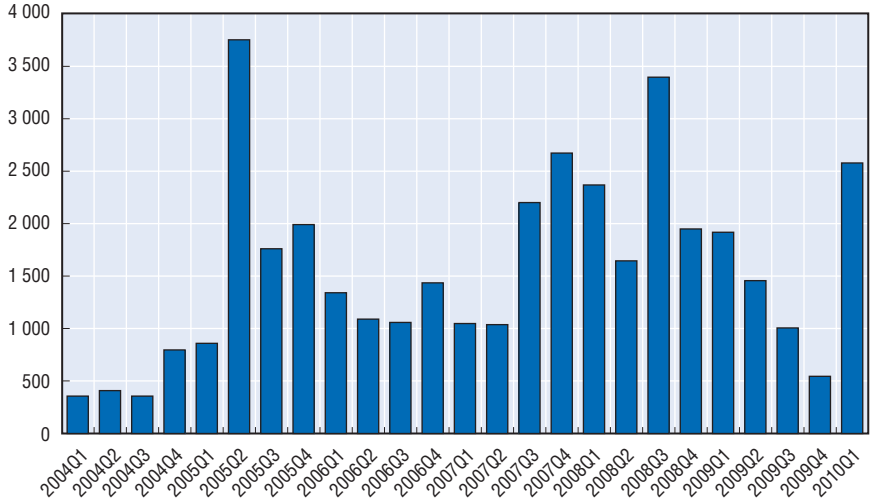
Major policy reforms from the mid-1980s brought a surge of FDI flows. Indonesia also benefited from the outward direct investment boom from Japan after the 1985 Plaza Accord as currency appreciation pushed Japanese enterprises and later those from the newly-industrialising economies to relocate their production base to lower-cost locations in Asia. A large amount of export-oriented FDI flowed into the labour-intensive manufacturing sector, such as textiles. Further reforms in 1994 led to a doubling of FDI in 1995, and Indonesia's performance in attracting FDI exceeded most Asian peers in 1996 as the eighth most popular destination for FDI in the developing world in that year. The 1997-98 crisis was a severe

blow to Indonesia's investment climate and caused massive net FDI outflows, as foreign firms withdrew capital from the economy. Indonesia's economic recovery since 2000 has been relatively slow compared to other crisis-afflicted Asian countries, particularly in terms of FDI inflows and exports. With macroeconomic and political stability, investor confidence has finally been picking up. Annual inflows over the past five years have averaged USD 7 billion

… and appear to have held up relatively well during the recent global crisis

During the current global financial crisis, inflows fell in each quarter of 2009 but recovered sharply in the first quarter of 2010 (Figure 1.3). They have generally remained robust by historical standards for Indonesia and in comparison with the fall in FDI in OECD countries. Nevertheless, many important source countries for investment in Indonesia were severely affected by the crisis, and this will make efforts at investment promotion and deregulation central to maintaining inflows in the near term. Quarterly figures are volatile and subject to revision, making predictions difficult, but there is no indication yet that the present crisis has altered perceptions about investing in Indonesia. Southeast Asia offers a large and dynamic market, and many producers in OECD countries and elsewhere have a long-term interest in maintaining a market presence.

Figure 1.3. **Recent FDI inflows into Indonesia**



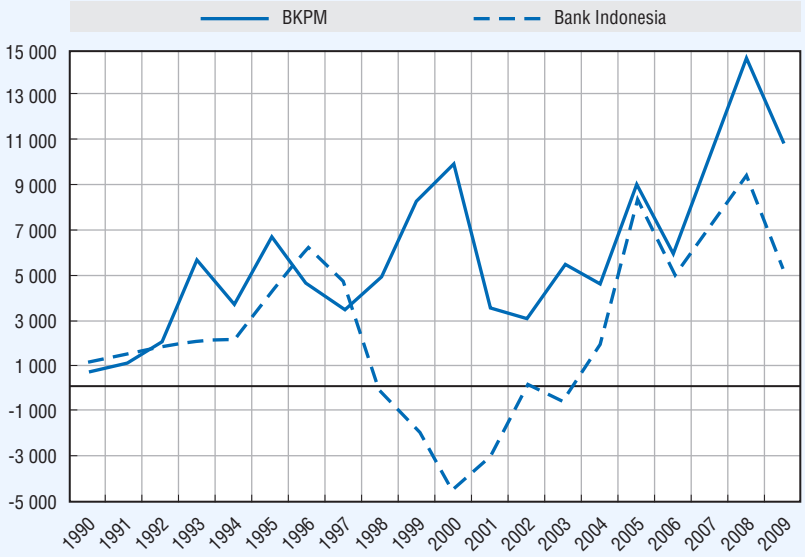
Source: Bank Indonesia (in USD million).

Box 1.1. **Reporting FDI statistics in Indonesia**

Indonesia has two main sources for FDI statistics: the Indonesia Investment Co-ordinating Board (BKPM), which issues permanent business licences to domestic and foreign investors; and Bank Indonesia (BI), which records international capital flows as part of balance of payments statistics. While FDI statistics from both sources are commonly referred to in the media, there are significant differences between them.

Figure 1.4. **FDI statistics (BI** *versus* **BKPM)**

USD million



- Sectoral coverage: BKPM records FDI figures based on issued business licences. Since licences for oil and gas, mining, banking, non-bank financial institutions, insurance and leasing are issued by other government bodies, these sectors are not covered under the BKPM statistics. BKPM is expected to increase the sectoral coverage gradually. BI statistics cover all sectors.
- Definition of FDI projects: BKPM categorises all investments made into a PMA company (foreign capital investment company) as FDI, even if it is a joint venture with a local partner. This practice tends to inflate BKPM's FDI figures, which may additionally include equity contributions from domestic partners and investments financed from domestic sources. BI instead follows the standard FDI categorisation of equity investment, retained earnings and other capital flows.

Box 1.1. **Reporting FDI statistics in Indonesia** *(cont.)*

- Divestment of foreign equity: BKPM approves modifications of foreign share ownership of a PMA company after establishment, but it is not recorded in BKPM's FDI flow statistics. Divestment of foreign equity at the end of a project is also not recorded in BKPM's FDI figures. Hence, BKPM FDI data did not show a sharp decline from 1997 to 2000 unlike BI's FDI figures, which record foreign divestment by foreign investors.
- On average, BKPM figures for FDI exceeded those from BI by 236% in 1990-2009. This discrepancy indicates that FDI projects licensed by BKPM have a significant local capital contribution from joint venture partners.

FDI flows fell sharply after the Asian financial crisis

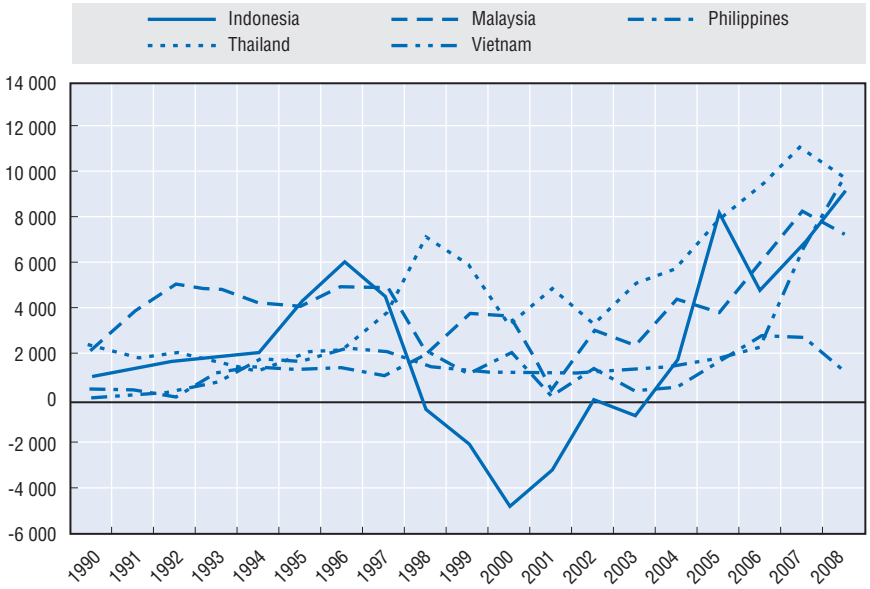
The Asian crisis hit Indonesia hard. FDI inflows fell sharply in 1997 and Indonesia suffered massive capital outflows in 1998-2003. The magnitude of economic shocks, amplified by political instability, was much more severe in Indonesia than elsewhere. Hence recovery from the crisis was also slower. No other Asian country experienced net FDI outflows due to the crisis and South Korea and Thailand even managed to attract more FDI. In the five years following the crisis, Indonesia was outperformed by all its Asian peers, including those whose FDI flows had been lower than in Indonesia in the pre-crisis period (Figure 1.5).

FDI flows started to pick up only in 2001 from these large outflows, but the recovery was weak, as another capital outflow was recorded in 2003. Over the crisis and recovery period (1997-2003), Indonesia saw a huge total FDI outflow of USD 5.1 billion. Data from OECD countries suggest that FDI by OECD based investors did not drop as much as BI figures suggest (Box 1.2). FDI policy was, nonetheless, liberalised at this difficult time to meet the conditionality attached to the IMF loans and facilitate restructuring of the corporate sector (as shown in Table 1.1). Foreign ownership shares in many surviving enterprises increased after the crisis due to the deregulation measures and requests by local partners suffering from financial difficulties.

The slow recovery of FDI flows was due to the serious loss of investor confidence in the short- to medium-term growth potential of the Indonesian economy. The huge burden on the financial and fiscal systems and the drop in living standards of a large part of the population offered a bleak outlook for demand growth. Political turmoil and subsequent instability discouraged new investment projects. Investor confidence was also undermined by several decisions by the Indonesian judiciary perceived as questionable, confusion caused by the 2001 big bang decentralisation programme, and a shift in the

Figure 1.5. **FDI inflows in selected ASEAN economies**

USD million



Source: Bank Indonesia and World Bank.

government attitude in favour of further labour protection. Foreign investors were much more sensitive to the shift in the policy environment than domestic investors as the recovery of FDI flows lagged behind that of domestic investment, which started to pick up in 1999.

Inflows in the past five years have not diverged significantly from FDI flows into most of Indonesia's regional peers. Indonesia attracted 13% of the total FDI flows going into ASEAN in 2008. But while government efforts to improve the investment climate, together with greater political stability, have clearly encouraged FDI flows in recent years, foreign investment has been oriented to short-term projects, not long-term ones such as in infrastructure development and mining where large investment needs persist.

FDI has been a relatively small source of capital in Indonesia

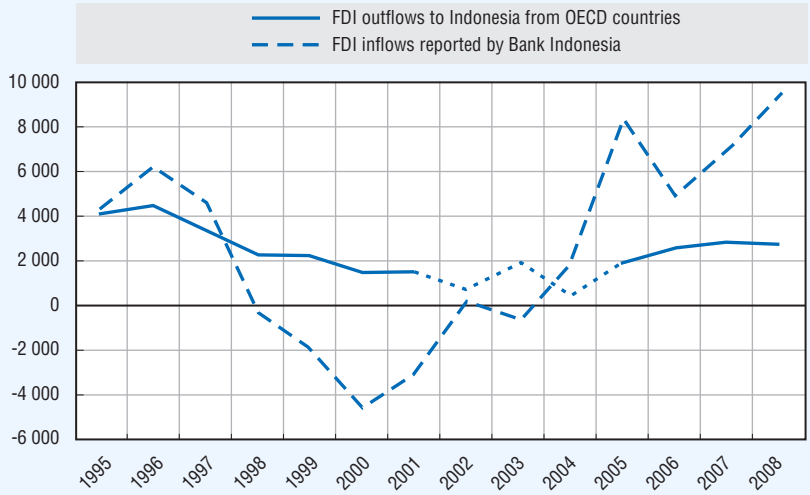
FDI's contribution to domestic capital formation has been relatively small in Indonesia, especially after the Asian crisis. The liberalisation period from the mid-1980s to 1996 increased FDI's share in gross fixed capital formation, but Indonesia has never matched the performance in the rest of ASEAN. Its performance in this respect has more closely matched that of China from 1980 to 1991 and again since 2004. While in recent years

Box 1.2. **FDI by firms from OECD countries in Indonesia**

Firms from OECD countries are among the largest investors in Indonesia. Their share of total inward investment, as measured by Indonesian sources, may well be understated given a tendency of some investors to invest in Indonesia through an affiliate located outside of the actual home country. Figure 1.6 compares reported inflows into Indonesia with what OECD countries report investing there. US data for 2002-2005 are not reported for confidentiality reasons, but even with this lacuna the story that emerges differs from that provided by Indonesian statistics. OECD investment in Indonesia has been relatively stable over time. Although it declined steadily from a peak in 1996, there was no net outflow in any year by firms from these countries.

Figure 1.6. **FDI reported by Indonesia and by OECD countries**

USD million



Note: US FDI data for 2002-2005 are missing for confidentiality reasons.

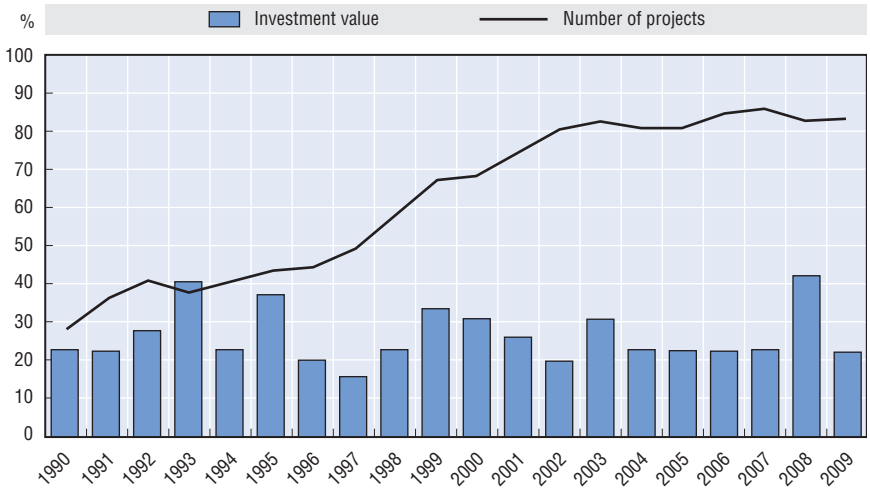
Source: OECD, *International Investment Statistics Yearbook* and Bank Indonesia.

FDI shares in Indonesia have recovered to pre-crisis proportions, it remains to be seen whether Indonesia will maintain its recently improved attractiveness to FDI and increase FDI shares in gross fixed capital formation closer to the ASEAN average of around 21% from the present level of roughly 5%.

Another way to assess the relative importance of foreign investors in total investment is to compare foreign and domestic projects reported by BKPM. In

value terms, foreign investments have represented roughly one quarter of all BKPM approved projects which are realised, with little discernible variation over time (Figure 1.7). In terms of the number of projects, foreign approved projects which are ultimately realised have accounted for a steadily rising share of the realised total since 1990 and now represent more than 80% of realised projects in any year, as reported by BKPM. It seems likely that many projects by local firms are approved at the local level and not necessarily recorded in the central BKPM statistics.

Figure 1.7. **The foreign share of realised BKPM-approved projects**



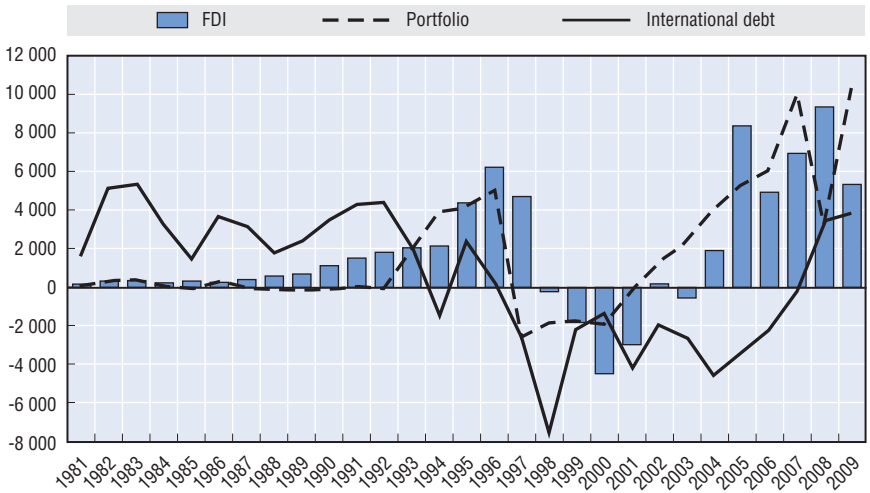
Source: BKPM.

Historically, until the early 1990s, international borrowing was the principal source of foreign capital to fund a persistent saving-investment gap. Since the crisis, the role of foreign investment as a supplementary capital source to domestic savings ceased as investment has been depressed below the level of savings.

The relative importance of FDI within total foreign capital inflows (including direct and portfolio investment and international borrowing) has changed over time, with a notable shift around 1993 (Figure 1.8). Before 1993, other investment, such as international borrowing, dominated total capital inflows to Indonesia; since 1993 FDI and portfolio investment have each surpassed international borrowing in most years. Direct and portfolio investments have been moving generally together, direct investment following portfolio investment with a short lag. In the wake of the Asian crisis, all three types of flows reversed, but direct and portfolio investments recovered much faster than other forms of investment.

Figure 1.8. **Foreign capital flows to Indonesia by component**

USD million



Source: Bank Indonesia.

The origin of direct investment in Indonesia

The exact origin of FDI inflows into Indonesia is hard to determine: BKPM data do not include key sectors such as mining, oil and gas and finance; many investors may choose to invest through affiliates in Singapore (especially for countries such as the United States which does not have a bilateral investment treaty with Indonesia[11]) or, for tax reasons, through Mauritius or the Seychelles; and BKPM attributes a significant amount of investment to "joint countries" with no indication of the exact origin. Table 1.2 reports BKPM figures and Table 1.3 those from OECD countries. The results are very different.

BKPM statistics attribute 58% of cumulative FDI to Asian firms (excluding joint country projects). European firms provide another one quarter of inflows and North American firms only 3.5%. According to BKPM, the largest investors in Indonesia are the United Kingdom, Singapore and Japan. The OECD figures tell a very different story, which can only partly be explained by the absence of non-OECD Asian investors in the shares (since even comparing the same country in the two tables yields very different estimates for the stock of FDI) and the difference in end-year (the BKPM figures are for 1992-2009, the OECD figures are cumulated to 2008). One-third of OECD investment in Indonesia comes from US firms, predominantly in the two sectors not covered by BKPM: mining and finance. Japan and Korea represent another 21% and European firms 41%.

From an investor perspective, the importance of Indonesia as a destination for outflows has changed over time. For Korean investors, Indonesia's share has

Table 1.2. **Cumulative FDI in Indonesia by country**

USD million; %

	1992-2009[1]	Shares[2]
Europe	**50 815**	26.4
Netherlands	6 533	3.4
Belgium	178	0.1
United Kingdom	31 980	16.6
Germany	7 247	3.8
France	1 761	0.9
Switzerland	1 233	0.6
Americas	**7 861**	4.1
United States	6 705	3.5
Canada	89	0.0
Brazil	166	0.1
Asia	**112 047**	58.2
ASEAN	38 177	19.8
Philippines	280	0.1
Malaysia	9 395	4.9
Thailand	344	0.2
Singapore	28 157	14.6
Non-ASEAN	57 604	29.9
Hong Kong (China)	10 801	5.6
Japan	27 117	14.1
South Korea	10 726	5.6
China	311	0.2
Chinese Taipei	8 475	4.4
Other excl. joint	**21 780**	11.3
Australia	5 280	2.7
Mauritius	15 490	8.0
Seychelles	974	0.5
Joint countries	**54 151**	
TOTAL	**246 654**	

1. 1992-2004 based on approvals; 2005-2009 on realisations.
2. excludes joint projects.

Source: BKPM (excludes oil and gas, mining and finance).

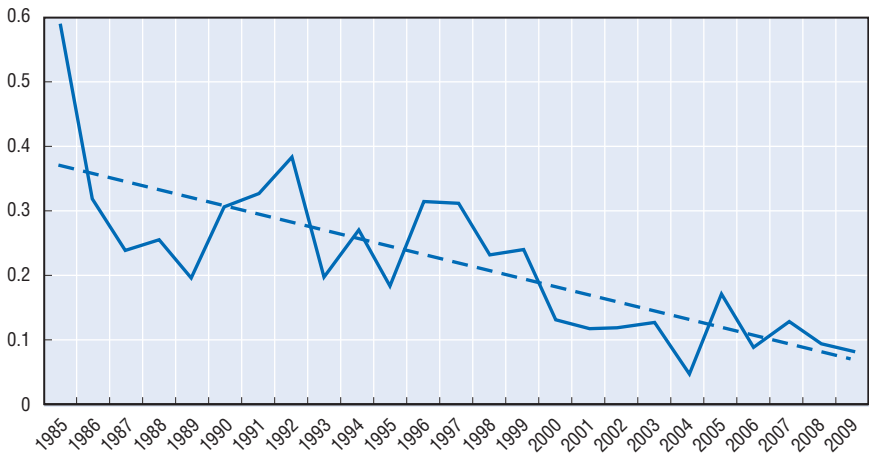
fallen from 16% during 1987-1992 to only 2% today. Much of this change can be explained by the rise of China, but Indonesia has also lost out to regional partners such as Vietnam. Japanese FDI in Indonesia has followed an even sharper downward trajectory (Figure 1.9). The high shares of the late 1980s were clearly unsustainable, and the Asian crisis accentuated this downward trend. In contrast, the US stock of FDI in Indonesia almost doubled in 2007 alone. Understanding the causes and the dynamics of these shifts is essential for effective foreign investment promotion in Indonesia.

Table 1.3. **The stock of OECD country FDI in Indonesia**
USD million; %

	2008 or latest year	
United States	17 909	34.3
Japan	7 445	14.3
Switzerland	6 675	12.8
United Kingdom	6 481	12.4
Korea (2009)	3 671	7.0
Finland	2 795	5.4
France	2 428	4.7
Germany	1 778	3.4
Australia (2007)	1 621	3.1
Netherlands	1 023	2.0
Sweden (2007)	194	0.4
Italy	159	0.3
Total OECD12	52 180	

Source: OECD, *International Investment Statistics Yearbook*.

Figure 1.9. **Japanese FDI in Indonesia**
Share of total Japanese FDI in selected Asian economies[1]



1. Asia : China, India, Indonesia, Malaysia, Philippines, Thaïland, Vietnam.
Source: Ministry of Finance, Japan.

While the sources of FDI in Indonesia have become more diversified over time, the concentration on a small number of investing countries is still high (Table 1.4). According to the BKPM's statistics on FDI project realisation by country, the five largest foreign investors (Mauritius, Singapore, Japan, the United Kingdom and Korea) accounted for 80% of the value of total foreign investment inflows in 2006-2008. The top investor, Mauritius, is a popular conduit for investors based in the third countries to

Table 1.4. **Top investor countries in Indonesia**
2006-2008

	Realised value	Number	Employment generated
1	Mauritius (28%)	Korea (20%)	Korea (27%)
2	Singapore (23%)	Singapore (16%)	Singapore (14%)
3	Japan (12%)	Japan (15%)	Japan (13%)
4	United Kingdom (11%)	United Kingdom (7%)	United Kingdom (12%)
5	Korea (6%)	Malaysia (7%)	Malaysia (6%)
TOTAL 5	80%	65%	73%

Source: BKPM.

channel funds, so the ultimate sources of investment from Mauritius are hard to determine. Singapore gained its importance as an FDI source in Indonesia due to its geographical proximity, the economic co-operation programme with Indonesia to set up the Batam free trade zone and its prominent function as a regional financial and trading hub. An unknown proportion of investment in Indonesia from Singapore may also be from other ultimate sources.

Most foreign investors locate in Java and Sumatra

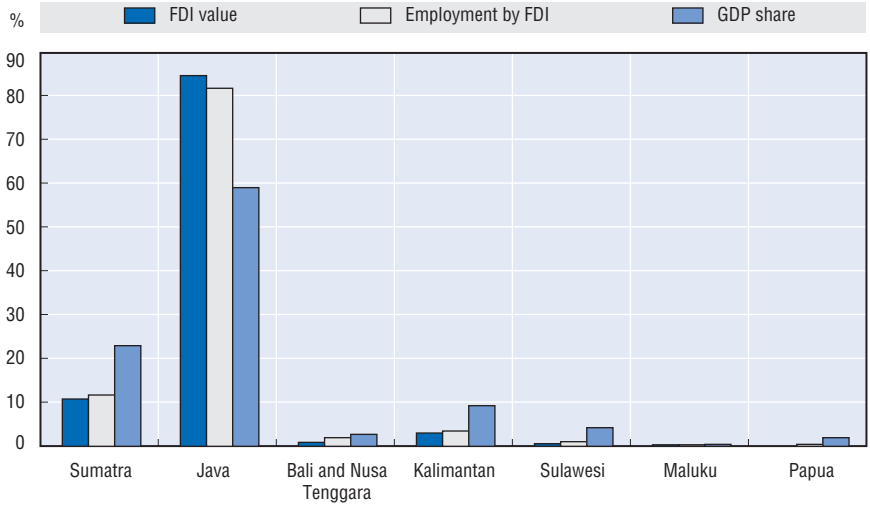
Like other economic activities, FDI inflows have shown a great disparity among regions within the country. Since 1992, Java has absorbed 60% of FDI projects on an approval basis. Sumatra is the second most popular region for foreign investors, attracting 21% of total FDI projects, the majority of which have gone to the province of Riau, including the major industrial locations of Batam, Bintan and Karimun. Although the importance of Java dropped slightly during the Asian crisis, it recovered quickly afterwards. The high concentration of FDI projects in Java continued from 2006 onward, with 85% of total FDI projects located in Java, particularly in the Jakarta Capital Region, despite its infrastructure deficiency (Figure 1.10). Sumatra accounted for 11% of FDI projects in the same period with about half of investment going to Riau.

The sectors favoured by foreign investors have changed over time

In the 1960s and 1970s, FDI was concentrated in the oil and gas sector. Beginning in the late 1970s, the manufacturing sector began to attract the most foreign investment as a result of a rapid change in Indonesia's industrial structure, which gained momentum in the mid-1980s from the more liberal policy stance. After the mid-1980s, most new FDI projects were export-oriented and consistent with Indonesia's comparative advantage in labour- and resource-intensive activities. FDI flows in the manufacturing sector, led by

Figure 1.10. **Distribution of FDI flows by region**

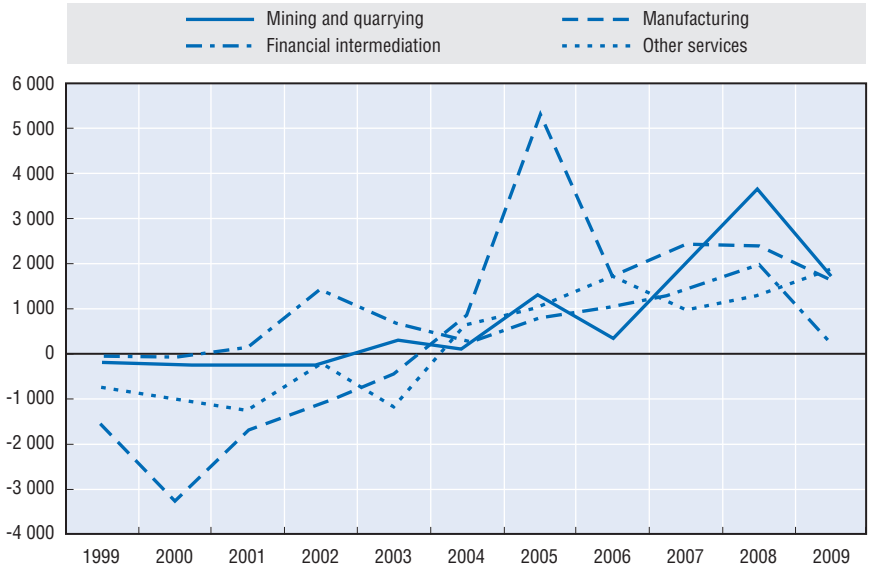
Percentage based on realised investments; 2006-2008



Source: BKPM.

Figure 1.11. **FDI inflows by sector**

USD million



Source: Bank Indonesia.

chemical and pharmaceutical, paper and metal products, accelerated in the 1990s up to the Asian crisis. The Asian crisis hit the manufacturing sector hardest, as reflected in a sharp decline in realised FDI projects (Figure 1.11), followed by non-financial services, including infrastructure projects. Financial sector FDI held up best during the crisis, owing to sectoral liberalisation and the opportunities to acquire local institutions. By 2004, inflows into all four major sectors were positive once again.

Investors from different regions tend to concentrate on different sectors. Based on cumulative inflows from 2004 to 2009, the mining sector is dominated by US firms (30%), followed by the EU and China (19% each) and then Japan (15%). The distribution sector is dominated by ASEAN investors (42%). In both manufacturing and finance, in contrast, investment since 2004 has been roughly equally divided between Japan, the US, the EU and ASEAN.

FDI has created jobs, particularly in the manufacturing sector

While FDI flows in services have been growing faster than those in manufacturing in recent years, FDI projects in manufacturing have generated much more employment: 41% of the total value of foreign investment in manufacturing accounted for 77% of total employment generated by foreign-invested projects in the country. This can be explained by the fact that many sub-sectors in manufacturing attracting FDI are highly labour-intensive, including the textile, leather goods and footwear, and food industries.

From 2006 to 2008, new foreign-invested projects created about 645 000 jobs, accounting for around 7% of the increase in total employment. FDI projects accounted for nearly half the jobs created in manufacturing, in contrast with the concentration of job creation in services observed in the overall employment statistics in the same period.

The recent overall shift of FDI flows to capital-intensive services away from labour-intensive manufacturing may adversely affect job creation through FDI in the future. Labour market regulations which were tightened to raise labour protection as well as rapid increases in minimum wages could be one factor influencing the type of investment projects.

Foreign direct investment has contributed to Indonesia's exports

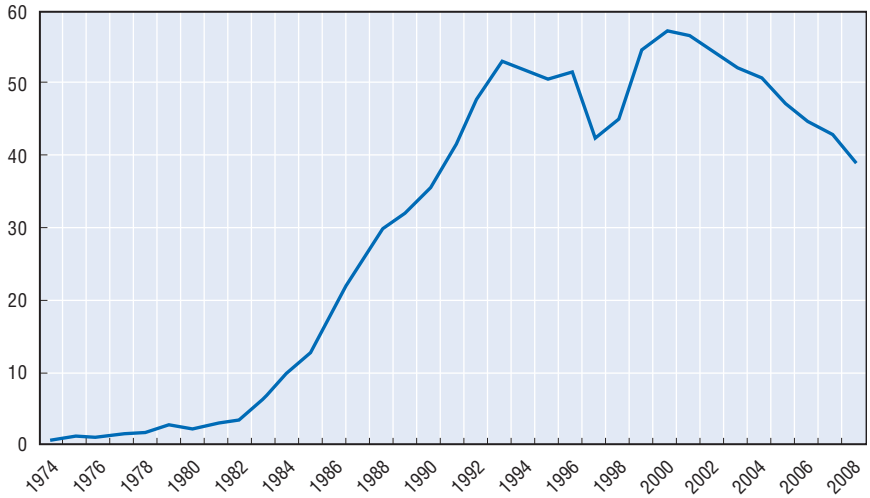
The export propensity of foreign multinational enterprises (MNEs) is generally higher than that of their domestic counterparts in developing countries.[12] In Indonesia, foreign MNE exports have accounted for an increasing share of total exports since 1990. Liberalisation since the early 1980s has caused a change in FDI projects from domestic-market oriented to export-oriented and has triggered the entry of foreign enterprises into labour-intensive, export-oriented manufacturing. The government has encouraged exports by

MNEs by relaxing foreign ownership restrictions for MNEs that export 80% or more of their output. Ramstetter and Takii (2005) estimate that the foreign share of exports by large and medium-sized plants increased from 22%-23% in 1990-91 to 38%-39% in 1996-97, then further to 45%-46% in 1999-2000.

Electrical and precision machinery was the largest category of product exported by foreign MNEs, indicating Indonesia's integration into regional production networks for this MNE-dominated industry. MNE export shares are relatively large in metal products, transport machinery, basic metals and chemicals. Export activities of MNEs in the manufacturing sector have arguably made a significant contribution to a change in Indonesia's export structure: the share of manufactured goods exports in total exports increased dramatically from only 3% in the early 1980s to 57% in 2000 as export-oriented foreign-invested enterprises expanded their operations in Indonesia (Figure 1.12).

Figure 1.12. **Manufacturing exports as a share of total merchandise exports**

Percentage



Source: World Development Indicators, World Bank.

Since the Asian crisis, Indonesia's export share in the world market has stagnated and has yet to recover fully to pre-crisis levels in both goods and services. Over the past decade, the world market shares of its traditionally competitive export products – textiles, apparel, leather and footwear, plus energy-related mining and quarrying – have declined. High technology sectors have yet to gain a revealed comparative advantage. Sluggish FDI flows may be one of the reasons for Indonesia's underperformance in exports. Over the crisis and recovery period, existing foreign-invested enterprises increased exports, taking advantage of currency depreciation, but Indonesia has not

attracted new foreign investment to foster innovation and competition to upgrade its industry and export structure.

FDI has generated productivity spillovers to domestic industries

Foreign-owned enterprises in Indonesia are found to be generally more productive than domestic enterprises.[13] They tend to have higher levels of investment and wages and better access to global markets.[14] Empirical evidence exists for positive productivity spillovers from foreign- to domestically-owned enterprises in Indonesia's manufacturing.[15] The technical absorption capacity of domestically-owned enterprises may matter for the size of the spillover as a large technological gap tends to reduce spillovers and locally-owned plants which already engage in their own R&D activity are likely to benefit more from foreign-owned plants than those which do not.[16]

Notes

1. Indonesian leaders declared independence in 1945, but the Netherlands only recognised the country's independence in December 1949; the Republic of Indonesia was established in 1950.
2. Lecraw (1996), pp. 249-250
3. Felker and Jomo (2003), p. 34.
4. OECD (1999), p. 65.
5. Felker and Jomo (2003), p. 37.
6. Law 22/1999 on Regional Autonomy and Law 25/1999 on the Fiscal Balance between the Central Government and the Regions.
7. Presidential Instructions 3/2006, 6/2007 and 5/2008.
8. Moody's upgraded Indonesia's credit rating from Ba3 to Ba2 in September 2009; Fitch Ratings upgraded it from BB- to BB in February 2008 and to BB+ in January 2010; and S&P upgraded it from BB- to BB in March 2010.
9. The score for 2010 is based on these three sectors, as well as horizontal restrictions, and hence is not strictly comparable with that for the broader index.
10. The high inflow in 1975 occurred after the liberal period had ended and was caused by a very large project in an aluminium smelter funded partly by Japanese official development assistance.
11. Indonesia has signed a Trade and Investment Framework Agreement with the United States.
12. For Indonesia and Thailand, see James and Ramstetter (2008).
13. Blomström and Sjöholm (1999) and Takii and Ramstetter (2005).
14. Arnold and Javorcik (2005).
15. Blomström and Sjöholm (1999) and Blalock and Gertler (2008).
16. Takii (2005).

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Chapter 2

Investment Policy

The investment climate was one of the worst casualties of the 1997-98 financial crisis. Over the past decade, the government has made considerable progress in creating a policy environment conducive to both domestic and foreign investment. This chapter describes efforts to reduce red tape, create a complete registry of land ownership, strengthen protection of intellectual property rights and improve systems to enforce contracts and settle disputes. A new Investment Law was enacted in 2007 which offers both national treatment for foreign investors and compensation based on market values in the event of expropriation. This chapter discusses the new Investment Law, as well as remaining restrictions on foreign investment contained in the Negative Investment List. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

The analysis of Indonesia's investment policies is structured around the questions set out in the *Policy Framework for Investment* (PFI, see Box 2.1). Each section is preceded by the relevant PFI question, which serves as general context for considering the main policy areas.

Box 2.1. **The Policy Framework for Investment**

The objective of the *Policy Framework for Investment* is to mobilise private investment that supports economic growth and sustainable development. It aims to contribute to the prosperity of countries and their citizens and to the fight against poverty.

Drawing on good practices from OECD and non-member economies, the *Framework* proposes guidance in ten policy fields identified in the 2002 United Nations Monterrey Consensus on Financing for Development as critically important for improving the quality of a country's environment for investment. It enables policy makers to ask appropriate questions about their economy, their institutions and their policy settings in order to identify priorities, to develop an effective set of policies and to evaluate progress.

The *Framework* was developed by OECD and non-member participants in a task force established under the aegis of the OECD Investment Committee as part of the OECD Initiative on Investment for Development launched in Johannesburg in November 2003.

The *Framework* was welcomed by Ministers from member countries at their annual OECD meeting in May 2006. OECD and non-member partners will continue to work together, in co-operation with the World Bank, the United Nations and other interested institutions and with the active engagement of business, labour and other civil society organisations, to support effective use and future development of the *Framework*.

1. Laws and regulations

What steps has the government taken to ensure that the laws and regulations dealing with investments and investors, including small and medium-sized enterprises, and their implementation and enforcement are clear, transparent, readily accessible and do not impose unnecessary burdens?

Policy uncertainty encompasses both predictability and transparency and is one of the greatest obstacles to investment. Firms need to know what the rules of the game are and require some assurance that those rules will not change once they have invested. Their views, along with other stakeholders, should also be solicited when policies are being developed or revised. Going beyond the rules and regulations themselves, their implementation and enforcement should be clear and transparent. Investors need to understand the practical implications of rules governing their investment, in terms of the conditions to fulfil, the procedures for a public review and the appeals process in the event of a dispute. This process can help to institutionalise procedural transparency by systematically ensuring that changes in implementing regulations and administrative decisions are subject to public review and appeals.

Rules and procedures should be designed in a way which achieves stated policy goals while imposing the least cost on investors in terms of red tape. Unnecessary administrative burdens can be a significant cost for potential investors, especially for small and medium-sized enterprises (SMEs), and can help to account for both a low level of investment and a high share of SMEs in the informal sector where rules can more easily be circumvented.

Economic policy certainty is improving, but some implementing regulations are still in process

In general terms, economic policy certainty has greatly improved in recent years in Indonesia. The Asian Development Bank found in 2003 that four out of five firms surveyed cited economic policy uncertainty as a constraint on their expansion.[1] A similar survey in 2007 found that 43% of firms still saw policy uncertainty as a serious obstacle, a high share but an improvement over only four years earlier.[2] Policy certainty is likely to have improved even further since then, with a raft of new laws coming into force in recent years.

The most important legal change concerning investors is the Investment Law (25/2007) signed on 27 April 2007. The Investment Law clarified a number of issues that had been uncertain for investors, not least the division of responsibilities for investment licensing between the central and local governments. The new law replaced two existing laws dating from the early years of the Suharto administration, one for foreign investors and another for domestic firms. It also led to a revised list of closed and restricted sectors which clearly outlined those sectors where foreign or domestic investors could not invest or only under certain conditions.

Some implementing regulations concerning both the Investment Law and sectoral regulations are still in process. In principle, implementing regulations must be in place within one year of the enactment of the law to which they refer.

Public consultation is becoming more institutionalised and the appeals process strengthened

Leading up to the 2007 Investment Law, the government actively consulted foreign investors. BKPM held intensive meetings with Chambers of Commerce, investor groups and other interested parties to obtain their views. According to a representative from the Indonesian Chamber of Commerce and Industry (KADIN), although the government has had a legal obligation to consult with KADIN since 1987, it is only in the past few years that this role has been fulfilled, and KADIN actively provided advice during the drafting of the new investment law.

Investors can sue in an administrative court if an investment project is rejected on grounds not stipulated in the law.[3] Furthermore, the government has committed itself to transparency and consultation in various agreements, including the ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA). With regard to specific services commitments under the AANZFTA, Parties "endeavour to provide interested persons of other Parties with a reasonable opportunity for comment prior to adoption of new measures", as well as to "provide licence applicants with an opportunity to remedy incomplete applications, status reports on the progress of applications on request, and reasons for the denial or termination of applications". Parties are also required to "observe minimum standards of procedural transparency, such as reasonable notice of administrative processes (*e.g.* licensing and rule-making in specific cases) and opportunities to present facts and arguments before final administrative action".

Red tape is still a serious obstacle to doing business in Indonesia…

In terms of starting a business, the World Bank's *Doing Business* Indicators rank Indonesia well behind all of its regional peers with the exception of the Philippines. Worldwide, Indonesia ranks 161 in this category, a notable improvement over a rank of 173 in the preceding year but still the worst performing of all *Doing Business* categories for Indonesia. The indicator includes the time involved, the number of procedures, the cost involved (excluding potential corruption) and the minimum paid-up capital required to start a new business for a typical domestic firm with up to 50 employees operating in a large city.

Some cities in Indonesia nevertheless perform significantly better than the national average in certain categories of the *Doing Business* indicator. For example, Yogyakarta ranks fifth and Makassar ninth globally for construction permits, and Manado 24th for registering property.

The problem of red tape has been compounded by the massive decentralisation over the past decade as the approval process has shifted to

the district and provincial level. In particular, regional regulations on taxes and levies have created an additional burden for investors. To counter this problem, the Ministry of Finance has evaluated regional regulations and made recommendations to the Ministry of Home Affairs concerning a regulatory review. As a result, more than 12 000 regional regulations (*Perda*) have been reviewed, resulting in the cancellation of 1 878 such regulations by the end of 2009 by the Ministry.

Indonesia was a star reformer in Asia in 2009

"Indonesia eased incorporation and post-incorporation processes for new business registration by introducing online services, eliminating certain licences, making the registry more efficient, and cutting company deed legalization fees, publication fees, registration fees, and business licence fees. As a result, 2 procedures and 16 days were cut and the average company start-up cost was reduced by almost 52% of gross national income per capita. Property registration also became easier because time limits were introduced for standard procedures at the land registry. In addition, Indonesia increased investor protections by expanding disclosure requirements for related-party transactions."

Source: World Bank, *Doing Business 2010*

... but procedures are being simplified

Indonesia was the most active reformer in the region in 2008-2009 according to the *Doing Business* indicators, reducing the time it takes both to start a business and to transfer property. Efforts to streamline the approval process focus typically on the time and number of procedures involved. Any improvements in this area may also help to reduce costs, both in terms of fees and also opportunity costs resulting from delays. The government planned to reduce the time needed to start a business from its own estimate of 104 days in 2008 to only 19 days in 2009, as well as reducing the number of procedures involved from 12 to nine.

2. Effective land ownership registration

What steps has the government taken towards the progressive establishment of timely, secure and effective methods of ownership registration for land and other forms of property?

Land is a crucial matter in Indonesia, owing to the large variety of titles which have evolved over the centuries. Ownership of land in Indonesia is regulated by Article 33 of the Constitution which stipulates that "the land, the waters and the natural riches contained therein shall be controlled by the State and exploited to the greatest benefit of the people" and by the Basic Agrarian Law 19/1960 which divides all land into either state land or certified land owned exclusively by natural persons with Indonesian citizenship. This represents one of the few areas of the investment climate where new legislation has not been drafted over the past decade, although a number of Government Regulations have been enacted and a new Land Law is currently being prepared. The government recognises the importance of this issue and has been working continuously to improve the situation.

The Agrarian Law (Article 16) provides for several types of land rights, including ownership, use, construction, management and cultivation. Rights to build, use or cultivate can be sold or used as collateral. Ownership rights do not apply to the sub-soil, the exploitation of which is governed by the Mining Law. With the exception of forestry and mining, the National Land Agency (BPN) is responsible for all matters relating to the Agrarian Law.

The government is making a concerted effort to register land

Since 1997, land holders have been required to register their land.[4] Currently, only 35% of land in Indonesia has been registered, most of it in urban areas, and of all registered land, 60% already has a Field Identification Number. To accelerate the process of registration, the government has established a Community Service for Land Certification (*Larasita*), including mobile units to register land in more remote regions. To increase public awareness of land registration procedures, BPN has also conducted land law counselling on television, radio and brochures, printed media and direct counselling to the community. So far, BPN has been constrained in its efforts by limited evidence of ownership, for example in rural communities where land has traditionally been held communally, also by a limited budget and the scarcity of surveyors and measuring equipment. In order to resolve land disputes quickly, a new Deputy for Land Dispute Resolution Affairs was established[5] and has resolved 1 878 cases of land disputes in the past four years.

Land registration is particularly important for micro, small and medium-sized enterprises (MSMEs) to allow them greater access to bank credit. Under Presidential Instruction 3/2006, the Ministry of Co-operatives and SMEs was ordered to produce 10 250 ownership titles for land owned by MSMEs by the end of 2006. There is a joint agreement between BPN and the State Minister of Cooperatives and SMEs in the Ministry of Home Affairs to speed up land-rights certification. As a result, 64 663 certificates have been issued since 2004.[6]

The leaseholds of foreign investors were to have been expanded

Prior to the implementation of the new investment law, land titles were offered to foreign investment companies for 25-35 years, with the possibility of renewal for similar durations. The new law (Article 22) stipulates a simultaneous extension in advance to make the duration of leases 60 years for leaseholds, 50 years for building rights and 45 years for the right to use land, once again with the possibility of renewal. A recent Constitutional Court decision cancelled the simultaneous extension and in-advance granting of titles with the result that the total duration of titles remains the same under the new and old rules. The lease period (plus possible extensions) is up to 95 years for leaseholds, 80 years for building rights and 70 years for the right to use land for any purpose.

Problems remain in registering property but the government is taking steps to speed up the process

Indonesia ranks 14th out of 24 countries in East Asia and 95th worldwide in terms of registering a property, according to the *Doing Business* indicators. The indicators are based on firms operating in the Jakarta region and hence may not be fully representative of the rest of the country, especially with regard to construction permits and the like. Other than taxes on the acquisition of land and buildings and on the transfer of property, Indonesia ranks poorly owing to the amount of time (15 days) which it takes to register the Land Deed at the Local Land Office under the name of the buyer. This delay is attributed by the World Bank to the backlog in registering land.

The latest *Doing Business* report nevertheless shows that the government has managed to reduce the time taken to register a property from 42 days in 2008 to 22 days in the 2010 Report. This improvement in large part explains why it has moved up in the ranking in terms of registering a property from 120 in 2008 to 95 at present.

Decentralisation has complicated the process for foreign investment companies when applying for land titles. With the enactment of Law 32/2004, revoking the Regional Authority Law 22/1999, it has been suggested that the local government might sometimes impose additional requirements.[7]

3. Intellectual property rights

Has the government implemented laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms? Does the level of protection encourage innovation and investment by domestic and foreign firms? What steps has the government taken to develop strategies, policies and programmes to meet the intellectual property needs of SMEs?

The government has shown considerable political will to combat intellectual property rights (IPR) violations, according to a recent report by the European Commission.[8] In the aftermath of the Asian financial crisis, the government signed the principal conventions and treaties concerning IPR and removed its reservations under the Paris Convention. As a result, it introduced or revised the full range of its intellectual property laws between 2000 and 2002. To facilitate enforcement, it created a Taskforce on IPR Violation Prevention and switched jurisdiction over civil cases to the Commercial Court. Enforcement remains problematic, however, and requires both capacity building and greater public awareness of the benefits of protecting IPR.

Indonesia is a signatory to many international treaties and conventions covering IPR

Indonesia is a signatory to many international treaties and conventions (Box 2.2). It is also a member of the Hague Agreement Concerning the International Registration of Industrial Designs although the government announced its intention to withdraw from the London Act of the Hague Agreement by 3 June 2010. The government intends to ratify the Geneva Act of the Hague Agreement (1999). It joined WIPO in 1979. According to the World Trade Organization, Indonesia has made significant progress in improving its legal framework to combat counterfeiting and reform its IPR laws. The latest WTO *Trade Policy Review* of Indonesia finds that "these legal provisions amount to a strong copyright regime on paper and the system is considered by some as having the strongest compliance with TRIPs in the region".[9]

Table 2.1. **International treaties and conventions on IPR signed by Indonesia**

Convention or Treaty	Presidential Decree
Paris Convention for the Protection of Industrial Property, and the Agreement Establishing the World Intellectual Property Organization	15/1997 and 24/1979
Berne Convention for the Protection of Literary and Artistic Works	18/1998
Patent Co-operation Treaty	16/1997
Trademark Law Treaty	17/1997
WIPO Copyright Treaty	19/1997
WIPO Performances and Phonograms Treaty	74/2004

Indonesia has enacted and updated a number of IPR-related laws to meet international standards

Indonesia has seven laws related to IPR, mostly enacted in 2000-2002, concerning: plant variety protection, trade secrets, industrial design, lay-out design of industrial circuits, patents, trademarks and copyrights.[10] Some IPR provisions are also included in other laws. The new Customs Law establishes the authority for Customs officers to seize goods that constitute IPR

violations.[11] Another law with implications for IPR is the Law on the National System of Research Development and Application of Science and Technology (18/2002) which aims to create a fertile environment for the development of science and technology in Indonesia. Furthermore, in 2007 the government enacted a Government Regulation on Geographical Indications (51/2007).

Many recent regulations relating to IPR have also been drafted, partly to comply with the TRIPS obligations under the WTO (Annex B). These include the implementation of optical disk regulations, amendments to the copyright law and the enactment of design protection. A Study Report as part of Indonesia's Individual Action Plan within APEC concluded that the new set of IPR laws in place provides a better legal foundation for IPR protection and government enforcement.

The government is also facilitating the process of applying for IPR protection

Indonesia has developed an automated system of IP administration to ensure that IPRs are granted expeditiously. The system will not only deal with the administrative process within Indonesia but will also support linkages and can be used by law enforcement institutions. Indonesia also continues to streamline administrative procedures and improve their quality by implementing regulations covering administrative aspects of IPR such as:

- Government Regulation 2/2005 which creates a registry of qualified IP consultants, as was already done for patent agents, in order to provide certainty and assistance to those filing applications for IPR.[12]
- Government Regulation 38/2009 (following on from GR 19/2007 and 75/2005) Regarding Types and Tariffs on Non-Tax State Revenues in the Ministry of Law and Human Rights which establishes the administrative fees that the Ministry can charge for its services, including those relating to IPR.

Efforts are being made to meet the IP needs of SMEs

Efforts made by the government to meet the IP needs of SMEs include:

- Introducing a special tariff or fee for SMEs in filing and administering their IP.
- Holding courses, seminars, workshops or other capacity building programmes on IP for SMEs in order to improve their awareness of IPRs.
- Organising programmes such as an IP market exhibition to accelerate the collaboration between inventors and investors.
- Printing and distributing various publications on IP for SMEs.
- Providing financial and technical assistance and facilitation for IP registration of SME trademarks and design.

Legislation has been complemented by efforts to improve enforcement

In March 2006, the National Task Force for IPR Violation Prevention was established.[13] The Task Force's aims are to: formulate national policies to combat IPR infringements; determine national efforts needed to prevent IPR violations; assess and determine measures for resolving IPR infractions, including prevention and law enforcement activities in accordance with the main duties of participating agencies; educate related government institutions, other organisations and the public at large about IPR matters; and establish and expand bilateral, regional, and multilateral co-operation. The Taskforce reports directly to the president and comprises the national police, customs, the attorney general, the judiciary, and members of the computer software and entertainment industries.

Commercial Courts have been designated by law as the judicial authorities for handling IPR civil cases, including provisional decisions (injunctions) while the IPR civil case is being settled. Previously, most IP civil cases were handled by the District Court, with appeals going to the Supreme Court – a long drawn-out process. It is reported that practitioners find the present arrangement to be a clear improvement over the District Court.[14] For all except patent cases, where no time limit applies, the Commercial Courts now have 90 days to reach a decision, with a possible one-time extension for one month. The Supreme Court faces a similar deadline (90 days), with the exception of patent cases (six months). Judges at the Commercial Court are required to have extensive knowledge of the fields of law covered and follow a special training programme.[15] The Directorate General for IPR has the right of investigation and DGIPR investigators are given the rights of police in cases where detention of goods is involved.[16]

The government has also introduced the possibility of arbitration or any other alternative dispute resolution system to settle IPR disputes. It has introduced a minimum sanction and/or fine for IPR infringers and has increased the amount of maximum sanction and/or fine.

But IPR enforcement remains a challenge for the government

Indonesia is generally recognised as having a high incidence of IPR violations, including patent infringements, copyright piracy and the counterfeiting of trademarks. It is estimated to be one of the largest producers of pirated products[17] and has once again been placed on the US Government's Special 301 Priority Watch List for inadequate IPR protection.[18] A recent report by the International Intellectual Property Alliance (IIPA) cites both corruption and a lack of transparency in the enforcement process, as well as inexperienced judges, a lack of prioritisation of cases, delays in adjudicating, a lack of resources and a lack of will from the Attorney General's Office.[19]

A survey by the European Commission finds that the main weaknesses of the IPR system in Indonesia identified by European firms are corruption (14% of respondents), deficient enforcement of domestic IPR regulations (14%), uncertainty of the outcome (14%), insufficient or incorrect implementation of the TRIPS requirements (13%) and the cost of proceedings (11%). But at the same time, it finds that "most of the respondents, *e.g.* 59% reported an improvement of the local IPR enforcement situation in the last 3 years".[20]

Further efforts are being made to raise public awareness and build institutional capacity

According to government submissions under the APEC Individual Action Plan, an on-going process of drafting the revision of IPR laws includes improvements in the following areas:

- the administrative aspects of IPR registration systems in order to comply with new IPR international standards such as the Amendment of the TRIPS Agreement (Article 31(f) regarding public health), and to ensure that IP rights are granted through an expeditious, simple and cost-effective procedure.
- the scope of IPR by introducing the three dimensional trademark and the partial design application in the industrial design registration system.
- the function of the patent appeal commission to ensure the adequate and effective administration of the patent appeal procedures.
- the function of the civil servant investigator to ensure the effective enforcement of IP rights.

International co-operation is part of the effort to build capacity. Indonesia is a regular participant of APEC IPR activities and participates in other international co-operation to train police, prosecutors and judges in IPR protection.[21]

Foreign firms also complain about a local production requirement

Pharmaceutical companies have complained that they must produce or utilise a process in Indonesia to obtain a patent for that product or process. The IIPA (2009) review of IPR in Indonesia mentions "a new unfortunate requirement to locally manufacture film prints and home videos in Indonesia".[22]

4. Contract enforcement and dispute resolution

Is the system of contract enforcement effective and widely accessible to all investors? What alternative systems of dispute settlement has the government established to ensure the widest possible scope of protection at a reasonable cost?

The government has taken many steps to improve the legal framework, including adopting an Arbitration Law for the first time, setting up specialised courts such as the Commercial Court with programmes for capacity building for judges. Amendments to the 1945 Constitution have also created the new Constitutional Court and a Judicial Commission to oversee judicial appointments and supervise judges. By this means, the judiciary has been freed from the political interference of the Justice Ministry which occurred under the New Order government.

In spite of these improvements over the past decade, there has not yet been a sustained effort at judicial reform involving a thorough review of civil procedural codes. The legal system in Indonesia has been viewed by investors in the past as costly, cumbersome and corrupt, with foreign investors frequently complaining about the lack of transparent and fair treatment.[23] Even when firms have obtained a favourable decision from a court, the appeals process has delayed settlement. Given that the legal system does not provide effective means to resolve commercial disputes, many firms have preferred alternative methods of settling disputes rather than litigation.

Under the *Doing Business* indicators, Indonesia ranks 146th worldwide in terms of "Enforcing contracts", with very little change over time. Enforcing a contract involves 39 procedures and 570 days and costs 123% of the total claim.[24] A survey of investors in 2007 found that 39% reported that legal and conflict resolution was a constraint on their business, albeit an improvement from the 52% reporting the same constraint in 2003.[25] More recent surveys are necessary to assess the extent to which the problem persists and how on-going capacity building and anti-corruption campaigns have improved the situation.

Firms often prefer alternative dispute resolution mechanisms

Commercial disputes may arise for foreign investors with joint venture partners, employees, local suppliers or contractors, or government agencies. Such disputes can occur because of the alleged failure of one party in a joint venture or contract to honour its obligations; they may also arise from unanticipated circumstances such as the dissolution of the business, or changes in government policy. Problems in joint ventures typically arise over dividend payments to minority shareholders. Employer-employee disputes are commonly due to wrongful dismissal or ill-treatment of Indonesian employees. The cheapest and quickest way to resolve disputes is by negotiation or mediation whenever possible. However, if the parties cannot reach an amicable settlement by these means, then they have no choice but to pursue the issue in the courts or refer it to an arbitrator. Arbitration is possible only if this is provided for in the contract that is the subject of the dispute, or if the parties to the dispute mutually consent to arbitration at the time of the dispute.

If a dispute arises between the government and the investor, the Investment Law (25/2007) provides for a dispute settlement mechanism in Article 32, including mutual understanding through discussion (*musyawarah*) and arbitration (with the consent of both parties). The government has also ratified several conventions concerning alternative dispute resolution mechanisms, such as the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) and the the Convention on the Settlement of Investment Dispute between States and Nationals of other States (1965). The government recognises that ratifying these conventions will help to attract foreign investment if investors are allowed to bring their disputes to arbitration.

The Law on Arbitration and Alternative Dispute Resolution (30/1999) is the basic mechanism for dispute settlement in Indonesia. If both parties agree, disputes can be settled through arbitration. The Indonesian National Board of Arbitration (*Badan Arbitrase Nasional Indonesia* or BANI) is the most commonly used arbitration institution in Indonesia and is promoted by the Indonesian Chamber of Commerce and Industry (KADIN). Other mediators include the National Mediation Centre, the Indonesian Institute for Conflict Transformation and the Capital Market Arbitration Board for capital market activities.

BANI is Indonesia's permanent court of arbitration. It provides a range of services covering arbitration, mediation, binding opinion and other forms of dispute resolution. The process is expedited by the absence of appeals or the possibility of the ruling being overturned by a higher court. BANI has developed its own rules and procedures for both domestic and international arbitration taking place in Indonesia, although other rules chosen by the parties (such as UNCITRAL Arbitration Rules) may also be applied. The Arbitration Board designates arbitrators in accordance with provisions of the agreements and from candidates recommended by the Secretariat.

BANI has developed a pool of arbitrators and experts in the practice of arbitration and conciliation. More than 100 arbitrators are now on BANI's Panel of Accredited Arbitrators, including respected professionals drawn from the domestic bar, university and business community as well as distinguished international jurists. About 30% of the arbitrators in the list are non-resident foreign nationals. BANI does not require that arbitrators be selected from pre-established lists, thus ensuring the greatest possible freedom of choice and flexibility in the constitution of the arbitral tribunal.

Settlement of investment disputes between the government and foreign investors or private entities can be facilitated through BANI under ICSID rules or any other rules stated in the Agreement (contract). BANI has signed co-operation agreements with various centres and organisations in other countries.[26]

Bankruptcy proceedings have sometimes been used as a weapon in disputes

The 1998 Bankruptcy Law was seen by many as being too creditor friendly and was criticised for leaving too much discretion to judges to interpret its provisions.[27] An amendment passed in 2004 (Law 37/2004) was designed to close this loophole by stipulating that bankruptcy petitions for financial institutions can only be submitted by the Ministry of Finance, by Bank Indonesia for banks and by the Capital Market Supervisory Board for certain other financial institutions.

Bankruptcy cases are handled by the Commercial Court set up in the aftermath of the Asian financial crisis. In spite of the relatively good performance of the Commercial Court in disputes involving intellectual property rights described earlier, it has been criticised in some quarters for its handling of bankruptcy cases. Some of the problems stem from the urgency with which the Court was created in 1998 given the widespread bankruptcies as a result of the crisis and the inability of local courts to handle the situation. Another problem sometimes attributed to the Commercial Court is the insufficient education and supervision of judges.[28] In other cases, the Commercial Court has rendered a decision judged by many to have been a sound one but which was later overturned on appeal by the Supreme Court.

Enforcement of the bankruptcy law faces challenges in the judicial system, including long proceedings, insufficient expertise and corruption. Even though the law prescribes a time limit on bankruptcy procedures, settlement of a bankruptcy case generally takes longer than 5 years compared to less than 3 years in China, Malaysia, Thailand, Singapore and Korea. The recovery rate of assets in bankruptcy cases is around 15% in Indonesia compared to more than 80% in Malaysia, Singapore, South Korea and Chinese Taipei.[29] As in other parts of the world, most bankruptcy cases are settled in out-of-court workouts in Indonesia. Creating a credible and efficient mechanism in the judicial system that can be resorted to when out-of-court negotiations break down is critical to bringing creditors and debtors together to solve problems.

5. Expropriation procedures

Does the government maintain a policy of timely, adequate and effective compensation for expropriation also consistent with its obligations under international law? What explicit and well-defined limits on the ability to expropriate has the government established? What independent channels exist for reviewing the exercise of this power or for contesting it?

Article 7 of the Investment Law (25/2007) states that the government shall take no measures to nationalise or expropriate the proprietary rights of investors, unless provided by statutory law. In the case of nationalisation, compensation shall be based on market values, a point not explicit in the previous Investment Law (1/1967). The new Law does not regulate procedures of compensation in terms of timing and effectiveness. These details are covered in bilateral investment treaties which regulate the details in line with international law: nationalisation and measures tantamount to expropriation must be for public purposes, under due process of law, non-discriminatory, and against prompt, adequate and effective compensation. Indonesia has signed over 60 Investment Promotion and Protection Agreements (Annex D).

Compensation for an expropriation is to be based on the fair market value of the investment immediately before the expropriation or before the impending expropriation became public knowledge, whichever is earlier. Interest must be paid at a normal commercial rate, which offers better protection to an investor than a requirement merely to pay interest. Payments should be made without unreasonable delay, be effectively realisable and freely transferable. The better of most-favoured nation or national treatment standards applies to the compensation for losses of a contracting party's investments due to armed conflict, a national emergency, revolt, insurrection, civil disturbance or other similar event.

Certain tax measures can have an effect tantamount to expropriation, and are therefore mentioned, but if the tax authorities of both contracting parties agree that a tax measure does not constitute expropriation, the investor has no right to international arbitration.

The investor has the right, under Indonesian law, to a review by a judicial or other independent party of both the case and the valuation. If the government and the other party have agreed to submit their dispute to arbitration, the injured investor may bring the case to international arbitration. The arbiter/arbitrators will then have the right to decide whether the measure taken by the government is lawful. Indonesia is a member of the Multilateral Investment Guarantee Agency.

6. The non-discrimination principle

Has the government taken steps to establish non-discrimination as a general principle underpinning laws and regulations governing investment? In the exercise of its right to regulate and to deliver public services, does the government have mechanisms in place to ensure transparency of remaining discriminatory restrictions on international investment and to periodically

review their costs against their intended public purpose? Has the government reviewed restrictions affecting the free transfer of capital and profits and their effect on attracting international investment?

Indonesia has substantially liberalised its investment regime since the mid-1980s, as discussed earlier, and has resisted calls for protectionism both during the Asian financial crisis and in the present global one. There is no substantive discrimination in the approval process for foreign investment, and the main restriction for foreign investors concerns foreign equity restrictions which vary across sectors from 49% to 95%. The overall restrictiveness of Indonesia in terms of statutory restrictions on foreign direct investment (FDI), as measured by the OECD *FDI Restrictiveness Index* is similar, on average, to other major emerging economies but substantially above that found in OECD countries.

National treatment is enshrined in law and most remaining restrictions pertain to foreign equity shares

Article 4(2) of the new Investment Law stipulates that the government, in making the basic policy on investment, is "to provide the same treatment to any domestic and foreign investors, by continuously considering the national interest". There is also no separate screening mechanism for foreign investment across the board. The Investment Co-ordinating Board (BKPM) oversees business registrations by both foreign and domestic investors to ensure that they comply with the law and states that it has no discretion to reject applications on any other basis.

In many sectors, particularly in services, foreign investors face limits on foreign equity ownership, but in many cases foreigners are allowed to hold a majority share. The Negative List of sectors where foreign investors face equity or other restrictions appears to be long in comparison with other countries, and indeed even with earlier lists published by the government, but this is partly a consequence of its transparency.

The pervasiveness of foreign equity restrictions in numerous sectors nevertheless makes Indonesia more restrictive towards FDI than the average in OECD countries according to the OECD *FDI Restrictiveness Index*. The *Index* measures the relative restrictiveness of FDI regimes across countries based on four criteria: foreign equity restrictions; screening; restrictions on key personnel; and other restrictions mostly related to land, branching and reciprocity conditions. Each country's score is then based on a simple average of the scores across 22 sectors. The *Index* is based only on statutory restrictions on FDI and is not an assessment of the investment climate per se. It does not, for

example, consider how or whether the restrictions are implemented. Nevertheless, it has proved to be a good predictor of FDI performance.

The Negative List has added to transparency

The list of sectors where private investment is not permitted, reserved to micro, small and medium enterprises (MSMEs), or where foreign investors are subject to certain restrictions (notably joint venture requirements and limits on the foreign equity share) is provided in a so-called Negative List (Annex C).[30] Many of the sectors listed do not discriminate against foreign investors but rather reserve certain sectors to the state or to MSMEs. Others sectors require special permits, often related to environmental concerns and some foreign investments are permitted in particular locations only if they do not contravene regional regulations. There are nevertheless a few sectors reserved to domestic firms and many others where foreign equity is limited to between 49% and 95%.

The Negative List was issued twice within the same year (2007) in response to complaints from the private sector about a lack of transparency. The purpose of the second Regulation was to clarify areas which had previously been ambiguous or open to interpretation. A new Negative List was released in 2010.[31] The Negative List adds greatly to the transparency of investment regulations and is an improvement over a positive list approach which was used in Indonesia until 1989 where foreigners could invest only in sectors included on the list. In principle, a Negative List mentions all sectors in which restrictions apply, although there is at least one example relating to telecommunications towers where additional restrictions were imposed which were not contained in the 2007 list, as discussed later. They have since been added to the new 2010 Negative List.

The basis for establishing the Negative List is being streamlined

Presidential Regulation 76/2007 sets out the criteria and requirements for determining the list of sectors and the types of restrictions in the Negative List. Its purpose as stated in Article 3 is to establish a fixed legal ground for the formulation of regulations relating to investment, ensure transparency in the process, and provide guidelines for the formulation, determination and review of items on the list, as well as guidelines in the event of a discrepancy between sectoral policies and the wording of the Negative List.

Under Article 17, the Co-ordinating Ministry for Economic Affairs (CMEA) is responsible for co-ordinating periodic evaluations of the Negative List in the light of the development of the economy and the evolving national interest. In fulfilment of this task, the CMEA established the National Team on Export and Investment Promotion (PEPI) to assess, format, evaluate and finalise the list. The aim is to limit the list to those business fields related to the national interest and to promote legal certainty by restricting any changes to

Presidential Regulations (Article 6). As part of the expanded role given to BKPM in the Investment Law, it is responsible for co-ordinating the implementation of Regulation 76/2007.

… and weaknesses in the present structure are currently being addressed

The new Negative List issued in 2010 (Presidential Regulation 36/2010) offers both increased sectoral liberalisation and an improved presentation of what was previously a confusing array of overlapping restrictions. Foreign equity restrictions still vary greatly by sector, as Ministries have been largely free to set their own equity limits, but most are now set either at 49% or between 51% and 95%.[32]

The new Negative List offers greater scope for foreign investment in a number of sectors, notably in the construction, culture and tourism and health sectors. In the electricity sector, foreign investors may now partner with local SMEs to produce between 1 MW and 10 MW. Above that level, 95% foreign ownership is permitted. Another innovation of PR 36/2010 is to introduce more favourable treatment for ASEAN investors in goods transport, international maritime transport and golf courses as part of the ASEAN Framework Agreement on Services.

A complaint of investors in the past has been the lack of stability in the List in some key sectors such as in telecommunications. Proposed new procedures stipulate that Ministries will be required to perform cost-benefit analysis to justify any future changes in restrictiveness under the Negative List. These procedures could greatly improve the process of establishing the Negative List and are in line with principles of good governance contained within the *Policy Framework for Investment* which suggest that measures should periodically be reassessed in light of the policy objectives they are intended to achieve. Performing regulatory impact analysis on existing and proposed restrictions will help to minimise sudden changes to the *status quo* by line ministries and hence add to predictability and thereby help to improve the investment climate.

New rules covering foreign investment in the mining sector have been developed

The mining sector contributes 3% to Indonesian GDP, with oil and gas adding another 7.3%. Indonesia has some of the world's largest reserves of gold and other minerals, including tin, coal, copper, bauxite and nickel. Before the crisis, Indonesia attracted 5% of the world's mining exploration investment while recently it has received just 0.5%.[33] Recent investments have mostly consisted of replacement of plant and equipment. According to one source, expenditure on greenfield exploration has been critically low in Indonesia, dropping from an average USD 40 million in 1995-97 to USD 7 million in

2001-05.[34] Revenue from taxes and royalties is nevertheless rising on the back of the sharp increase in commodity prices prior to the recent global crisis.

Mining has traditionally fallen outside the purview of the BKPM. For three decades leading up to the crisis, the sector was governed by Mining Law 11/1967 based on a contract of work system which went through eight different versions (generations) over that period. The contract of work system stipulated the terms and conditions covering foreign investment in the mining sector which were not spelled out in the Mining Law. The contract of work system provided considerable certainty for investors. It allowed them to develop, produce, process and market all under one licence and offered investors considerable guarantees: immunity against any possible changes in laws or in royalty payments and tax rates, duty-free imports of capital equipment and freedom from any future exchange or export controls. Foreign investors could also avail themselves of international arbitration as stipulated in the contract.

Decentralisation made the pre-existing contract of work system unworkable, as attested by the number of disputes between investors and local governments. After almost four years of deliberations, a new Mining Law 4/2009 was enacted at the beginning of 2009. It replaces the old contract of work with a business licence (IUP), as in other sectors. The new Law offers certain advantages, notably in harmonising the rules for foreign and domestic investors (as well as between state-owned and private firms) since foreigners could not previously hold mining concessions (KP) but were restricted to signing contracts with local concession holders. The concession system applied mostly to smaller mining projects. Business licences in coal mining may also now be for an area twice as large as previously.

Implementing regulations are still being decided, but, overall, the new Mining Law does not provide the same certainty to investors as the old system – particularly with respect to local taxes and royalties. In addition, disputes must be settled in Indonesia courts. Law 4/2009 nevertheless provides greater certainty than the legal void that has characterised much of the past decade in which no new contracts of work were issued. Existing contracts of work will be grandfathered, with a possible 10 year extension once they expire, subject to conversion into a production IUP.

The new legal framework includes several provisions which are less appealing to investors than the previous system, including:

- *Divestiture requirements*. After five years of production, the foreign operator must begin to divest a share of the company to local public or private investors or to the central or regional government so that after nine years the foreign share does not exceed 80%. Divestiture requirements were also included in early generations of the contract system but were dropped from later generations.

- *Shorter duration of licence*. The old contracts were valid for 30 years and could be extended for a further 20 years, while the new licence is valid for 20 years with two possible 10-year extensions.
- *Local refining and processing requirement* No such regulation existed previously and only one third of mineral mining products were being processed locally as of 2007. Holders of existing contracts are given five years to comply.
- *Priority to local mining service companies* Existing mining operations have three years within which to begin prioritising domestic service companies, after which time mining firms will only be allowed to use foreign-owned service companies if no qualified local company has been forthcoming through a local tender. Normally in a bid to reduce risks, mine owners outsource between 70% and 80% of mining activities to mining service companies. An Energy and Mineral Resources Ministerial Regulation (28/2009) stipulates that mining companies must now conduct mining, processing and purifying activities themselves, with the activities still outsourced to be surface stripping and transport.[35]

The new law will also give preferential treatment to SOEs and to local private actors to develop reserves in state concessions.

The new Mining Law has not yet settled the uncertainty surrounding the regulatory environment for mining in Indonesia, but it is a first step in that direction. The new permit system creates a unified regime for investment in mining and has been used in other countries, including Australia. The higher degree of political risk in Indonesia has nevertheless led the president of the Indonesian Mining Association and others to question whether it is the most appropriate system for regulating investment in Indonesia. With district governments currently issuing most licences, there have reportedly been numerous inconsistencies, frequent changes and even cancellations of licences.[36]

Competition among regions to attract mining investment may help to improve governance at the local level over time. In the near term, investment in the sector was expected by BKPM to grow from USD 1.35 billion in 2008 to an estimated USD 2.15 billion in 2009 and a further USD 6 billion in 2010-12.

7. Investment promotion and protection agreements

Are investment policy authorities working with their counterparts in other economies to expand international treaties on the promotion and protection of investment? Has the government reviewed existing international treaties and commitments periodically to determine whether their provisions create

a more attractive environment for investment? What measures exist to ensure effective compliance with the country's commitments under its international investment agreements?

Indonesia has signed 65 bilateral investment guarantee agreements, including the renewal of existing agreements, with approximately 20 still awaiting entry into force (Annex D). Most agreements were signed in the 1990s, if not earlier, while only five have been signed since the beginning of 2005. Some of the largest direct investors in Indonesia have not signed agreements with Indonesia, including Hong Kong (China) and Chinese Taipei. These agreements ensure that the government guarantees and protects investors' rights, as well as offering for investors, *inter alia,* national treatment, most-favoured-nation treatment, protection from arbitrary expropriation, compensation for losses, the right to transfer, and tax exemptions. Parties bound to the agreements are also expected to co-operate in promoting investment.

Indonesia is also bound by some regional agreements covering investment protection, such as the ASEAN Comprehensive Investment Agreement, the ASEAN-Korea Investment Agreement, the ASEAN-China Investment Agreement and the ASEAN Free Trade Agreement with Australia and New Zealand. Japan recently signed an Economic Partnership Agreement with Indonesia which includes an investment chapter. Investors from these countries have the option of entering Indonesia through an affiliate in a country which is already party to an investment agreement with Indonesia. Indonesia currently has 58 bilateral Avoidance of Double Taxation Agreements with other economies, up from 47 agreements in 1997.

8. International arbitration instruments

Has the government ratified and implemented binding international arbitration instruments for the settlement of investment disputes?

Indonesia has ratified the Conventions on the Settlement of Investment Disputes between States and Nationals of Other States 1965 (ICSID Convention) and on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) by the enactment of Law 5/1968 and Presidential Decree 34/1981 respectively. As a result, foreign arbitral awards may be enforced in Indonesia according to the guidelines in the Supreme Court Regulation 1/1990.

The Arbitration Law includes a provision on the Recognition and Enforcement of Foreign Arbitral Awards in Indonesia. The foreign award will be taken into consideration unless it is not a commercial matter, does not pass the reciprocity test or is a threat to public order. The Arbitration Law transfers the power to enforce international arbitration awards from the Supreme Court, which had been criticised for being slow to act on decisions, to the District Court of Central Jakarta. Since 1999, according to one source, Indonesian courts have swiftly enforced international arbitration awards – some within a month of the request.[37]

Article 32(4) of the 2007 Investment Law provides that disputes between the government and foreign investors shall be settled through international arbitration. Indonesia ratified the Convention establishing the Multilateral Investment Guarantee Agency in 1986. For disputes arising between an investor and a host contracting party, BITs offer international arbitration in accordance with ICSID practices or contained in the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL). Indonesia has also become a member of UNIDROIT (International Institute for Unification of Private Law).

An investor may pursue either local remedies or international arbitration and has up to three years to assess whether to pursue international arbitration, after which time international arbitration is barred. Conversely, an election to international arbitration precludes seeking local remedies (by a court order). For investments made prior to the notification of termination, the provisions of the Agreement remain in force for 15 years.

The government adheres to the Charter of the United Nations with respect to dispute settlement arrangements involving governments, *i.e.* that disputes need to be settled through, negotiation, inquiry, mediation, conciliation, arbitration, judicial settlement, resort to regional agencies or arrangements, or other peaceful means of their own choice (Article 33).

Notes

1. Firms were asked to respond positively if policy uncertainty was a moderate, severe or very severe constraint. (ADB 2003).
2. LPEM-FEUI (2007). The two surveys are cited in OECD (2008).
3. Law 5/1986 as amended by Law 9/2004 concerning the Administrative Court.
4. Government Regulation 24/1997
5. Perpres 10/2006
6. 1 479 certificates (2003), 14 919 (2004), 6 703 (2006), 5 035 (2007), 27 520 (2008), 9 007 (2009).

7. Nafis Adwani, "Land acquisition under Indonesian law in a nutshell", Seminar on Doing Business in Indonesia, 21 November 2008.
8. European Commission (2009), p. 6.
9. WTO (2007), p. 64.
10. Six laws are administered by the Directorate General of Intellectual Property Rights (DGIPR) and the Ministry of Law and Human Rights, and the law on plant variety by the Ministry of Agriculture.
11. Customs Law 10/1995 as amended by Law 17/2006, which fulfils a provision of the TRIPS agreement concerning "Special Requirements Related to Border Measures".
12. IP consultants must be both nationals and permanent residents in Indonesia. Under Article 8, IP consultants have the right to represent, accompany or assist the interests of the user of his services by filing and processing applications in the field of IPR within DGIPR, as well as having power of attorney. They are also required to maintain the confidentiality of information and provide free IPR services and socialisation for those with insufficient resources.
13. Presidential Decree 4/2006
14. Goldstein and Straus (2009), p. 108.
15. Goldstein and Straus (2009), p. 104.
16. APEC (2009), p. 47.
17. See, for example, the IIPA (2009) report. The European Commission (2009) estimates that 80% of computer software in Indonesia is pirated.
18. Indonesia was on the Priority Watch List from 2001 to 2006 but was downgraded to the less severe Watch List in recognition of its efforts to combat piracy from 2006 until the 2009 USTR review.
19. IIPA (2009), p. 52, 55.
20. European Commission (2009), p. 4.
21. APEC (2009), p. 47.
22. IIPA (2009), p. 1.
23. Darrell Johnson, "Building democracy", Ernst & Young, Oxford Business Group PriceWaterhouseCoopers Business Guide 2007.
24. Based on the assumption that the claim represents 200% of the country's per capita income.
25. The two surveys were conducted by different sources and may not be strictly comparable.
26. Including in Japan, the Netherlands, Korea, Australia, the Philippines, Hong Kong (China) and Singapore and with the Foundation for International Commercial Arbitration and Alternative Dispute Resolution.
27. Santoso *et al.* (2006), p. 211.
28. *Ibid*. p. 212.
29. *Asian Banker*, Research Note, January (2009).
30. Presidential Regulation 77/2007 as amended by PR 111/2007.
31. Presidential Regulation 36/2010.

32. The various sectoral restrictions include the following percentages: 0, 49, 51, 55, 60, 67, 75, 80, 85, 90 and 95.
33. Molnar and Lesher (2008), p. 23.
34. Bhasin and Venkataramany (2007), p. 2.
35. "Service firms to lose $750m in revenue", *Jakarta Post*, 2 November 2009.
36. John Aglionby, "Indonesian law may deter investment", FT.com 16 December 2008.
37. Urbach Hacker Young International (2008), *Doing Business in Indonesia*, p. 6.

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Chapter 3

Investment Promotion and Facilitation

Indonesia has been active in promoting and facilitating investment as part of overall investment climate reforms. This chapter examines various measures adopted by the government to reduce administrative burdens on investors such as one-stop integrated services at both central and local levels. The role of an national investment promotion and administration agency, the Indonesia Investment Co-ordinating Board (BKPM), is reviewed in the context of streamlining administration in a decentralised system. Investment incentives provided by the government are also explained, including a recently approved special economic zone scheme. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

Investment promotion and facilitation measures, including incentives, can be effective instruments to attract investment provided they aim to correct for market failures and are developed in a way that can leverage the strong points of a country's investment environment.

Indonesia has been actively expanding its investment promotion and facilitation as part of the overall investment climate reforms since 2004. These measures have focused particularly on reducing administrative burdens on investors, especially by implementing one-stop integrated services (*Pelayanan Terpadu Satu Pintu*; PTSP) at both central and local levels. Implementation of PTSP has been gaining momentum. Strong government leadership and careful planning of implementing steps in consultation with stakeholders will contribute to more efficient and predictable investment administration services.

The Investment Law enacted in 2007 sets the overall legal framework for investment policies, consolidating former investment laws/regulations and incorporating the decentralised governance structure. Investment promotion and facilitation is an important part of the Investment Law which clarifies the role of Indonesia's investment administration and promotion agency, the Indonesia Investment Co-ordinating Board (BKPM), and the possible forms and eligibility criteria of investment incentives. Continuing review of various existing incentives including export and area-based incentives will ensure that the cost of providing incentives is justified *vis-à-vis* the benefits. The National Team on Export and Investment Promotion (PEPI) is well placed to conduct such reviews.

In a decentralised economy, local governments have more responsibilities as well as greater flexibility in improving their local investment climate. Enterprising local governments have introduced innovative policy reforms and actively promoted investment to attract more projects in their local areas. This healthy competition can spread good practices across the country. The central government has been encouraging local government efforts by clarifying functions/responsibilities between central and local governments, providing guidance in enforcement of central government laws/regulations at the local level and facilitating learning and exchange of good practices among local governments.

Fostering investment linkages between foreign affiliates and local enterprises has been a high priority of the government, resulting in the introduction of various investment policy measures. A broad policy to build

the capacity of local enterprises to take advantage of business opportunities with foreign affiliates has been important along with the government's role in facilitating business matching. Capacity building programmes should be developed in close consultation/partnership with the private sector.

1. Investment promotion strategy

Does the government have a strategy for developing a sound, broad-based business environment and within this strategy, what role is given to investment promotion and facilitation measures?

Investment promotion has attracted increasing attention from the government

Since the Asian financial crisis greatly damaged Indonesia's investment climate, with massive capital outflows incurred over several years, investment promotion has become critical for Indonesia. Successive short-lived administrations introduced measures to liberalise the economy, privatise state-owned enterprises and restructure insolvent banks and enterprises. President Megawati declared 2003 to be the year of investment and started reforms to create an enabling environment for private investment, most notably initiating the process of preparing a new Investment Law. Under President Yudhoyono, investment promotion has been given an even stronger emphasis.

Development planning is formulated in the Medium-Term Development Plan which outlines the government's agenda for a five-year period in accordance with the Law on the National Development Planning System (25/2004). The Plan for 2005-2009 announced by President Yudhoyono after the first direct presidential election embodied campaign promises and focused more on policies and rebuilding institutions than on physical targets. Accelerating investments, exports, and tourism through reforms to ensure a healthy business climate is included in the five key priority areas for increasing the rate and quality of growth (Bank Indonesia, 2005). Consistent with the Plan, the President issued three reform packages to improve the investment climate in 2006-2008, detailing specific measures to be completed within a targeted timeframe. In the newly prepared Plan for 2010-2014, investment promotion is once again a national priority. The goal of enhancing investment is to be achieved by administrative simplification, regulatory reform, information system improvement, and the development of special economic zones. The 2007 Investment Law defines the type and criteria for granting fiscal incentives for investment and facilitates the acquisition of land, the movement of key personnel and imported inputs.

Fundamental restructuring of licensing authorities is envisaged

The government envisages a fundamental restructuring of licensing authorities for investment administration involving the Indonesian Investment Co-ordinating Board (*Badan Koordinasi Penanaman Modal,* BKPM), sectoral ministries and local government. Under the Investment Law which adopts the decentralised governance system, local governments are responsible for administering investment projects within their respective jurisdictions except for certain projects which are still placed under central government authority. The central government has the authority to administer investments: *a)* related to non-renewable natural resources with a high environmental risk, *b)* in high national priority industries, *c)* linked to the functions of uniting and linking regions, or the scope of which is across provinces, *d)* linked to national defence and security, *e)* using foreign capital derived from the government of another country based on a treaty entered into between the Indonesian government and the government of another country and *f)* in other fields that by law fall under the central government's authority. To implement the provisions of the new Investment Law, a decentralised system to administer investment projects is required where much licensing authority is devolved from central to local government. On the other hand, implementing the one-stop integrated services centre (PTSP) will require the transfer of sectoral licensing authorities from ministries to BKPM at the central level as well as from local government departments to local investment administration agencies at the local level.

Since the Investment Law defined the structure of investment administration, various regulations[1] have been issued. To avoid confusion and inconsistent implementation of investment administration reforms, careful planning, continuing consultation with business and local governments and monitoring of progress is important.

2. Investment promotion agencies

Has the government established an investment promotion agency (IPA)? To what extent has the structure, mission, and legal status of the IPA been informed by and benchmarked against international good practices?

BKPM administers and promotes investment projects in Indonesia

At central government level, BKPM, established originally in 1967 as the Foreign Capital Investment Advisory Board,[2] has been responsible for administering investment project applications, covering both domestic and foreign direct investment. In 1973, BKPM assumed an additional function of investment promotion. Its Chairman has tended to come from the private

sector since 2001 and reports directly to the President. This has helped BKPM to drive the reform agenda and facilitate co-operation with the business sector, including the signing of a recent memorandum of understanding with the Indonesian Chamber of Commerce and Industry (KADIN) to undertake joint efforts in enhancing investment. Since 2009, the BKPM Chairman has had a position equivalent to a Minister.

While investment registration used to take up most of BKPM's resources, promotion has been given an increasing importance. The Investment Law effectively placed BKPM's role in the overall government strategy for investment facilitation and promotion. Under this framework, the relative importance of BKPM's functions is expected to shift further from investment registration to facilitation and promotion.

The National Team on Export and Investment Promotion is established to advance reforms

The government re-organised the National Team on Export and Investment Promotion (PEPI) as part of the investment climate reform package in 2006.[3] It was originally set up under the Megawati presidency in 2003 to advise the government on trade and investment policies.[4] The tasks of the PEPI include: formulating general policies for export and investment promotion, economic deregulation and streamlining bureaucratic procedures, integrating tourism, trade, and investment promotion, and promoting the use of domestic products.

PEPI is chaired by the President and consists of four working groups covering: policy formulation (chaired by the Minister of Trade), policy implementation (chaired by the State Minister of Administration Reform), promotion of local goods (chaired by the Minister of Industry) and tax facilities (chaired by the Minister of Finance). Each working group consists of high-level government officials from relevant ministries/departments. These working groups are supported by the Secretariat with staff recruited from both public and private sectors. PEPI is expected to serve as an inter-ministerial mechanism to analyse and formulate policies for export and investment promotion. BKPM and KADIN are both involved in working group activities.

Local level IPAs vary in capacity

Each province has an investment board reporting to a provincial governor. There are currently 33 regional investment promotion boards at provincial level which are responsible for assisting governors in formulating regional investment policies, providing information to investors, and promoting and facilitating investments. Following decentralisation, BKPM has transferred its functions to over 497 local investment agencies.[5] While BKPM administers all foreign investment projects and those domestic investment projects with scope covering multiple provinces, provincial governments administer domestic

investment projects with scope covering multiple districts/cities, and district/city government projects with scope limited to one district/city.

As each provincial government can decide the formation, structure, major tasks and functions of its investment promotion board, there is a large diversity in their authority, capacity and effectiveness. For example, the Central Java Investment Board has developed a highly professional capacity to promote the Central Java province by maintaining and updating a well-structured website and organising the regular Central Java Investment Business Forum. Investment services units within district or city governments also operate with various level of competence, providing investor services within their respective jurisdiction and issuing licences under their authority such as location and building permits. Some local governments have been assisted by BKPM, non-governmental organisations (NGOs) and donors in strengthening their capacity and streamlining local regulations and licensing procedures for business. To facilitate the further implementation of the one-stop integrated service (PTSP), benchmarking of local PTSPs and co-ordination by the central government in implementation may be useful.

3. Monitoring IPA performance

Is the IPA adequately funded and is its performance in terms of attracting investment regularly reviewed? What indicators have been established for monitoring the performance of the agency?

Investment promotion functions are to be strengthened at BKPM

At the national level IPA, BKPM seems to spend a disproportionate amount of (both human and financial) resources on regulating investment activities by issuing various licences and allocates a relatively small amount to investment promotion. In the 2009 budget, the government allocated USD 10.8 billion to the BKPM's operations of which only 30% was for investment promotion.

BKPM is given a mandate beyond the four internationally recognised roles of an IPA, namely image building, investment generation, investor services and policy advocacy. It is engaged in national level investment policy formulation, responsible for co-ordinating within the government on the implementation of national investment policies and for issuing licences and offering fiscal and non-fiscal facilities for investors. For example, BKPM is currently finalising an Investment Roadmap focusing on three main sectors of agribusiness, infrastructure and energy which will provide strategic guidance and direction in investment policy making in these sectors.

On the investment promotion side, BKPM provides investor information on laws/regulations, administrative procedures, and investment opportunities via its website, organises investment fairs/seminars within the country and overseas, and targets promotional activities to individual corporations. It collaborates with the Trade and Tourism Ministries to organise a joint promotion programme to expand tourism, exports and investment. It visits a number of countries with potential investors to hold investment promotion events every year, publishes an English language magazine *Invest* every two months, and advertises in major foreign media. It also organises company visits and industry-specific investment events with sector ministries. BKPM has six Indonesian Investment Promotion Centres abroad in Singapore, Tokyo, London, Los Angeles, Sydney and Chinese Taipei which provide information and consultation services for investors.[6] For emerging countries with potentially large investment funds such as China, India and Middle Eastern countries, BKPM plans to undertake vigorous investment promotion activities, including opening representative offices to promote Indonesia and to answer inquiries about Indonesia's investment climate. Sector ministries, local governments, Chambers of Commerce and Industry and government representative offices abroad also carry out promotional events; and BKPM often co-ordinates these promotional activities with other government bodies and business associations.

BKPM provides investor services to facilitate investment projects, including *a)* responding to investors' questions on various aspects of their activities submitted in a Letter of Intent, *b)* a help desk facility to assist investors solve practical problems in implementing investment projects, and *c)* a task force consisting of BKPM, regional investment administration boards, and other relevant institutions to solve more serious problems which could not be settled via a help desk facility. An aftercare unit carries out post-establishment promotion programmes by servicing existing investors and nurturing good relationships. Provision of investor services is to be enhanced in the coming years through PTSP. Policy advocacy which is considered to be the most effective function of the IPA to attract investment[7] has focused on proposing fiscal and non-fiscal incentives for investments, while BKPM is involved in various task forces or working groups set up by the government on investment policies.

Dissemination of investor information through BKPM's website has been continuously improving. A new-look website became operational in February 2010. To support this website, BKPM has assigned a team to respond to daily inquiries. The BKPM website can, nonetheless, provide a more complete set of laws and regulations affecting investors, publicise more available materials such as *Invest* magazines and brochures, and update information more regularly.

BKPM maintains key performance indicators

BKPM's activities are monitored by the President, to whom it reports. BKPM also regularly reports to Parliament on the country's investment performance and maintains key performance indicators of promotional activities including the amount of realised investments and the number of incoming missions from other countries.[8] Since these indicators are affected by factors outside BKPM's control. BKPM's performance in providing investor services can also be assessed by, for example, investor query response times, the timeliness, accuracy and usefulness of information on the website, and the quality of assistance provided to investors. A user survey on BKPM's services among investors may be useful to indicate which areas need strengthening.

4. Streamlining administrative procedures

How has the government sought to streamline administrative procedures to quicken and to reduce the cost of establishing a new investment? In its capacity as a facilitator for investors, does the IPA take full advantage of information on the problems encountered from established investors?

The government has improved business start-up procedures

The government has worked repeatedly to streamline administrative procedures for investors such as through government regulations, guidelines and laws. The 2006 reform package to improve the investment climate aimed at simplifying and speeding up business licensing and investment procedures by reducing company registration processing times, simplifying trade licensing, developing an electronic data information system, reducing customs inspection times and issuing guidelines for the operation of integrated one-stop services.[9] The 2007 reform package followed up the 2006 package by targeting a reduction in the total time needed to establish a company and obtain business licences to 25 days. By September 2007, the time to start a business was reduced to 22 days from 50-60 days estimated in previous surveys.[10] The World Bank's *Doing Business* Survey 2010 also recorded improvement in starting a business in Indonesia where the number of procedures decreased from 11 to 9, the time taken decreased from 76 to 60 days and the cost was greatly reduced.

Establishing a one-stop integrated service is on the government's agenda

Establishing a one-stop integrated services centre (*Pelayanan Terpadu Satu Pintu*, PTSP) has been on the government's agenda for several years[11] but has been an uneven process across Indonesia's 524 autonomous regions. More

enterprising regions have demonstrated great progress while others have lagged behind. The Investment Law reiterated that one-stop integrated services shall provide investors easier access to business services, fiscal facilities and information on investment regulations and opportunities. As a follow-up in 2009, the government instructed government departments and institutions to delegate their authority to the Chairman of BKPM, or the head of a respective regional body responsible for investment.[12] As of March 2010, 15 Ministers[13] had delegated their licensing authority to the Chairman of BKPM, and two Ministers[14] have placed their officials in BKPM to implement the PTSP.

Previously, BKPM had approved both domestic and foreign investment projects by issuing an Investment Approval Letter in the initial stage as well as a Permanent Business Licence (IUT) which is valid during commercial operations; approved changes in investment projects including changes in location, business field and production, source of funds, share ownership, company status, and project completion schedule; and issued several licences related to starting a business including those allowing investors to import capital goods and raw materials for investment projects[15] and for employing foreign workers.[16] Presidential Regulation 27/2009 changed the mechanism from the Letter of Approval to a Registration System, reducing the processing time from 7 days to 1 day through PTSP.

The government is also implementing an Electronic System for Information Services and Investment Licensing[17] to support PTSP operations. The System provides information on regional and sectoral investment opportunities as well as investment licensing procedures and online licensing services including automatic processing of licence applications, document tracking and an audit trail. These efforts demonstrate the government's strong intention to reduce the costs of doing business by simplifying and speeding up administrative procedures. BKPM has issued detailed instructions[18] and rules for developing, managing and operating the System. The System can be accessed through the National Single Window for Investment[19] which was first launched in February 2010 in the Free Trade Zone and Free Port of Batam and will be installed in all local government PTSP centres.

There is still scope for reducing the administrative burden on investors

While the government has committed itself to streamlining administrative procedures, current institutional practices may be a challenge to reform. After obtaining preliminary approval from BKPM, a company has to obtain a multitude of licences and approvals from various government agencies. First, under the Company Law (40/2007), company formation requires several steps including clearance of the company name with the Ministry of Law and Human Rights, signing an establishment deed with a notary, registration for a taxpayer identification number, approval of the deed

from the Ministry of Law and Human Rights, and registration with the Company Register at the Local Trade Office for the company registration certificate. After the company's legal establishment, permits to establish a physical presence are required, including the land title certificate, the business location permit, the construction permit, and the nuisance permit from local governments. A company is also required to obtain operational licences such as a trading permit, an industrial permit or a tourism sector licence, depending on its activity. A company may also be required to obtain product and activity-specific licences. Requirements related to employment are stringent, especially with regard to the employment of foreign workers.

The number of licences required for a business has been seen to be excessive, with several licences collecting the same information such as the trading permit and the company registration certificate. Some permits have become a requirement for companies to participate in government tenders and obtain bank loans rather than serving their original purpose of collecting information, ensuring public welfare, and regulating the market. High costs of complying with the licensing requirements encourage companies to remain informal. A survey found that a large number of firms do not have the required licences, with large variations across the country.[20] Over the past few years, the government has embarked on a programme to streamline licensing processes and clarify the division of responsibility between the central and sub-national governments. As simplifying investment procedures has been made one of the national priorities for the new Medium-Term Development Plan for 2010-2014, further progress is expected. Implementation of PTSP has already consolidated multiple licences into one administrative step, cutting the processing time significantly.

Decentralisation has led to an uneven process in implementing policies

Decentralisation has made licensing requirements more burdensome for businesses in some regions while other regions have shown great improvement in investor services, especially through PTSP. In the initial phase of decentralisation, some regions introduced local regulations which did not enhance the investment climate, due to the lack of clarification and guidance. These cases have been minimised since the government mandated the central government to establish Norms, Standards, Procedures and Criteria (NSPK) which serve as guidelines for lower-level governments in performing delegated tasks and hence ensures a certain level of services and standards across the country.[21] For example, many local governments promptly adjusted their regulations to comply with the higher level regulation issued by the Ministry of Finance which stipulated that a trading permit be granted free of charge. The *Doing Business* 2010 survey[22] showed that some cities already perform up to international standards.

Since many licences required to set up business are processed at local level, PTSP could be more effective if also established at local level. Although a move to set up PTSP centres at district/city level started in the mid-1990s, progress has been uneven despite government efforts to promote the idea.[23] By 2007 nearly 40% of local governments implemented one stop services[24] but performances vary, reflecting diverse capacity, political support, co-operation from other technical departments and pressure from local business. For example, the Jakarta Special Capital Region succeeded in cutting the number of days required to obtain all business licences by more than a fifth by setting up an effective one-stop services centre in 2008. In contrast, the establishment of a one-stop services centre in some regions has produced another layer of administrative procedures. Since ministerial decrees cannot oblige local governments to act, the government mandated one-stop services centres under the Investment Law in 2007. With subsequent implementing regulations, the government has been promoting the nationwide spread of good practices. For example, BKPM has organised events to recognise good practices by local governments by giving an investment award to regions which offer the best investor services[25] and by collaborating with "regional champions" in promotional activities and workshops. It has initiated a capacity building programme with various training modules, covering licensing, business processing, data management and investment reporting to help strengthen PTSP administration capacity at the local level.[26]

Local governments issue investment-related licences and provide non-licence services under their areas of authority.[27] For those investment administration functions which fall under the central government's authority, the Chairman of BKPM can delegate as well as revoke certain authorities to issue licences and provide non-licence services including administration of foreign-invested enterprises to governors or regents/mayors based on its assessment of local governments' capacity and performance to meet the necessary quality standards in investment administration services.[28] Local governments report their progress in investment administration annually to BKPM. An evaluation system of local governments' PTSPs including NSPK for further delegation of authority is currently being prepared by BKPM.

5. Dialogue with investors

To what extent does the IPA promote and maintain dialogue mechanisms with investors? Does the government consult with the IPA on matters having an impact on investment?

BKPM interacts frequently with both domestic and foreign investors. At the national level, BKPM regularly organises meetings with KADIN as well as with foreign business associations such as the American Chambers of Commerce, the Australia Indonesia Business Council and the Japan Club. These meetings have served as a forum to report developments of government investment policies to, and obtain feedback from, the business sector. BKPM also discusses policies affecting investment with sectoral Ministries.

BKPM regularly organises meetings at local level with provincial investment boards as well as local investors to *a)* inform about central government laws, regulations and facilities related to investment, and *b)* address problems and grievances encountered by investors in carrying out projects by making recommendations based on consultations within the government. BKPM has also been active in proposing measures to attract more private investment, especially fiscal incentives for investment. It participates in high-level working groups or task forces such as PEPI so as to share its proposals with other government ministries.

Although BKPM interacts often with investors, a more systematic way to benefit from this interaction could be developed. For example, BKPM could evaluate its current programme of consultation and dialogue with investors in terms of geographical coverage, content and targeted sectors and develop a consolidated programme of consultations for each year. Problems and grievances brought up in consultations could be shared with local IPAs which could in turn inform BKPM of problems encountered at local level. Based on the outcome of consultations, BKPM could produce a consolidated set of recommendations to the government.

6. Investment incentives

> What mechanisms has the government established for the evaluation of the costs and benefits of investment incentives, their appropriate duration, their transparency, and their impact on the economic interests of other countries?

Indonesia has a long history of offering investment incentives

Incentive legislation in Indonesia started with the 1967 Foreign Investment Law which provided concessions on taxes and other levies for investments in priority fields/activities.[29] The same incentives were provided to domestic investments under the 1968 Domestic Investment Law. Between 1970 and the mid-1980s, firms investing in priority sectors were granted a basic tax holiday of three years with an extension if they met specified conditions.[30] These incentives were intended to signal a policy turn from a

highly nationalistic approach to a more open one as well as to mark an initial effort towards more comprehensive reform of the tax structure – the corporate tax rate was 60%. The incentives were provided almost automatically without adequate screening.

These fiscal incentives ended in 1984 while the corporate income tax rate was simultaneously reduced from 45% to a maximum of 35%.[31] The removal of incentives had seemingly no negative impact on FDI flows or on its composition in subsequent years, though other neighbouring countries maintained generous tax incentives for foreign investment.

In the 1990s when competition for investment intensified among ASEAN members, the government re-introduced fiscal incentives for selected sectors and locations in new regulations in 1996.[32] More generous tax holidays of up to 10 years were offered in priority industries;[33] loss carry forward was extended to 10 years for certain sectors and locations; and accelerated depreciation was re-introduced. The new scheme was more discretionary as decisions were granted on a case-by-case basis by an inter-ministerial team led by the Co-ordinating Minister for Economic Affairs. Implementation of the incentive scheme did not follow transparent decision-making procedures and was hampered by malfunctioning of the inter-ministerial team. Several projects receiving incentives provoked controversy as they appeared to be given due to political connections rather than qualifications of the projects.[34] Tax holiday incentives were revoked by Parliament in 2000.

In 2000 the government introduced a new set of fiscal incentives, including a reduction of taxable income by 30% of investment, an extension of loss carry forward up to 10 years, accelerated depreciation, and a 10% reduction in taxes on dividends paid to foreign entities.[35] These incentives were never implemented because a regulation specifying which business sectors and locations were eligible for incentives was not issued.

In 2007 the government announced incentives which were a re-packaged version of the 2000 regulations.[36] A list of business fields eligible for incentives, demonstrating the country's industrial policy priorities, mostly covers natural resources related sectors in which the country has a comparative advantage (such as forestry, paper, oil refining, rubber), green industries (such as coal gasification, geothermal), labour-intensive industries (such as textiles), and sectors where technology transfer is desired (such as electronics). A procedure to grant the incentives was also clarified in the 2007 regulation: applications have to be made to BKPM, which then makes a recommendation to the Ministry of Finance. The Ministry of Finance decides and publishes decrees to grant incentives to specific projects. The regulation is to be evaluated within two years by a Monitoring and Evaluation Team formed in accordance with a decree of the Co-ordinating Minister for Economic Affairs.

The Investment Law clarified the types of investment facilities

The Investment Law clarified the types of investment facilities and the criteria for granting them. The Law's provisions constitute an overall framework for investment incentives which will guide any specific regulations covering incentives. The Law stipulates that to be eligible for incentives an investment has to meet at least one of the following criteria: it must *a)* absorb many workers, or be *b)* considered a priority activity, or *c)* in infrastructure construction, *d)* transfer technology, be *e)* in a pioneer industry, or *f)* located in an area in serious need of investment, *g)* promote environmental sustainability, *h)* involve R&D and innovative activities, be *i)* in partnership with SMEs, or *j)* in an industry that uses domestically-produced capital goods, machines or equipment.

Types of fiscal incentives may include *a)* a reduction in corporate income tax by a specified amount of the total investments made within a definite period, *b)* exemption or relief on import duties and VAT of capital goods, machines or equipment which are not produced at home, *c)* exemption or relief on import duties on raw materials or components for a definite period with specified conditions, *d)* accelerated depreciation or amortisation, and *f)* a reduction in land and building taxes.[37] Furthermore, income tax holidays or reductions within a certain amount and time period may be given to new investment in any priority industries with the greatest potential for spillovers.

In line with the Investment Law, the government enacted the Income Tax Law (36/2008) which reduced corporate income tax rates from 30% to 28% in 2009 and further to 25% in 2010. Publicly listed companies that have at least 40% of their shares traded in the local stock exchange can enjoy an additional 5% reduction from the corporate income rate.

The government has also pursued zone-based investment promotion in parallel

The government's zone-based investment facility started with the objective of increasing exports when export promotion became a priority in the mid-1980s. The first export processing zone (EPZ) was created in the greater Jakarta area in 1986, producing mainly garments for export. The second major EPZ, the Batam free trade zone, was developed with assistance from Singapore to exploit Batam's strategic location and relatively low costs. It was given special facilities/exemptions to cut red tape, relax foreign ownership restrictions on property and business, and provide additional fiscal incentives and more secure land leases. The government has also developed a number of small industrial zones in various cities and regions.

The Law on Special Economic Zones was enacted to accelerate investment

The various EPZs and bonded zones in Indonesia are limited in scale, in the scope of eligible activities, and in the power of the zone authority. Flexibility of businesses in importing, hiring and selling is rather restricted and export promotion is the main emphasis. Nonetheless, promotion of a zone-based investment promotion is seen as promising for Indonesia which is geographically too large to ensure adequate infrastructure, human resources and administrative capacity across the whole country in a short period of time. The government has been considering setting up a framework to develop more comprehensive economic zones to accelerate investment activities in the country and recently enacted the Law on Special Economic Zones (39/2009). The Law allows for zones covering a large area to exploit scale economies and encourages more diverse economic activities by eliminating the export requirement. The government expects SEZs to become a locomotive for economic development in targeted areas, enhance infrastructure development and expand public-private partnerships.

These zones can provide non-fiscal "incentives" such as simplified administrative procedures, relaxed labour and immigration regulations and exemption from the negative list for foreign investment. Fiscal incentives in SEZs combine the customs-related incentives available in bonded zones and tax incentives available under the Investment Law while local governments may decide to provide further incentives within their jurisdictions. An SEZ may be proposed by either a private firm or a district government through a provincial government to the National Board established at central level and will be managed by on commercial principles, by an administrator who reports directly to a secretariat set up within a provincial government. While implementation regulations are to be issued, the criteria for approving an SEZ may include: proposals made by the local government, commitment by the local government to provide infrastructure, a clear boundary of the proposed SEZ and a location in close proximity to international trade transport links.

A mechanism to evaluate investment incentives is being put in place

Indonesia has already various schemes to provide fiscal incentives for investors affecting corporate income taxes, import duties, VAT, luxury taxes and land and building taxes under certain conditions. A review of the various incentive schemes is necessary to assess whether the costs of granting incentives are justified against the expected benefits. Any proposal to add new incentives should be examined carefully to evaluate the expected merits of the incentives against the costs and to ensure that the incentives are consistent with the overall framework provided by the Investment Law.

PEPI has a mandate to evaluate, impose and revoke trade and investment incentives. In a planned mechanism, a government agency can submit a proposal on particular incentives to PEPI; upon approval by Ministry of Finance, PEPI will analyse the costs and benefits of the proposal; organise an inter-ministerial meeting to decide on the proposal based on its analysis; and then submit its decision to ministries with jurisdiction over the proposed incentives. The working group on incentives has not yet been established under PEPI to operationalise this mechanism. For incentives on tariffs, the Ministry of Finance's Tariff Team conducts an analysis of any proposals made by sector ministries, holds stakeholder consultation and decides on the proposals.

7. Promotion of investment linkages

What steps has the government taken to promote investment linkages between business, especially between foreign affiliate and local enterprises? What measures has the government put in place to address the specific investment obstacles faced by SMEs?

The government strategy to promote foreign-local business linkages has changed over time

To promote linkages between foreign and local enterprises, the government used to impose various conditions on FDI projects. Foreign investors had to form joint ventures with local enterprises and increase the proportion of equity in domestic hands within a certain period of time.[38] Local content requirements were also imposed in several sectors including the machinery, electronics and automobile industries as part of the import substitution strategy. These requirements on FDI deterred foreign business, discouraged rather than encouraged the transfer of technology and slowed productivity growth. The local content policy resulted in a vertically-integrated production system within large enterprises rather than the development of subcontracting networks between large, medium and small enterprises as originally envisaged. The government strategy has shifted to using incentive measures to promote linkages instead of using compulsory requirements. For example, the current investment incentive scheme includes a one-year extension of loss carry-forward if the use of domestic raw materials or domestically manufactured components exceeds 70%.[39]

Backward linkages from FDI projects have developed, as in the case of Astra International in the automobile industry. The benefits have not been maximised due to the constraints of domestic industries in terms of human, financial and technological resources. Only a few local enterprises capable of

producing consistently high quality items can develop subcontracting arrangements with foreign enterprises. But once the linkage is established, local enterprises can benefit from capacity building opportunities such as technical training provided by foreign contractors and can learn modern management skills, quality control, and standardisation. They also often have access to soft loans from the contractors and market information to expand their businesses.

Indonesia has a long tradition of protecting MSMEs

As in other developing Asian countries, Indonesia has a long tradition of protecting micro, small and medium-sized enterprises (MSMEs) by reserving certain industries to MSMEs and requiring partnerships with MSMEs in certain sectors in its FDI policies. This policy has never been withdrawn and was reconfirmed in the Investment Law. These sectors are specified in the Negative List.

Indonesia's programmes to support MSMEs have evolved in response to past experience and international practices. To assist MSMEs, the government has also provided: credit programmes,[40] subsidies for raw materials, marketing, promotion and export support, and technical training and extension services.[41] The effectiveness of these direct assistance programmes was often undermined by the lack of capacity of government agencies in providing services, the supply-driven approach without a mechanism for responding to the actual needs of MSMEs, and co-ordination problems among government agencies. In the early 1990s, the government turned to a more indirect assistance programme to foster business partnerships between large enterprises and MSMEs in which large enterprises are required to assist MSMEs in building capacity and accessing loans. The impact of this approach was also disappointing as it did not offer commercial incentives.

Recently, the government has been making its MSME support programmes more market-oriented and demand-driven. The decentralised economic governance system also requires a clarification of functions between central and local levels, whereas most earlier MSME-targeted programmes were centrally designed and implemented. The 2007 reform package[42] included 29 actionable measures covering four areas of *a)* improved access of MSMEs to financial resources, *b)* developing private entrepreneurship and human resources, *c)* enhancing market opportunities for MSME products, and *d)* regulatory reform. Government regulations[43] mandated local governments to empower MSMEs through various support programmes which provide business development services such as management and other business training, promote local products to investors, and facilitate linkages between small and large businesses.

In keeping with other reforms, the government launched the Small Business Credit programme (*Kredit Usaha Rakyat*; KUR) in 2007 to provide

insured loans to MSMEs for projects which are feasible but not yet bankable.[44] To supplement the collateral for loans, a government guarantee through an insurance company is used. KUR is operated by six state-appointed banks using their commercial resources. KUR loans have rapidly expanded, resulting in better access to finance for small enterprises.

The Law on MSMEs (20/2008) represents the government's commitment to prioritise support to MSMEs. It mandates the government to improve the business climate,[45] facilitate the business development capacity of MSMEs,[46] provide financing and loan guarantees[47] and facilitate partnerships between large enterprises and MSMEs.[48] It does not clarify the differentiated functions between the central, provincial and local governments.

Past and international experiences can help Indonesia in developing investment linkages

PEPI includes a working group on promoting local goods which will develop government policies to facilitate linkages between foreign affiliates and local enterprises. An important lesson from past experience both in Indonesia and internationally in this area is that such a productive linkage has to be ultimately based on a business case and cannot be artificially created. The government can organise and disseminate information on potential local suppliers and contractors better, for example, via a user-friendly business directory that can facilitate business matching between local and foreign enterprises. A cluster-based approach to attracting investment may be encouraged at the local level as a cluster can help develop backward linkages with local industries. Capacity-building programmes for local suppliers/contractors including MSMEs can be better developed with the private sector and some capacity building activities may be outsourced to the private sector. The government can also encourage foreign and large local enterprises to adopt a code of responsible business conduct such as the OECD *Guidelines for MNEs* which ask enterprises to encourage local capacity building through close co-operation with the local communities including business interests as well as developing the enterprise's activities in domestic and foreign markets, consistent with sound commercial practices.

8. Drawing on international expertise

Has the government made use of international and regional initiatives aimed at building investment promotion expertise, such as those offered by the World Bank and other intergovernmental organisations? Has the IPA joined regional and international networks?

BKPM is a member of the World Association of Investment Promotion Agencies (WAIPA). It has regularly participated in capacity building programmes organised by UNCTAD on investment promotion and has been actively working with the World Economic Forum, the World Knowledge Forum and other international bodies. Aceh/Nias, the region seriously affected by the Asian tsunami in 2004, was assisted by FIAS, which conducted a mini-diagnostic assessment of the investment climate.[49] Indonesia has also benefited from capacity building programmes organised by the APEC Investment Experts Group.

ASEAN member countries have agreed to collaborate closely in promoting foreign investment. The Framework Agreement on the ASEAN Investment Area (1998) provides a list of joint activities which can be conducted by ASEAN investment promotion agencies, including investment promotion, regular consultations, investment-related training programmes and information exchange on promoted sectors/industries. By enacting the ASEAN Comprehensive Investment Agreement (ACIA) in 2009, investment promotion and facilitation activities of all the ASEAN member countries are to be further harmonised and integrated. Although the ACIA does not detail a specific mechanism for co-operation among IPAs in this respect, IPAs of the ASEAN member countries may need to conduct promotional activities not only for themselves but also for the ASEAN region.

To what extent has the government taken advantage of information exchange networks for promoting investment?

The government has profited from information and experience exchange networks provided by various regional and international fora, including ASEAN, ASEM,[50] APEC and UNCTAD. Timed back-to-back with regular meetings organised by these institutions, various business meetings, workshops and exhibitions are held to promote Indonesia as an attractive investment destination, informing potential investors of opportunities and providing business matching opportunities.

The five Indonesia Investment Promotion Centres established overseas are responsible for developing information exchange networks with local and international investment and trade related organisations within their respective country or region. At a bilateral level, BKPM collaborates with other IPAs such as those in Australia and China to facilitate information exchange through website links.

Notes

1. Presidential Regulation 27/2009 on the PTSP and four implementing regulations of the Chairman of BKPM: *a)* Regulation 11/2009 on procedures for PTSP implementation, development and reporting; *b)* Regulation 12/2009 on guidelines and procedures for investment applications; *c)* Regulation 13/2009 on guidelines and procedures for investment control and implementation, and *d)* Regulation 14/2009 on an electronic system for information services and investment licensing (SPIPISE). These regulations are expected to constitute the norms, standards, procedures and criteria to guide both central (namely BKPM) and local (province and district/city) PTSPs in issuing investment related licences and providing non-licence investor services and as a reference for investors in using PTSPs.
2. *Badan Pertimbangan Penanaman Modal Asing*; BPPMA. The BPPMA's main task was to give advice to the President regarding the implementation of foreign investment regulations. It was replaced by a new body, the Technical Committee on Investment, in 1968 with the enactment of the Law on Domestic Investment and then by BKPM in 1973.
3. Based on Presidential Decree 3/2006 which replaced Presidential Decree 87/2003.
4. *Inpres* 87/2003.
5. Consistent with the principles set out in Law 32/2004 on Local Government and elaborated in Government Regulation 38/2007 on the Division of Roles between National, Provincial and Local Governments, the division of authorities in investment administration among central, provincial and local governments is clarified in the Investment Law 25/2007 as well as Presidential Regulation 27/2009 on Investment Applications within the Framework of Integrated One Stop Services.
6. The functions of these Centres are stipulated in the Head of BKPM Regulation 9/2009.
7. Morriset (2003).
8. Indonesia received 17 countries in 2007, 14 countries in 2008 and 20 countries in 2009.
9. Ministry of Home Affairs Regulation 24/2006.
10. Notary surveys by LPEM (2005 and 2007).
11. Presidential Decree 29/2004, followed up with a number of regulations by ministries and local governments.
12. Presidential Regulation on One-Stop Integrated Services for Investment (27/2009).
13. They include the Ministers of: Public Works; Trade; Agriculture; Industry; Finance; Culture and Tourism; Health; Transport; Public Housing; Information and Communication; Marine Affairs and Fisheries; Forestry; Energy and Mineral Resources; National Education; and the Chief of the Indonesian National Police.
14. Minister of Workforce and Transmigration and Minister of Law and Human Rights.
15. Customs Approval Letter and Limited Importer Licence (APIT).
16. Decree on Expatriates Employment Plan (SK-RPTKA), TA.01 recommendation and Decree on Legalisation of Expatriates Employment Plan (SK-IKTA).
17. *Sistem Pelayanan Informasi dan Perizinan Investasi Secara Elektronik* or SPIPISE.
18. BKPM Regulation 14/2009 on Electronic System for Information Services and Investment Licensing.

19. *www.nswi.bkpm.go.id/portal/wps/portal/internet/home*.
20. KPPOD, USAID and Asia Foundation (2007).
21. Government Regulation 38/2007 on the Division of Roles between National, Provincial and Local Governments.
22. World Bank (2009). Yogyakarta is globally ranked 5th in terms of the fewest procedures to deal with construction permits and Makassar was globally ranked at the 9th in days to deal with construction permits.
23. The Ministry of Home Affairs issued decrees in 1997 and 2006 to require local governments to establish a one-stop services centre.
24. KPPOD, USAID and Asia Foundation (2007).
25. Winners in 2009 were Purwakarta, Sidoarjo, Sragen, Yogyakarta, Cimahi and Bandung.
26. A permanent training centre was set up by BKPM in 2003.
27. As stipulated by Government Regulation 38/2007 concerning the distribution of roles between central, provincial and local governments.
28. As set out in BKPM Regulation 11/2009 on procedures for PTSP implementation, development and reporting.
29. The concessions include exemptions from: company tax for a specified period of no more than five years; dividend tax on the part of accrued profits paid to shareholders for a specified period no more than five years; import duties on fixed assets required for investment projects; and capital stamp duties on the issuance of capital originating from foreign investment; as well as a further reduction of company tax rates of not more than 50% for a period not exceeding five years after expiration of the tax exemption period, offsetting losses suffered during the exemption period against profits subject to tax, and accelerated depreciation of fixed assets.
30. In 1970, the criteria for incentives were incorporated in the amendment to the Foreign and Domestic Investment Laws. A basic tax holiday of two years was granted to all firms in priority sectors and each additional year was extended if the project would save a significant amount of foreign exchange, was high-risk or large-scale, located outside Java, and in a priority sector.
31. The Law on Taxation (6/1983).
32. Government Regulation 45/1996 on income tax.
33. A two-year extension was possible for certain new businesses established outside Java and Bali.
34. For example, all firms granted the tax facility in April 1999 were affiliated with President Suharto.
35. Government Regulation 148/2000 on corporate tax facilities.
36. Government Regulation 1/2007 and 62/2008.
37. This list does not include extension of loss carry forward, though it was included in incentives under Government Regulation 1/2007. It is probably because the Investment Law came later.
38. Government Regulation 17/1999 on requirements for owning shares in FDI companies.

39. Government Regulation 1/2007 on income tax facilities for investment in certain business fields or regions.
40. The Small Enterprises Development Programme (1973-1990) which provided subsidised loans for investment capital and working capital and the Small Enterprises Credit Programme (1990-1998) which required at least 20% of commercial banks' loans to be allocated to SMEs.
41. The Small Industries Development Programme (BIPIK), initiated in 1980, set up Technical Service Centres (UPTs) which provided extension and technical services to clusters of SMEs.
42. President Instruction 6/2007.
43. The Law on Regional Governance (32/2004) and Government Regulation (38/2007).
44. KUR may be in the form of working capital or investment loans with a maximum amount of IDR 500 million to MSMEs given a guarantee from a state credit insurance company (PT Askrindo). Projects must be feasible in the sense that they can pay back principal and interest in full. The guarantee can be provided for up to 70% of the credit received. KUR has since developed three types of loans.
45. Including activities such as expanding access to financing, and simplifying business licensing regulations.
46. Including activities such as improving production techniques and human capital capabilities in entrepreneurship and management.
47. Including activities such as financing provided directly by the government or state enterprises, promoting the development of a venture capital industry and the creation of non-bank financial institutions.
48. It may be through subcontracts, mentorship programmes and trading arrangements.
49. FIAS (2005).
50. The Asia-Europe Meeting process (ASEM) is the main multilateral channel for communication and dialogue between Europe and Asia since 1996.

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Chapter 4

Competition Policy

Indonesia's regulatory framework for competition has strengthened since the enactment of the first Competition Law of 1999 and the establishment of the Commission for the Supervision of Business Competition (KPPU) in 2000. The government has also implemented sectoral reforms to promote competition and productivity growth in sectors dominated by state-owned enterprises. This chapter examines the performance of KPPU in implementing the Competition Law over a decade and points out remaining challenges. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

Well-structured competition policy favours innovation and contributes to conditions conducive to new investment. Sound competition policy can also help to transmit the wider benefits of investment to society.

Indonesia's competition regulatory framework has improved since 1999, starting from highly distorted market conditions where monopolistic practices by a few conglomerates were prevalent and the government maintained many anti-competitive regulations. Indonesia's first Competition Law was enacted in 1999 and the Commission for the Supervision of Business Competition (*Komisi Pengawas Persaingan Usaha*; KPPU) has started work to enforce the Competition Law since 2000. Competition policy reform has been accompanied by reforms in other related areas including trade and investment liberalisation, state-owned enterprises, and corruption.

The Competition Law has been developed consistent with international norms and practices. Various guidelines have been developed and disseminated to clarify these provisions and KPPU has played an active role in instilling a competition culture among enterprises, government officials and the general public. In particular, spontaneous policy advocacy and recommendations made by KPPU have reformed government policies and regulations having potential anti-competitive consequences. KPPU has also started evaluating local government policies and regulations. Given KPPU's increasing activities, the human and financial resources of KPPU could be further augmented.

Although the improved legal and institutional framework has contributed greatly to a fairer business environment, ensuring equal treatment regardless of ownership structure, a review of certain provisions could be considered to increase the enforcement power of KPPU and clarify duplicate articles in the law. For example, introducing a leniency policy for cartel behaviour could assist KPPU in enforcing cartel prohibitions further. The tight timeframe for handling cases at KPPU and the courts should be carefully balanced against the need to ensure efficient resolution. Fines for violating the Competition Law could be made more effective by linking them to the amount of the turnover of those convicted.

Post-merger notification for mergers and acquisitions (M&As) resulting in an asset value or selling price exceeding a certain amount is mandated under the Competition Law. An implementing regulation to set a procedure for reviewing anti-competitive M&As is being finalised while KPPU has released a

regulation on voluntary pre-merger notification. Issuing the implementing regulation for M&As will contribute to a clear legal framework for investment.

The government has implemented sectoral reforms to promote competition and productivity growth in infrastructure and utility sectors, leading to the termination of the monopoly or monopsony status often held by SOEs. These reforms have opened important sectors to private sector participation and improved the competitive environment. Continuing efforts should be made to address any anti-competitive practices by incumbent SOEs.

The OECD has developed formal recommendations and best practices in competition policies such as the recommendations on international co-operation, hard core cartels, structural separation of regulated industries, merger review, and competition assessment. A more in-depth assessment of Indonesia's competition policy could be conducted in cooperation with the OECD Competition Division.

1. Transparency and non-discrimination

Are the competition laws and their application clear, transparent, and non-discriminatory? What measures to the competition authorities use (*e.g.* publishing decisions and explanations on the approach used to enforce the laws) to help investors understand and comply with the competition laws and to communicate changes in the laws and regulations?

The government's regulatory framework did not support a competition culture in the 1990s

While economic reforms to liberalise trade and investment policies generated more competition from the 1980s onward, the bulk of policy-related barriers to competition persisted into the early 1990s. During this time, the government maintained various regulations, including price and entry controls, provisions for public sector dominance, and the creation of cartels. *Ad hoc* interventions were also made in favour of specific firms and sectors, with the justification that they were protecting the national interest, raising revenue, promoting infant industries or more value-adding activities or ensuring the undisrupted supply of essential commodities. These distortionary regulations not only allowed the monopolistic practices of a few conglomerates to continue but also increased the cost of doing business for other enterprises. Hence, Indonesia's market structure was characterised by high levels of concentration in many industries and markets.

The momentum for reform was triggered by the Asian financial crisis which exposed the country's institutional weaknesses. A few conglomerates

with political ties exploited their dominant position to distort the market. After the crisis, Indonesia implemented measures to make its economy more open, competitive and efficient.

The Competition Law was enacted in 1999

The main legal instrument to ensure competition is Law 5/1999 prohibiting monopolistic practices and unfair business competition (the Competition Law). Enacting the Competition Law and subsequent legal developments were prompted by internal initiatives to address a general resentment against conglomerates and triggered by external pressure to implement the reform packages in the midst of the economic crisis in 1998. Prior to the Competition Law, provisions related to competition were found in several laws, and these existing competition provisions remain in force as long as they are not contradictory to its provisions and not superseded by any new laws.[1]

The objectives of the Competition Law are multiple with a potential to cause conflicts between them. Article 3 states four objectives: *a)* to maintain public interest and improve the efficiency of the national economy as one of the means to improve public welfare, *b)* to create a conducive business climate through healthy business competition, thus securing equal business opportunity for large, middle and small scale entrepreneurs, *c)* to prevent monopolistic practices and/or unfair business competition by entrepreneurs, and *d)* to create effectiveness and efficiency in business activities. It is a challenge to balance these objectives and apply the law consistently and predictably (OECD, 2010).

The Competition Law is divided into three major substantial arrangements:

- *prohibited agreements*: oligopolistic and oligopsony[2] practices, price fixing, price discrimination, selling below market price, resale price maintenance, territorial restriction, boycott, cartels, trust, vertical integration, exclusive dealing, anti-competitive agreements with foreign parties which may cause unfair business competition and harm public welfare.
- *prohibited activities*: monopolistic and monopsony practices, market controlling, predatory pricing, tender collusion and conspiracy.[3]
- *dominant position*: abuse of dominant position, interlocking directorates, cross ownership, and mergers and acquisitions (M&As).

Abuse of dominant position and other related provisions in the Competition Law

Enterprises are prohibited from taking advantage of their dominant position, either directly or indirectly, under the Competition Law. Dominant position is defined as 1) one or a group of entrepreneurs controlling 50% or more of the market share in one type of good or service, or 2) two or three of entrepreneurs or groups of entrepreneurs controlling 75% or more of the

market share in one type of good or service. To prevent abuse of dominant position, the Law prohibits one person from holding multiple director/commissioner positions in enterprises operating in the same relevant market, entrepreneurs from being majority owners in several enterprises operating in the same relevant market, and mergers and acquisitions which may cause monopolistic practices and unfair business competition. This prohibition is largely consistent with international norms.

KPPU states that firms are not penalised for growing beyond certain market thresholds set by the Competition Law to determine a dominant position. Violation of the law always requires the existence of monopolistic practices and unfair business competition in addition simply to having a dominant position by market share. The Competition Law does not prohibit a certain degree of market power but rather abusive behaviour such as using a dominant position to control the market. KPPU always conducts an analysis to determine if there are any monopolistic practices or unfair business competition.

Specific regulations on M&A review have not been issued

Article 28 of the Competition Law states that entrepreneurs are prohibited from merging with or acquiring companies if it might cause monopolistic practices or unfair business competition. The Competition Law (Article 29) also provides a mandatory post-completion notification to KPPU of all transactions involving asset or sales value above a certain threshold, but more detailed provisions concerning prohibited mergers and acquisitions and notification procedures including the threshold amount for post-notification have not been announced as government regulations. In some countries, competition agencies conduct merger reviews very effectively without any mandatory requirement for parties to notify. In these countries, voluntary reviews are undertaken at the request of the enterprises concerned and, if the enterprises fail to notify, they are subject to the risk that their mergers are subsequently found to breach the law with the possible result that fines are imposed and/or the merger is unwound. In the case of Indonesia, the delay in issuing regulations concerning the mandatory notification threshold has resulted in KPPU not actively reviewing M&A transactions in the past. A few transactions have been challenged after implementation by KPPU on anti-competitive grounds once KPPU became aware of the transaction. Hence the environment for M&A transactions lacks predictability and effective enforcement.

In 2009, KPPU published a regulation on voluntary pre-merger notification,[4] allowing enterprises contemplating mergers to obtain an advance binding clearance from KPPU. Pre-notification is available for four types of transaction including: mergers and consolidations beyond the thresholds,[5] share acquisitions where at least 25% of the voting rights are acquired, acquisitions of assets resulting in a change of control, and any other

transaction resulting in a change of control. Thresholds for pre-notification are also set in terms of asset value, sales turnover and market share. The new mechanism brings a welcome predictability to M&A planning. A final opinion issued by KPPU on pre-notified transactions provides a greater degree of compliance certainty. KPPU is currently finalising another regulation to mandate and clarify a merger notification and review process.[6]

Certain sectoral regulators may have their own rules and regulations on M&As. For example, all M&As in the banking sector have to be approved by Bank Indonesia (BI) before transactions. BI may also merge or consolidate troubled banks. To ensure fair competition in the banking sector, the total assets of a bank after merger and acquisition are limited to a maximum of 20% of total banking assets.[7]

The Competition Law allows several exemptions

Article 50 of the Competition Law provides exemptions from provisions of the law for: *a)* actions and agreements intended to implement applicable laws and regulations, *b)* agreements related to intellectual property rights and franchises, *c)* agreements for the stipulation of technical standards of goods and services which do not inhibit or impede competition, *d)* agency agreements which do not stipulate the resupply of goods and services at a price level lower than the contracted price, *e)* co-operation agreements in the field of research for upgrading or improving the living standards of society at large, *f)* international agreements ratified by the government, *g)* export-oriented agreements or actions not disrupting domestic needs and supplies, *h)* business actors of the small scale group, and *i)* activities of co-operatives aimed specifically at serving their members. KPPU has issued several guidelines to help interpret these exemptions. These exemptions may be too widely defined, providing inadvertently a possibility for enterprises to bypass the law (OECD, 2010).

State-owned enterprises and other institutions established or designated by the government may be exempted from the Competition Law. Article 51 of the Competition Law stipulates that "monopoly and/or centralisation of activities related to the production and/or marketing of goods and/or services which serve the needs of people in general and production vital to the state shall be regulated under the law and shall be performed by SOEs and/or entities or institutions established or appointed by the government". Hence, this exemption only applies to specific activities, not the entire range of activities of SOEs. KPPU has issued operational guidelines on implementing Article 51 to provide a clear understanding of which activities may be exempted and detailed conditions and requirements in applying the exemption.

Except for the above limited exemptions, the Competition Law applies regardless of the ownership structure of an enterprise, including foreign

ownership. KPPU has recommended that the government review several laws supporting the monopolistic practices of SOEs, such as revising the Law on Workers' Social Insurance (32/1992) which establishes the monopoly position of PT Jamsostek in insurance by requiring all firms to deposit their workers' insurance with the company.

Transparent procedures for competition law enforcement are set in regulations

The Competition Law specifies the composition and power of KPPU to administer the law and sets out detailed provisions on procedures and penalties. An investigation can be initiated by either a complainant or by KPPU itself as a result of monitoring. From identification of a potential violation, a case proceeds through several steps with clear time limits including: a preliminary investigation within 30 business days, a further investigation within 60 business days (extendable once for another 30 business days), a decision by KPPU in an open public session within 30 business days, and compliance of the decision by parties within 30 days. Providing a reasonable time limit has the desirable effect of ensuring that matters do not languish unfinished, though a concern was raised in an UNCTAD report (2009) that the tight time limit set out above may hamper KPPU in conducting rigorous analyses and investigations on some large and complicated cases.

Decisions by KPPU can be appealed to any district court and ultimately to the Supreme Court. The district courts and Supreme Court are under even tighter time frames (30 days for a full decision). While defined timeframes are consistent with fostering investment, too tight timeframes might make a quality assessment difficult, resulting in unpredictability. The Supreme Court Regulation 3/2005 clarifies the procedures for filing objections against KPPU's decisions. KPPU has published KPPU Regulation 1/2006 to clarify further the procedures for handling cases, including the rights and obligations of the parties being examined.

KPPU actively communicates with investors to increase compliance with the law

In monitoring industries for potential violation of the Competition Law, KPPU conducts open hearings targeted to strategic industries as well as those in which high market concentrations are observed or which attract public attention. These public hearings[8] are attended by both firms in the industry and any stakeholders and are used as a platform to obtain testimony on anti-competitive cases and communicate KPPU's opinions and working procedures.

In handling cases, the reported parties are given an opportunity to review investigation reports as well as any evidence used in the reports prior to

KPPU's decision. All decisions taken by KPPU are explained in open public sessions and available on its website.

KPPU conducts awareness-raising campaigns for a wide range of stakeholders

Awareness of competition policy and its benefits has traditionally been low among government officials and the general public as a result of the long tradition of state monopolies and anti-competitive practices. Hence, the role of KPPU in competition advocacy has been very important.

As mandated by the law, KPPU publishes guidelines to clarify concepts, definitions and standards of analysis. They include guidelines on tender conspiracy, determining the relevant market, applying administrative sanctions, mergers and issues related to intellectual property rights, franchises and SOEs. KPPU maintains a website (*www.kppu.go.id*) and distributes monthly newsletters[9] and other publications. It has also conducted numerous conferences/workshops/seminars to publicise the Competition Law, competition concepts and KPPU's role, often in partnership with civil sector organisations. KPPU has also published a textbook on the Competition Law to serve as the main reference in competition law study.

Experience and knowledge in competition policy have been steadily accumulating in the country. Students have more opportunities to learn about competition in universities and law schools; competition has become a popular research topic in academia; international aid agencies have funded various studies on competition; and many more court judges have been trained in competition issues.

2. Implementation of competition laws

Do the competition authorities have adequate resources, political support and independence to implement effectively competition laws?

KPPU is an independent authority responsible for enforcing the Competition Law

KPPU is an independent and autonomous body directly reporting to the President.[10] While the Competition Law requires no fewer than seven Commissioners, there are currently 13 Commissioners (2006-2011), out of which 11 are active. Commissioners are appointed for a five-year term and dismissed by the President subject to approval of the Parliament. They can be reappointed for another term and prolongation of the mandate is allowed if

there is no immediate replacement. The minimum quorum for the commission to make a decision is 50% plus one commissioner. The statutory criteria for selecting Commissioners include a set of qualifications concerning general fitness for office but do not prohibit persons with political positions from becoming Commissioners. The only requirement that is particularly relevant to the role of Commissioners is experience in business or knowledge and expertise of law and economics. Current Commissioners are mostly academics in law or economics.

KPPU has a technical secretariat with about 300 staff mostly with legal and economic backgrounds which has grown from a minimal size of 10 staff in 2000. Retention of qualified staff seems to be a problem as the turnover rate is high, even though salaries of KPPU technical staff are much higher than the civil servant salary scale.

KPPU's budget comes from the state budget and revenues. In the past an annual budget proposal by KPPU was submitted to the Ministry of Trade and approved by Parliament. Starting in 2010, the budget will be allocated separately from other government ministries and departments. The budget allocation expanded rapidly from IDR 6 billion in 2000 to IDR 85 billion in 2006 and maintained the same level afterwards. KPPU has also received technical support from various foreign, regional and international agencies in the form of training, seminars and studies.

Given the large size of the country and the high volume of enforcement work required, the resources of KPPU may need to be augmented.

The functions and powers of KPPU are defined under the Competition Law

KPPU is given wide investigative powers in enforcing the Competition Law. While it may summon and bring expert and other witnesses, and anybody considered to have knowledge of any violation of the Law, Indonesia has no leniency policy for hard core cartels which is considered as international best practice in enforcing cartel prohibitions. When summoned parties are not willing to fulfil the summons, assistance from investigators can be requested to bring them to appear in hearings.

Various administrative and criminal sanctions are specified for violating the Competition Law. KPPU is authorised to impose administrative sanctions but is not allowed to impose criminal sanctions. The current practice is that criminal sanctions are imposed by the court with support of the public prosecution office. As administrative sanctions, it can declare anti-competitive agreements to be null and void, order the ceasing of anti-competitive activities and abuse of dominant positions, revoke mergers and acquisitions, impose compensation payments, and impose penalties between IDR 1 billion and IDR 25 billion (USD 0.1 million and USD 2.7 million

equivalent). To provide clear standards and increase transparency, KPPU has issued guidelines on administrative measures which describe how KPPU interprets and implements administrative sanctions, including the calculation of fines.

As criminal sanctions, the court can impose penalties between IDR 5 billion and IDR 100 billion (USD 0.5 million and USD 10.9 million equivalent) or imprisonment of 3 to 6 months, depending on which provisions are violated. Additional criminal sanctions may include the revocation of business permits, prohibition of an entrepreneur who violated the Law becoming a director/commissioner for a limited period, and termination of activities that cause damage to other parties. During investigation, parties are required to submit evidence and prohibited from refusing or hampering the investigation. For those not co-operating in an investigation, a criminal sanction may be imposed in the form of penalties between IDR 1 billion and IDR 5 billion or imprisonment for up to 3 months.

The scale of penalties may be too low if a case involves one of the largest Indonesian companies. It may be useful to raise the ceiling on penalties or link penalties to a convicted party's size of profits/assets/revenues. KPPU's guidelines, nonetheless, instruct the commission to make reference to the company's sales value and turnover during the period of violation in determining an amount of penalties. Internationally, the most generally accepted figure for penalties are up to 10% of the turnover of the business concerned.[11]

Enforcement of sanctions is still a challenge

Enforcement of the Competition Law has been undermined by the weak judicial system. When sanctions by KPPU are not complied with voluntarily, KPPU needs to resort to the judicial system and the police for enforcement. Both the amounts of penalties paid voluntarily and those paid after the court's execution have been low.[12] It may be partially due to the lack of competence within district courts in handling competition cases. In 2003 the Supreme Court issued an instruction[13] to district courts on the handling of appeals to KPPU's decisions. The instruction required district courts to send back cases to KPPU when evidence is not complete, recognising KPPU's independent authority and competency in handling competition cases.

3. Anti-competitive practices

To what extent, and how, have the competition authorities addressed anti-competitive practices by incumbent enterprises, including state-owned enterprises, that inhibit investment?

KPPU reports a rise in its activities

KPPU's activities are on the rise as measured by the number of reports received and decisions rendered by the Commission. The number of reports received by KPPU increased to 733 in 2009,[14] reaching a cumulated total of 2 827 over 9 years (2000-2009) of KPPU's operation; KPPU has handled 205 cases and has issued more than 140 decisions; and the total amount of fines and compensation imposed by KPPU reached IDR 1 001 trillion by end-2009. KPPU's performance in convicting cases has been generally better than in other young jurisdictions (UNCTAD, 2009). Most cases involve public procurement fraud including tender fraud and conspiracies. KPPU has transferred cases suspected of corruption to the Corruption Eradication Commission (*Komisi Pemberantasan Korupsi*; KPK) which is mandated to fight against corruption in the public sector. KPPU and KPK have signed an MOU to enforce the anti-competition and anti-corruption laws simultaneously.

Deeper reforms could assist in further addressing any anti-competitive practices by incumbent SOEs

KPPU examinations do not discriminate with respect to investment type or ownership, and some investigations taken up by KPPU involve incumbent SOEs. For example, a state owned cement producer was fined IDR 2 billion (USD 0.2 million equivalent) by KPPU in 2006 for anti-competitive distribution contracts.

Currently an exemption is provided to SOE monopolies that produce or market goods or services concerning "the needs of the people in general and production branches vital to the state". With further pro-competitive reform, this exemption might become less relevant and could possibly be removed. The government has been amending existing laws to terminate the monopoly status of SOEs, especially in infrastructure and utilities.[15] Sector-specific reforms in some cases have led to the establishment of sector-specific regulators in a process of opening SOE-dominated sectors to more private sector participation. (See the discussion of the telecommunications sector in Chapter 5.)

4. Policy evaluation and intra-governmental communication

Do the competition authorities have the capacity to evaluate the impact of other policies on the ability of investors to enter the market? What channels of communication and co-operation have been established between competition authorities and other relevant government agencies?

KPPU has a mandate to evaluate the effect of government policies on competition

Article 35 of the Competition Law obliges KPPU to provide advice and opinions on government policies indentified as potentially harming competition. KPPU had made 76 recommendations on government policies by end-2009,[16] all publicly available on its website. While the recommendations are not binding, about half have been adopted by the government, such as KPPU's recommendation to terminate collective airfare setting by the Indonesian Airline Association on the grounds of unfair price fixing (cartel) (Box 4.1). In response to KPPU's recommendation, the Coordinating Ministry for Economic Affairs established a special unit responsible for evaluating the effects of certain government policies on competition. KPPU also recommended to the Ministry of Transport that it revise its decree allowing a private taxi company association to set taxi tariffs. KPPU's awareness raising activities for government officials has been helping government agencies respond positively to KPPU's recommendations.

Box 4.1. **Recommendation made by KPPU concerning a cartel in the airline industry**

Indonesia's airline industry consists of several operators including both state-owned and privately-owned ones. Twelve operators are members of the Indonesian Airline Association (INACA). The Minister of Transport Decree 25/1997 provided that INACA could establish scheduled passenger tariffs on domestic economy class routes. Accordingly, INACA used to set the reference tariffs through the consensus of all members and in consultation with the Minister of Transport.

In the midst of the Asian financial crisis, the price agreement among the INACA members collapsed as operators competed to protect or gain market share in the face of depressed market demand. Later in 1999, INACA managed to reach a new consensus on the tariff range.

KPPU conducted an analysis and organised stakeholder consultations on INACA's pricing mechanism and concluded that it constituted a cartel and therefore potentially in conflict with the Competition Law. It made a recommendation to the government that the right and authority for INACA to establish tariffs be abolished and the pricing mechanism be liberalised from the fixed tariff range. The government accepted the recommendation by adjusting the government regulations.

As a result, airline tariffs have been dramatically reduced and the airline industry has become more competitive and expanded its market. While some airline operators objected to KPPU's recommendation at first, they have enjoyed growing demand for flights.

In the past, KPPU's advocacy capacity was generally limited to the central government and KPPU did not effectively address a multitude of local government regulations which might constrain healthy competition. Many local government-created monopolies continue to operate. KPPU has now started evaluating local policies and making recommendations.

KPPU conducts discussions and hearings with government bodies and other stakeholders to evaluate the effects of various government regulations on competition. These discussions may lead to a recommendation by KPPU for the government to reform certain regulations. This role is consistent with the principles contained in the OECD's 2009 Recommendation on Competition Assessments. The OECD welcomes the association to its Recommendations by non-members and Indonesia may wish to consider doing so.

KPPU has co-operation agreements with other government bodies

KPPU has established co-operation agreements with several government agencies including: the Capital Market and Financial Institution Supervisory Agency (Bapepam-LK) for monitoring and investigation, the Central Statistics Agency (BPS) for data provision, KPK for conspiracy cases involving public servants, the Ministry of Communication and Information for cases and policies in the ICT sector, and the Indonesian Financial Transaction and Reports Analysis Centre (PPATK) for sharing financial transaction data. It collaborates with academic and research institutions in collecting data and publishing research on competition. These agreements in the form of an MOU are expected to facilitate joint efforts in monitoring, analysing, harmonising regulations, collecting information and disseminating competition policies.

Synergies between competition law and anti-corruption

There is often a two-way link between cartel behaviour and corruption in connection with public procurement. In some cases, cartel behaviour generates the inflated profits required to pay bribes. In others, procurement officials may be bribed to perform one of the functions that cartels generally find very hard to achieve: ensuring that the members of the cartel carry out the illegal activities that they have conspired to commit. This link often means that the detection and prevention of one (cartels or corruption as the case may be) contributes to the detection and prevention of the other. In this regard, it is encouraging to see that KPPU has referred these matters to KPK but also KPPU has used its own competition enforcement powers to penalise not only the members of public procurement cartels but in some cases also the corrupt public procurement officials. While the relationship between KPPU and KPK has been generally productive, a potential problem of inconsistent law enforcement may arise from two separate judicial processes where KPPU cases go to the District Court, KPK cases to the Corruption Court (OECD, 2010).

5. Industrial policies

Does the competition authority periodically evaluate the costs and benefits of industrial policies and take into consideration their impact on the investment environment?

KPPU regularly conducts a competition impact assessment of government regulations and policies which includes qualitative cost-benefit analysis. Technical guidelines on assessment have been developed to provide internal guidance on assessing and making recommendations on government policies. Initial analyses are targeted at identifying government regulations and policies which may limit the number of businesses, restrict the ability of businesses to compete fairly, or reduce the incentive for businesses to compete in a healthy manner. Further analyses are conducted to evaluate the impacts of the identified regulations and policies on existing and potential businesses, price and output, product variety and quality, business efficiency, innovation, industrial and market growth, and related markets.

6. Competition aspects of privatisations

What is the role of the competition authorities in case of privatisations? Have competition considerations having a bearing on investment opportunities, such as not permitting market exclusivity clauses, been adequately addressed?

KPPU does not have the authority to propose privatisations or prevent those decided by the government, although it monitors the impact of privatisation on competition with a view to preventing the creation of a private monopoly. When it considers a particular privatisation to be detrimental to competition, it may recommend that the government review its privatisation plan. A privatised enterprise can also ask KPPU to assess its plan under the voluntary pre-merger notification procedure. After privatisation, KPPU may conduct a competition impact assessment and make binding decisions if it finds the privatised company in violation of the Competition Law.

7. International co-operation

To what extent are competition authorities working with their counterparts in other countries to co-operate on international competition issues, such as cross-border mergers and acquisitions, bearing on the investment environment?

Cases involving foreign parties are within KPPU's responsibility

International co-operation may be useful for KPPU in investigating cases involving foreign parties. Article 16 of the Law prohibits any contract with other parties overseas which imposes provisions that can cause monopolistic practices or unfair business competition. Although the article on mergers and acquisitions does not specifically mention cross-border M&As, KPPU's regulation on pre-notification of M&As confirms that the competition law includes cross-border ones as well. KPPU has in the past found several foreign companies to be acting anti-competitively.

KPPU has been engaged in multilateral co-operation on competition

Multilateral co-operation on competition policies has been facilitated mainly through ASEAN, APEC and UNCTAD. KPPU has played an active role in compiling APEC Individual Action Plans and in the process of APEC peer reviews, both of which cover competition issues. The UNCTAD voluntary peer review on competition law and policy was conducted in 2009. KPPU has also been engaged in negotiating FTAs which may include a competition section. The Indonesia-Japan Economic Partnership Agreement signed in August 2007 and the ASEAN-Australia-New Zealand FTA signed in February 2009 include an agreement to co-operate on competition which may include sharing experience, exchanging information and staff, and participation of officials in training courses and advocacy programmes.

KPPU is a member of several international organisations concerning competition including the International Competition Network, the ASEAN Expert Group on Competition, and the East Asia Competition Forum. KPPU is one of the initiators of a regional competition forum, the ASEAN Consultative Forum on Competition in 2003, which later became a formal working group under the ASEAN Secretariat as the ASEAN Expert Group on Competition.[17] KPPU has been one of the regular observers at the OECD Competition Committee since 2006.[18] In co-operation with the OECD Competition Division, KPPU has hosted workshops, contributed to OECD meetings and instruments, and promoted compliance with OECD best practices. It has also sent officials to workshops organised by the OECD-Korea regional centre for competition where Indonesian delegates have been active participants.

KPPU has also implemented technical assistance programmes with enforcement agencies in six other countries.[19]

Notes

1. These include the Criminal Law, the Civil Code, the Law on Industry (5/1984), the Company Law (1/1995), the Law on Co-operatives (5/1992), the Law on MSMEs (9/1995) and the Law on Consumer Protection (8/1999).
2. "Oligopoly" and "oligopsony" in the Competition Law refer to circumstances in which an agreement between enterprises is made with the intention of jointly controlling the production, marketing, buying or receiving of goods or services.
3. "Conspiracy" in the Competition Law refers to agreeing to rig tender bids, conspiring to obtain a competitor's business secrets or conspiring to hamper a competitor's production or marketing with the intention to reduce quality, quantity or punctual delivery.
4. KPPU Regulation 1/2009 on pre-notification of merger, consolidation and acquisition.
5. The threshold is set at IDR 2.5 billion in assets or IDR 5 trillion in turnover of a merged company. For financial services, the threshold is set at IDR 10 trillion in assets, IDR 15 trillion in turnover or 50% in market share of a merged financial institution.
6. A new regulation is expected to clarify the timing of notification as there is a difference in interpreting the article. While some assume that notification can be made after the completion of certain transactions, others including KPPU consider that notification should be made immediately after the signing of agreements of certain transactions.
7. Government Regulation 28/1999 on mergers, consolidation and bank acquisition.
8. Such meetings were held for paper and pulp industry, wheat flour industry, and day-old chicken industries.
9. *Kompetisia*: a newsletter on Indonesian competition law and policy by KPPU.
10. As established in June 2000 under the Competition Law and the President Decree on KPPU (75/1999).
11. Although the timeframe to calculate the turnover varies from one country to another, annual turnover in the previous year is a commonly adopted practice.
12. Less than 0.2% of fines imposed by KPPU have been paid voluntarily, and only 1.4% of total fines have been paid even after court execution.
13. Supreme Court Regulation 1/2003 on procedures for filing an appeal for the KPPU's decision.
14. KPPU (2009).
15. The monopolies of Telkom for long-distance and local calls, Indosat for international calls, Bulog for rice distribution, Pertamina for exploration for oil and gas and refining, storage and distribution of petrol and other fuels, and PLN for power generation and distribution have been abolished or weakened through legislative changes.
16. KPPU (2009).
17. The Group promotes regional competition policies consistent with the ASEAN Economic Blueprint.
18. Indonesia's observer status on the OECD Competition Committee has been extended till 2011.
19. They are: the US Federal Trade Commission, Germany's *Bundeskartellamt*, the Japan Fair Trade Commission, the Korea Fair Trade Commission, the Chinese Taipei Fair Trade Commission, and the Australian Competition and Consumer Commission.

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Chapter 5

Infrastructure Development

Indonesia once outperformed many of its peers in infrastructure provision but, since the 1997-98 crisis, has lagged behind much of the region in terms of both public and private investment in infrastructure. The government has been forthright in acknowledging weaknesses in infrastructure and has taken major steps to increase funding, improve regulatory quality and allow for greater private participation. It has set a target for universal access in the power sector by 2020 and has imposed universal service obligations in other sectors, notably telecommunications. State monopolies have been eliminated in telecommunications over the past decade and currently also in the operations of major ports. Increased private participation is possible in toll roads, railroads and power generation. Where SOEs still operate, efforts are under way to ensure that they operate on commercial principles, under an independent regulatory authority. This chapter reviews these efforts to create an institutional environment suitable for private participation in infrastructure. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

"Firms with access to modern telecommunication services, reliable electricity supply, and efficient transport links stand out from firms without them. They invest more, and their investments are more productive."[1]

Infrastructure is a fundamental cornerstone of the investment climate. Poor quality or inadequate infrastructure raises costs for all firms and restricts the flow of goods, services and market information both within the economy and abroad. Furthermore, by segregating markets, these infrastructure weaknesses also limit competition, thus dulling incentives to innovate and to improve productivity. All firms, from rural micro-entrepreneurs to multinational enterprises, are affected, although infrastructure problems usually hit smaller firms hardest. Power shortages, for example, force firms to invest in expensive generators.

In many countries, the levels of investment required to provide good quality infrastructure cannot be financed by the public purse alone. Many countries, including Indonesia, are seeking to encourage the private sector to participate in infrastructure provision. Private sector participation can bring more than just capital; including a more competitive environment, as well as the mobilisation of the private sector's technological expertise and management competences. In spite of these numerous potential advantages, public-private partnerships (PPPs) present a challenge for governments, given the complexity of the contracts and the multiple objectives which they try to achieve. The OECD has developed *Principles for Private Sector Participation in Infrastructure* to assist governments in attracting investment and mobilising private sector resources for the benefit of society

Inadequate infrastructure, especially in Indonesia's outer islands, is widely recognised as a constraint on sustainable economic growth. The OECD *Economic Assessment of Indonesia* reports that a 1% improvement in a composite infrastructure indicator is associated with an increase in GDP of nearly 0.9% in the long run.[2] Indonesia has fallen behind many of its regional peers since the Asian financial crisis, in large part because the sources of financing for infrastructure have dried up: private investors – particularly foreign ones – have shied away from large-scale projects in an uncertain policy environment, while budget constraints meant that the government virtually stopped funding new infrastructure investment in the immediate aftermath of the crisis.

Other factors besides financing have also contributed to the dearth of new infrastructure projects, particularly regulatory uncertainty at both local

and national levels. As a result of decentralisation, capacity constraints have emerged among local officials with newly assigned responsibility for infrastructure regulation at the local level, particularly with respect to project design and development.[3] At the national level, the regulatory framework has improved recently as new laws have been enacted in individual sectors.

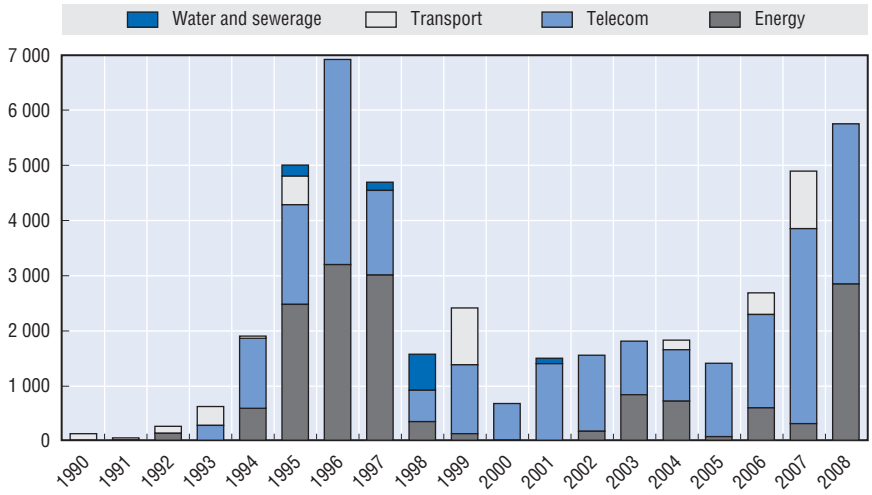
The government has been forthright in acknowledging weaknesses in infrastructure and has taken major steps to increase funding, improve regulatory quality and allow for greater private participation. It has set a target for universal access in the power sector by 2020 and has imposed universal service obligations in other sectors, notably telecommunications. State monopolies have been eliminated in telecommunications over the past decade and currently also in the operations of major ports. Increased private participation is possible in toll roads, railroads and power generation. Where SOEs still operate, efforts are under way to ensure that they operate on commercial principles, under an independent regulatory authority.

Infrastructure spending by the private sector collapsed in the wake of the Asian financial crisis

In common with the experience of many emerging market economies, private participation in infrastructure in Indonesia soared in the first half of the 1990s before collapsing in the wake of the Asian financial crisis after 1997. The past three years have seen a rapid recovery in all sectors except for water and sewerage (Figure 5.1). Over one half of total investment in public-private

Figure 5.1. **Public-private partnerships in infrastructure, 1990-2008**

USD million



Source: World Bank and PPIAF, PPI Project Database.

partnerships since 1990 has been in the telecommunications sector and another one third in the energy sector.

Public spending has not filled the gap left by the disappearance of PPPs

In the 1970s and 1980s, total investment in infrastructure construction amounted to 10% of GDP, mostly from public sources, and in 1996 still attained 7% of GDP, with the private sector taking on a larger role. By 2001, the same measure had fallen to only 2.1% of GDP. Some of this decline came from the absence of private capital, but another part came from the shrinking scope for investment by the government and particularly by SOEs given budget constraints in the aftermath of the crisis. The situation has since improved, but spending as a share of GDP, at 3.6%, remains far below that achieved a decade earlier. Furthermore, 80% of SOE spending is on operations and maintenance.

As a result, Indonesia lags behind its peers in terms of infrastructure

Transport and energy infrastructure both rank among the most serious obstacles for both foreign and domestic investors, and transport is the only area where the investment climate was perceived by investors to have deteriorated between 2003 and 2007 – although it is likely to have improved since then. Indonesia's unique geography and under-investment following the 1997 crisis have meant that it still lags behind many of its regional peers in infrastructure provision in all major infrastructure sectors: ports, roads, power, water and sanitation. In telecommunications, teledensity was still below much of the rest of Southeast Asia at the end of 2008, but strong market growth and investment imply that the gap is closing rapidly.[4]

Increasing infrastructure spending and sectoral reforms are a national priority

Improving the quality and availability of infrastructure in Indonesia is a clear priority of the government. Two Infrastructure Summits took place in 2005-2006 during the first term of President Yudhoyono, and these efforts continued following the presidential election in 2009. The second Yudhoyono administration drew up a list of measures to be adopted within the first 100 days of the new administration. An Asia Pacific Ministerial Conference on PPP for Infrastructure Development was held in Jakarta in April 2010, with the Indonesian government represented at the highest levels.

Government spending on infrastructure is rising rapidly, with the government budget allocation in 2009 at twice the level of 2005. Infrastructure spending (excluding local governments) as a share of GDP has risen from 2.7% in 2006 to 3.6% in 2009, although this is still below a government estimate that Indonesia will need to spend USD 30 billion each year on critical infrastructure from 2010 to 2014 or about 7-8% of GDP. More than two thirds of this amount

is expected to come from the private sector through PPPs. Domestic investors have not yet been tapped to any significant degree, although the domestic capital market offers good future potential through the banking and insurance sectors, pension funds, bond markets and other sources.

New laws have been enacted in all major infrastructure sectors (Table 5.1) to clarify the regulatory environment faced by investors. Recent emphasis has been on reforming regulations concerning the acquisition of land for infrastructure projects which has been a major bottleneck for infrastructure projects in the transport sector. The National Land Agency is currently preparing a new law on land acquisition for infrastructure development which is expected to provide a much stronger legal basis for the land acquisition process in due course.

Table 5.1. **Recent sectoral laws relating to infrastructure**

Law	Sector
36/1999	Telecoms
20/2002 (annulled)	Electricity
2003	Geothermal energy
7/2004	Water resources
38/2004	Roads and toll roads
23/2007	Railways
30/2007	Energy
11/2008	Information and electronic transactions
17/2008	Sea transport
1/2009	Aviation
22/2009	Road traffic
30/2009 (approved by Parliament)	Electricity

1. Setting infrastructure policy

What processes does the government use to evaluate its infrastructure investment needs? Does the national government work in co-operation with local and regional governments to establish infrastructure investment priorities? Does the government have clear guidelines and transparent procedures for the disbursement of public monies funding infrastructure projects? Are the regulatory agencies that oversee infrastructure investment and the operations of enterprises with infrastructure investments independent from undue political interference?

Infrastructure investment planning at the national level is co-ordinated by Bappenas, the National Development Planning Agency. Bappenas prepares

5-year Medium-Term Development Plans based on inputs from sector ministries, key state enterprises and local governments and in consultation with investors, local communities and other stakeholders. The Law on Regional Autonomy in 1999 transferred considerable powers and responsibilities to regional and local governments, particularly with respect to roads, water and irrigation. Provincial and local governments now have their own development planning agencies whose role is broadly similar to Bappenas. The central government continues to provide the national strategic planning for integrated, seamless infrastructure, as well as the needed policy framework.

The government has established an inter-ministerial Policy Committee for the Acceleration of Infrastructure Provision or KKPPI which also contributes to the evaluation process for infrastructure investment needs.[5] KKPPI reports directly to the President and is responsible for policy co-ordination across ministries, accelerating infrastructure development and deciding how to implement the public service obligation. KKPPI also comprises a PPP Unit to serve as a centre of technical expertise in project preparation and to co-ordinate smaller PPP units set up within individual ministries.

KKPPI was originally intended to take on a central role in the PPP process but reportedly was given insufficient means and authority to fulfil its role and was consequently bypassed by line ministries in their relations with the Ministry of Finance.[6] The government is working to revitalise KKPPI and to strengthen the PPP Unit so as better to create policy initiatives and facilitate private sector investment.

Indonesia is in the process of reforming the legal framework governing infrastructure provision through several new laws issued in recent years (see Table 5.1). The key drivers for change have included regional autonomy and the desire to eliminate quasi-government powers of SOEs, allow more private sector participation, and separate more clearly government's policy-making, regulatory, and ownership roles. Implementation of the new laws is still at a relatively early stage. A number of implementing regulations have been issued by the government to elaborate on recently enacted laws, and revisions of many other regulations to increase private participation in infrastructure are being prepared.

At the national level, regulatory agencies have been created *i.a.* in telecommunications (as described below) and for toll roads, and the planned Port Authorities will regulate the functioning of the major public ports. At the sub-national level, local governments now regulate a range of services, including most notably water supply, but are expected to follow national policies and guidelines. In the power sector, PLN retains a state monopoly of distribution while tariff setting results from deliberations between the executive and legislative branches.

Enactment of the new Electricity Law (30/2009) is expected to bring about a fundamental change in the power market by changing the status of PLN from monopolist to electricity business licence holder, thereby reducing its monopoly power.[7]

According to the government, the regulatory agencies mentioned above have gained increasing independence over the past ten years, and, along with better governance systems, increasing public consultations and the rise of civil society groups, undue political interference is gradually disappearing. At least one sectoral regulator has nevertheless been criticised for its lack of real autonomy, but the competence of regulatory authorities is improving. There is now an increasing demand for a new institution to be set up as an independent regulatory body to oversee private sector undertakings in infrastructure.

2. A framework for private participation

What measures has the government adopted to uphold the principle of transparency and procedural fairness for all investors bidding for infrastructure contracts, to protect investors' rights from unilateral changes to contract terms and conditions? What steps have been taken to attract investors to supply infrastructure at fair and reasonable prices, to ensure that investor-state contracts serve the public interest and to maintain public support for private involvement in infrastructure?

The Asian financial crisis left a legacy of suspicion between private investors in infrastructure on the one hand and the government and Indonesian public on the other. Many projects were cancelled and disputes settled through arbitration. The government has now put in place a legislative and institutional framework to accommodate private investment in infrastructure which attempts to learn the lessons of the 1990s concerning the apportioning of risks between the government and the investor. The government will no longer provide blanket guarantees but instead will offer explicit guarantees for specific private infrastructure projects. Structures have also been created which will ultimately help to mobilise domestic capital.

A new legislative framework is now in place to accommodate PPPs

A Presidential Regulation on Public-Private Co-operation in the Provision of Infrastructure (67/2005) emphasises transparency and fairness by requiring that all PPP projects involve both pre-feasibility studies and public consultation and that they be awarded through an open tender process. The

regulation also empowers the central government to provide the following: direct support for projects that are justified on economic and social grounds but that will not be financially viable without pre-agreed government fixed contributions; and contingent support or guarantees from the State Budget for certain types of risk that cannot efficiently be managed and mitigated by private investors and lenders. The regulation does not provide for central government support for sub-national projects. The Presidential Regulation was accompanied by a Minister of Finance Regulation on Management of Infrastructure Provision Risks (38/2005) which defines how contingent fiscal risks and any associated payments are to be managed.

A recent Presidential Regulation (13/2010) revises PR 67/2005, *inter alia* to reflect feedback from prospective investors. It addresses various issues identified by investors, such as government support and clearer procurement procedures. As part of its support, the government has prepared a Land Fund which will allow the government to acquire land before the tender process, as well as a Guarantee Fund and an Investment Fund for infrastructure development projects involving the private sector. The new regulation also simplifies the procurement process and allows for unsolicited bids.

An institutional structure has been created to mobilise private investment and share risks

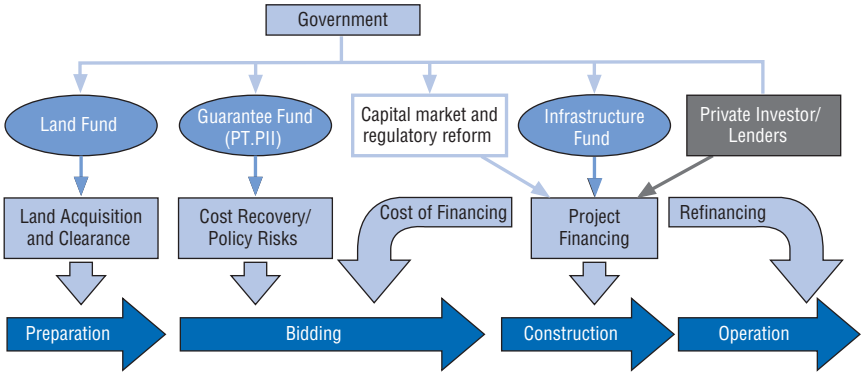
The government has undertaken several related initiatives to attract investors to infrastructure sectors, while at the same time managing any contingent liabilities. In particular, it has established the following facilities (summarised in Figure 5.2):

- **Indonesia Infrastructure Financing Facility.** The IIFF, which was established on 15 January 2010, acts as a non-bank financial intermediary to mobilise mostly local financing for infrastructure and to help develop capacity in both the government and the domestic financial sector to develop viable PPP projects. The facility conforms to international best practices concerning corporate governance and risk management. The government holds a minority share, together initially with both the ADB and the IFC (with the World Bank providing a subordinated loan). Ultimately, the private sector is expected to take a share in the IIFF, once it has demonstrated its effectiveness.
- **Infrastructure Guarantee Fund.** The Fund was, established at the end of 2009 to improve the creditworthiness of PPP projects by providing guarantees of financial compensation in the event of changes in government policies causing projects to be cancelled. The Fund is also expected to allow the government better to manage its own fiscal risk by ring-fencing government obligations *vis-à-vis* guarantees. It has been

established as a state-owned company and funded through the state budget together with loans from the ADB and the World Bank. According to the Minister of Finance, the fund enables Parliament to participate in setting the aggregate resource envelope for guarantees while allowing KKPPI and the Ministry of Finance to decide on the allocation to individual projects.

- The **Centre for Government-Private Co-operation** (PKPS) within Bappenas is to prepare and formulate policy, as well as co-ordinate, synchronise and evaluate government-private sector collaboration in infrastructure. Through the PKPS, prospective investors in infrastructure projects can obtain information on offered projects, including investment procedures and the rules of the game. The Centre has published a PPP Book containing a list of the country's infrastructure projects that are being offered to private investors and is intended partly to gauge investor interest. A 2009 edition has been followed by a 2010-14 version.
- A **Risk Management Unit** within the Ministry of Finance evaluates projects prepared by the PPP Unit and decides on the appropriate level of government financial support.
- A **Project Development Facility** (in operation under Bappenas) funds project preparation so that government agencies can prepare detailed feasibility studies and bidding documents up to international standards before tendering the project.

Figure 5.2. **The institutional framework for infrastructure**



Source: Government of Indonesia.

The government has set targets for increasing the coverage of infrastructure provision

To ensure that all sections of society benefit from infrastructure provision, as well as to maintain public support for private involvement in

infrastructure, the government has reformed and implemented the Public Service Obligation (PSO) and Universal Service Obligation (USO) to address inherent imbalances in infrastructure provision, by separating unprofitable (but socially desirable) basic services from commercially viable operations. The government has sought ways to identify the most efficient mechanism to channel needed subsidies through the PSO programme. Thus, the opaque practice of "hidden input subsidies" has been replaced by direct compensation to the infrastructure provider based on the difference between prevailing tariffs and the cost of supply.

The State Electricity Company PLN was the first to use this new PSO mechanism, which is now being rolled out to other sectors, such as the post, rail, shipping, air travel, remote air and seaports, as well as the public health system. Commercialisation of the PSO services through competitive bidding has started. Meanwhile, the USO system has been implemented in the telecommunications sector, where investment in rural or isolated areas and border areas is often not commercially viable (see below).

3. Telecommunications

In the telecommunications sector, does the government assess market access for potential investors and the extent of competition among operators? Does the government evaluate whether telecommunication pricing policies are competitive, favouring investment in industries that depend on reliable and affordable telecommunications?

Indonesia lags behind its regional peers in terms of access to telecommunications services but is catching up very rapidly. The number of mobile subscribers has been growing swiftly, and the country's teledensity rate is now at 74%. Liberalisation has been both partial and progressive. The operators with a dominant market share in fixed and mobile services are still partially owned by the government which compromises attempts to foster an independent regulatory body for the sector. These vertically-integrated incumbents are also able to erect entry barriers to newcomers, with the result that market shares have remained remarkably stable over the past five years.

A telecommunications blueprint was prepared in 1999 to help plan sectoral liberalisation, but the results have not always lived up to expectations. Problems have arisen in allocating frequencies, setting interconnection terms and expanding service coverage. And foreign equity restrictions in both fixed and mobile telephony, as well as in telecommunication towers, have risen over time. The overall result has been

investor uncertainty and rent seeking by incumbents and well-connected investors. To address these concerns, a ministerial team was set up in 2008 to develop a new telecommunications infrastructure blueprint.

Indonesia still lags behind peers in ASEAN in both fixed and mobile telephony

Only 13% of the Indonesian population has direct access to fixed telephone lines, which is above some of its neighbours but still very low by the standards of OECD countries. A more telling indicator concerns mobile telephony, which has become the dominant form of telephone service, where Indonesia lags behind all of the larger ASEAN member economies listed in Table 5.2. In terms of internet users, Indonesia is on a par with the Philippines and far behind other major ASEAN members. At current growth rates, however, the gap between Indonesia and other countries in the region will close. Mobile phone subscriptions have roughly doubled every two years since 1998 to an estimated 190 million in the first quarter of 2010, while fixed line subscribers have been growing by 30% per year since 2003.

Table 5.2. **Telecommunications: subscribers/users per 100 inhabitants**
2008 or latest year

	Fixed	Mobile	Internet users	Broadband
Indonesia	13	62	8	0.2
Malaysia	16	103	56	5.0
Philippines	5	75	6	1.2
Singapore	40	138	73	22.0
Thailand	10	92	24	1.4
Vietnam	34	80	24	2.4

Source: ITU.

The role of the state has been reduced slowly over time

The 1964 Telecommunications Act treated the sector as strategic for economic, political and military reasons and hence reserved all activity to the state. Faced with the failure of the state monopoly significantly to expand access, the 1989 Telecommunications Act (3/1989) opened the sector to private participation, but only through public-private-partnerships (PPPs)[8] with one of the two then majority state-owned operators, Telkom (for local and long-distance domestic calls) and Indosat (for international calls). A third operator, Satelindo, was created as a joint venture between Telkom, Indosat and the Bimagraha Group (with one of President Suharto's sons as a founder and major shareholder) for both international and mobile services. Cross-ownership with Indosat meant that it did not increase competition in the market, however.[9]

State monopolies in the two market segments led to high prices, poor quality of services and low teledensity, together with little technological progress in the sector. The introduction of PPPs did little to correct these shortcomings, partly because the regulatory structure was both unpredictable and based on the award of exclusivity rights to attract potential investors. The Asian financial crisis brought all but one PPP (SingTel) in telecommunications to an end, sometimes involving costly arbitration.

The Telecommunications Law (36/1999) set the stage for further liberalisation, with the state phasing out the exclusive rights for, and further divesting from, existing operators. The government nevertheless retains shares in both PT Telkom (52%) and Indosat (14%), as well as having indirect control over the cellular operator Telkomsel through Telkom which holds 65% of the company. The government also holds non-transferable golden (*Dwiwarna*) shares in both Telkom and Indosat which gives it special voting and veto rights over elections and removals of executive directors and commissioners and over amendments to the Articles of Association.[10] At the same time, the government moved towards cost-recovery pricing in order to encourage private investors.

... but the degree of competition is still insufficient

Cross-shareholdings between Telkom and Indosat were eliminated in 2001. Telkom's monopoly in fixed line local calls was ended in 2002, eight years earlier than had initially been planned. Long distance and international telephony were opened up to competition in 2003. In spite of these changes, Telkom still held 90% of the market for fixed-line services in 2006. Fixed wireless involves five competitors, including Telkom and Indosat, as well as three regional operators.

The mobile sector was opened to competition in 2001 and there are now 10 operators competing for market share. The government argues that mobile call costs are coming down sharply, service levels are respectable and the sector has become increasingly dynamic and diversified. But Indonesia still lags behind its peers in terms of coverage and costs. Indonesia has the highest subscription fees for both mobile and internet subscribers of any of the countries listed in Table 5.2 – almost twice as high for mobile services as in Singapore which is by far the best regional performer. Perhaps not surprisingly given the cost structure, mobile operators in Indonesia are estimated to be among the most profitable operators worldwide.[11] Furthermore, three operators (Telkomsel, Indosat-Satelindo and Excelcomindo) controlled 94% of the market in 2008, roughly the same share as five years earlier.

Although the government has allowed the entry of new operators in most sub-sectors, the structure of the industry, together with the existing

regulatory framework, allows incumbents to deter entry by potential rivals. Because existing regulations allow for vertical integration, incumbent operators with dominant market shares can erect entry barriers through cross-subsidies and bundling, as well as by locking in customers. Mobile calls between operators, for example, are much higher than under the same operator, thus favouring the largest incumbent.

The Telecommunications Law (36/1999) specifically prohibits monopolistic practices and unfair business competition, in accordance with prevailing statutory regulations (*i.e.* Law 5/1999). Two prominent cases have been investigated by KPPU on competition grounds. One in 2008 involved alleged cartel practices in short messages services (SMS) by six mobile operators. The case has still not been resolved since one operator has sued KPPU in civil court which entails a lengthy delay.[12] The second case involved alleged monopolistic practices by a foreign investor which, through a government-controlled holding company, indirectly held significant shares in both Telkomsel (35%) and Indosat (42%). The foreign investor contested the allegation, arguing that the government remained the largest investor overall in the two companies and retained a golden share. In 2008, the investor eventually sold its share in Indosat to another foreign investor.

... and the rules of the game keep changing

A Negative List issued in 2000 envisaged allowing only 49% foreign ownership of any telecommunications firm, a figure which was changed in a revised Negative List issued in the same year to 95%. The two versions of the Negative List issued in 2007 reduced the foreign equity share once again to 49% in fixed line services and 65% in mobile telephony, where it has remained in the 2010 Negative List. Because these limits have not been applied retroactively, some mobile operators have foreign equity shares exceeding the 65% ceiling.[13] Indonesia's commitments under the General Agreement on Trade in Services (GATS) allow for 35% foreign equity in both fixed and mobile services.

The existence of the Negative List does not preclude the possibility of additional restrictions in the future. In an effort to promote domestic equipment suppliers in the sector, new regulations preventing the participation of any firm with foreign equity in owning or managing telecommunication towers was introduced by the Minister of Communication and Information in 2008. Telecommunications towers were subsequently included in the 2010 Negative List.

The telecommunications regulator needs to be given greater autonomy

The Indonesian Telecommunications Regulatory Body (BRTI) was established in 2003 (effective January 2004). The responsibilities of the BRTI

include regulation and supervision concerning licensing, monitoring operations performance and quality of service, and the interconnection tariff and equipment.[14] The BRTI is also responsible for safeguarding competition and settling disputes between network and service operators.

Motivated partly by the WTO Agreement on Basic Telecommunications (1997) and partly by IMF conditionality, the BRTI was supposed to act as an independent agency to ensure a transparent and competitive telecommunications sector. Numerous experts have questioned the degree of independence of the BRTI, especially given that the Director General of Posts and Telecommunications is the *ex officio* chairman of the BRTI. Furthermore, the BRTI has no independent authority to issue resolutions but must do so instead through the Ministry.[15]

The government has imposed USOs on private operators

To address low teledensity in more remote areas, the government has imposed a universal service obligation (USO) on operators. The USO legal framework in Indonesia includes:

- Telecommunications Law 36/1999, which stipulates that all telecommunication providers have to contribute to a universal service obligation, by providing infrastructure and service or through other means.
- Government Regulation 52/2000, which defines USO as, among other things, providing access to the telecommunications network or services.
- Government Regulation 28/2005, which stipulates a contribution of 0.75% of gross revenue into a USO Fund (compared to 6% for a USO fund in Malaysia). This was raised to 1.25% in 2009.
- Regulation of the Minister of Communication and Informatics 11/2007, which expands USO service from basic telephony to information technology in general.

The government launched a pilot USO programme in 2003, with selected operators contracted to install physical connections in targeted villages. The programme was based on a turnkey approach, with infrastructure and equipment financed directly from the national budget. It has been criticised for insufficient funds, lack of local skills for maintenance and difficulties in collecting revenue.[16] Currently the government is undertaking the Palapa Ring programme to overcome the low level of teledensity. The programme covers 30 provinces and 440 cities/municipalities in Indonesia.

USO funds are to be distributed by the Authority for Rural Telecommunication and Information Technology, a non-profit public service institution. The USO programme has been criticised in the past for a lack of transparency in the use of funds. KPPU estimated that only around one tenth

of the money raised was actually used to expand coverage in 2003-2004.[17] Furthermore, where the USO scheme has in the past required designated operators to expand coverage within a given area and specified time, sanctions for non-compliance have rarely been applied.[18] USO tenders were called in December 2007. Two bids were selected out of 11, but eventually the tender was cancelled – leading one successful bidder to sue the government.[19]

4. Electricity

> Has the government developed a strategy to ensure reliable access to electricity services by users, and economic incentives to invest and supply electricity? What programmes exist to ensure, on a least-cost basis, access to electricity services by a wide range of users? Are these programmes time-bound and based upon clear performance targets?

Inadequate and unreliable electricity supply continues to hamper development in Indonesia. By one estimate, increasing electricity generation capacity alone by 5% would boost economic growth by about 0.3 percentage points.[20] The government has ambitious plans to expand capacity but must rely partly on private sector participation. Interest in PPPs has picked up recently, but – as in other infrastructure sectors – the experience of the crisis in the late 1990s has left a legacy of mutual suspicion.[21] The government has sought to create a new regulatory environment suitable for private participation and to end the state monopoly over distribution but has faced setbacks, including judicial ones. Private participation is also discouraged by continuing, albeit declining, subsidies to consumers.

With an electrification rate of only 65%, Indonesia lags far behind the Philippines (86%), Vietnam (89%) and Thailand (99%).[22] Furthermore, electrification varies greatly by province, from 100% in Jakarta to only 25% in an outlying province. Indonesia's unique geography can explain part of the difference with other countries, but another part stems from a decade of under-investment. Between 1998 and 2004, no new power plants were built. Furthermore, connectivity is only part of the issue, since supply is often of poor quality and unreliable. As a result, the ADB estimates that 35-40% of electricity used in the electronics, chemicals, textiles, and wood industries comes from private generators.[23]

The government seeks to address these weaknesses in its medium-term strategy for 2010-2014. By 2014, it plans to double generating capacity by adding 30 GW of capacity through annual investments of almost USD 9 billion and thereby to achieve coverage of 77% of the population by 2014. According to

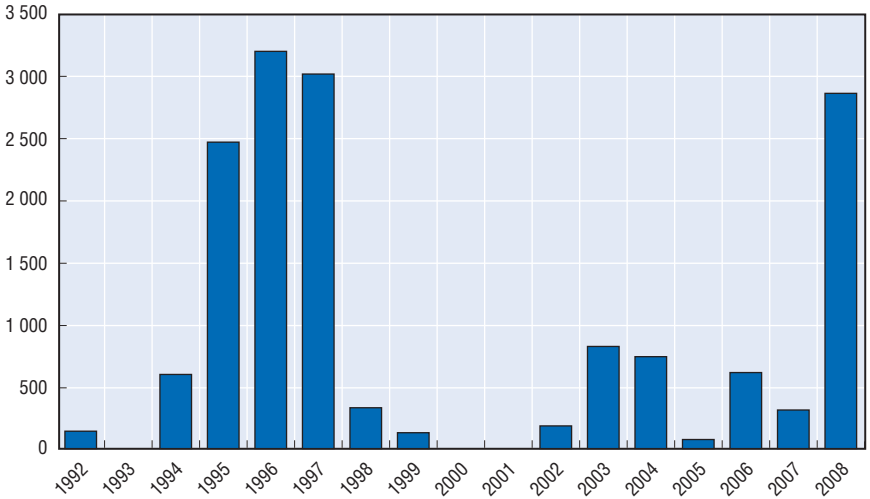
OECD/IEA (2008), the Ministry of Energy and Mineral Resources is very conscious of the need for private sector investment to achieve its energy development goals. The Energy Blueprint 2005-2025 promotes private investment as one of five core strategies and lists specific measures to achieve this. By one official estimate, 60-70% of the USD 50 billion in required investment in the power sector over the next ten years will have to come from the private sector.[24]

At present, the state-owned electricity company, PT PLN (*Perusahaan Listrik Negara*), has 83% of generating capacity, with the rest provided by private power utilities in areas not served by PLN (3%) and independent power producers (IPPs) under power purchase agreements (14%). These shares have changed little since 2004. PLN used to have a monopoly over transmission and distribution, but with its change in statutes in the Electricity Law, it is now in charge of transmission and distribution only in its designated operating areas. Private power producers can participate in generation activities even in PLN's operating areas and, outside of these areas, all parts of the electricity business are open to private power producers – from generation through to distribution.

Figure 5.3 shows the erratic trend in investment in PPPs in electricity in Indonesia. Unprecedented activity in the years leading up to the crisis was followed by a decade with little investment. The figure for 2008 suggests that investment in PPPs in that year exceeded the cumulative total of the preceding decade. There are currently 17 IPP projects under construction, with an additional capacity of 2 252 megawatts.

Figure 5.3. **PPPs in the Indonesian electricity sector**

USD million



Source: World Bank.

An Electricity Law (20/2002) was passed in September 2002 which would have strengthened regulation of the sector and ended the monopoly of PLN in distribution by allowing private companies to sell directly to consumers within five years. Before this could happen, the Law was annulled by the newly created Constitutional Court[25] at the end of 2004 on the grounds that it contravened Article 33(b) of the Constitution which states that "branches of production that are important to the state, and that affect the public's necessities of life, are to be controlled by the state". The Court dismissed the government's argument that regulation was sufficient to ensure control by the state.

The government responded quickly with Government Regulation 03/2005 which, Butt and Lindsey (2008, p. 256) argue, appears to mitigate, even nullify, much of the Court ruling.[26] The ruling nevertheless created considerable uncertainty in the eyes of investors. A new Electricity Law (30/2009) was enacted recently. It stipulates in the preamble that since electric power plays a very important and strategic role in national development, it is to be controlled by the state. The Law still awaits implementing regulations.

Although electricity tariffs will continue to be set by the government and approved by Parliament, the new Law allows for regional variations.[27] Private power producers must apply tariffs which are in line with central or regional government stipulations, however. In 2009, the subsidy for electricity alone was IDR 54 trillion or almost USD 6 billion. The government expects to reduce the subsidy for electricity and to ensure that they go to those most in need of them: the poor and small-scale industries. It has ceased paying subsidies to larger industrial electricity consumers. In addition to the financial cost of these outlays, they discourage private investors in both the oil and electricity sectors by preventing cost recovery pricing.

Investment in renewable energy is set to increase

Reducing subsidies over time is important not only for fiscal reasons and to encourage private investment but also for its environmental benefit. Currently, only 3% of power generation is geothermal and 8% hydroelectric, but plans for additional capacity are expected to have a far higher share for renewable sources of energy. Of the 30 GW in additional capacity by 2014, 15% is expected to be in hydroelectric and geothermal, with most of that capacity coming on stream at the end of the period. Much of the rest (75%) will come from coal which is of good quality in terms of ash and sulphur content. In the short term, Phase II of a 10 GW Crash Programme is expected to have over half of added capacity in renewables, representing over 60% of the total investment. Almost all of the geothermal capacity is expected to be provided by IPPs. The legal framework for this expansion is currently under preparation.

A recent Ministry of Finance Green Paper on Climate Change Mitigation in Indonesia estimated that Indonesia has 40% of the world's geothermal resources although it ranks third in terms of actual capacity. As part of its strategy to develop geothermal power, the government has proposed a generic power purchase agreement between PLN and geothermal IPPs that gives IPPs the right to sell geothermal electricity at the full cost of electricity, with the Ministry of Finance reimbursing PLN for the difference between this price and the price paid for conventional electricity. At the same time, according to the government, profit-sharing arrangements will ensure that the government obtains a fair share of the economic profits while maintaining the IPP's incentives for efficiency.

5. Transport

What processes are followed to inform decisions on the development of new transport facilities, as well as the maintenance of existing investment in transport infrastructure? Are the requirements for all modes of transport regularly reviewed, taking into consideration investor needs and the links between different modes of transport infrastructure?

Investor surveys suggest that transport costs are a serious constraint on business operations. Overall, logistical costs are estimated to reach up to 14% of total production costs in Indonesia against only 5% in Japan.[28] Poor transport infrastructure affects not only export-oriented production but also the extent of integration of the domestic economy. The government has given a high political priority to transport infrastructure but investment in the sector is still struggling to keep up with demand. Recent measures to facilitate land acquisition should help to reduce one of the major bottlenecks. Private investment in transport infrastructure (other than specialist own-use facilities) is so far comparatively limited and largely confined to toll roads and, to a lesser extent, ports.

Land acquisition is a major obstacle in infrastructure projects

The government has the right of eminent domain allowing the expropriation of property in the public interest under Law 20/1961. The procedure is nevertheless complicated and time-consuming, as it may only be executed by the President. A particularity of Indonesian PPP regulations is that projects are tendered before the land required for the project has been acquired, leading to costly delays as landowners hold out for higher prices. Presidential Regulation 65/2006 amends an earlier regulation (PR 36/2005) to provide for the procurement of land for public interest purposes, such as the development of toll roads, railways, ports, airports, train stations, power plants and natural or cultural

reserves. Implementing regulations were issued in May 2007. These regulations have not fully eliminated either speculation or costly delays. Presidential Regulation 13/2010 is intended partly to remedy this situation by ensuring that land is procured before the tender process to select a private partner commences.

The National Land Agency is currently preparing a draft new law on Land Provision for the Public Interest, which is scheduled to be completed in 2010. Once enacted, the new law is expected to reduce the time spent negotiating from 120 days to 60 days and facilitate the adoption of a court-led consignment scheme by allowing it after only 51% of the land has been acquired, compared to 75% in the existing regulations.[29] Specific features of the draft law include: a clear definition of public interest; public and stakeholder consultation from the time when the location is initially designated; just and fair compensation through independent appraisal; and one institution responsible for land acquisition with its dedicated fund for this purpose. Furthermore, land that has been designated as a project site by the government will not be allowed to be traded without the permission of the governor or mayor.

The government has also created two special funds to facilitate implementation of toll road projects:

- A **Land Revolving Fund** established within the Ministry of Public Works was allocated IDR 600 billion (USD 65 million) in the 2006 budget to pre-finance land acquisition for toll road projects.
- A **Land Capping Fund** is used to finance any excess of land acquisition cost over the amount committed by the concession holder. It is intended only for toll road projects.

Toll roads are a priority for the government

At the national level, the general plan for the national road network is set by the Ministry of Public Works under decree 369/2005. Indonesia currently has only 742 kilometres of toll roads, compared to over 6 000 kilometres in Malaysia and over 45 000 kilometres in China. In the first term of President Yudhoyono, 85 kilometres of new toll roads were built.[30] Investor interest has picked up recently. According to BKPM, in June 2008 alone, ten new toll roads worth IDR 3 800 billion (USD 414 million) went up for tender, including major arterial roads for both Java and Sumatra. The budget for the road sector was also increased in 2009. The government expects to build another 700 km of toll roads between 2010 and 2014. The Toll Road network plan envisages building 3 000 km of toll roads in total.

A Toll Road Regulatory Agency (BPJT) was created under the Road Law (38/2004) and is responsible for regulation, business management and monitoring of toll road enterprises. The BPJT recommends initial tariffs for toll roads and how they are to be adjusted over time. It also takes over toll roads at the end of their

concessions or recommends the further operation of these toll roads by a private operator. To encourage toll road investment, it also prepares for the commercialisation of new projects, including by facilitating land acquisitions.

Ports, airports and rail are being restructured

Given Indonesia's geography, shipping is essential both for internal and external trade. With 81 000 kilometres of coastline, there are over 2 000 ports in Indonesia. These ports have suffered from congestion which has in turn increased shipping costs. According to JETRO, shipping a container from Tanjung Priok, the closest port to Jakarta, to Yokohama in Japan costs 50% more than from Manila, 10% more than from Singapore and 20% more than from Malaysia. Congestion is partly an outcome of the poor design of ports but also due to procedural costs. The European Chamber of Commerce also complains that the main ports are also constrained by the lack of good road and rail hinterland facilities.

The 2008 Shipping Law provides the foundation for a comprehensive reform of the Indonesian port system. Most notably the law removes the legislated state-sector monopoly on ports and opens the door for new participation by the private sector. This is expected to allow competition in ports, which could put downward pressure on prices and drive general improvements in port services. Private firms will eventually be allowed to operate the 111 main ports under the control of Pelindo, the state-owned ports operator. A regulatory agency will be created and the government will no longer be responsible both for running and regulating the port system. To rationalise the clearing process and expedite exports, the government has reduced the number of ports allowed to handle foreign trade from 141 to 25.[31]

In the railroad sector, the government has enacted a new Railway Law 23/2007 to replace an earlier one (Law 13/1992). Under the old system, unbundling was attempted by separating rail services run by the state-owned railway company PT *Kereta Api* (PT KA) from operations and maintenance of the rail track. Private participation was permitted, but only under a joint agreement with PT KA. In practice, a KKPPI sector review found that PT KA acted as both regulator and operator, with a complex fee structure between the operator and the government.[32]

Implementing regulations were approved in 2009 for Law 23/2007. A new state-owned company was set up to manage the rail track separately from PT KA, which should allow for greater scope for private participation and eventually for privatisation of PT KA. The new company will receive an allocation of IDR 19 trillion over the next three years to invest in the rail system.[33]

Private investors have responded to the improved environment. The government of central Kalimantan has issued a request for pre-qualification

for investors to finance, design, construct, operate and maintain a 185 km special purpose railway in East Kalimantan to transport coal to a new port. The project is expected to cost USD 900 million. The land was reportedly acquired in only a few months.[34] A Middle Eastern investor, together with the National Aluminum Company (NALCO) will invest USD 4 billion in an aluminium smelter and power plant as part of the project. In a similar initiative in 2009, a USD 1.3 billion project was announced to build a 300 kilometre track in Sumatra to transport natural resources, with a controlling stake to be held by a private investor.[35]

Out of 230 airports in Indonesia, roughly 80% are operated by the government or through the state-owned airport companies Angkasa Pura I and II.[36] The new Aviation Law removes the restriction that private investors must operate through a joint venture with Angkasa Pura.

Box 5.1. **Planning process for transport infrastructure in Indonesia**

At the national level, responsibility for transport infrastructure policy is split between the Ministry of Public Works, which manages national roads (including toll roads), and the Ministry of Transport which deals with other modes. Regional autonomy has given local governments responsibility for local infrastructure and services.

The planning processes for individual sectors are different and still evolving. Long-term national master plans are currently being developed for railways and ports, as required by recently enacted laws, and will be updated periodically. They are expected to guide investment decisions in each sector. For example, the national port master plan should allow the Port Authorities to prepare individual port master plans which will allow them to identify projects, conduct feasibility studies, and prepare medium-term investment plans.

With regard to transport facilities, the processes must conform to the National and Inter-Island Spatial Development Planning, and also with the national, regional/provincial and local transport systems. New toll road development is included in National Road Network Plan and then tendered to the public. Non-toll road projects are proposed in the national state budget for financing. Procedures for maintenance planning necessarily differ from sector to sector. For the national road network, the Ministry of Public Works has developed the Indonesian Road Management System – an electronic system used for programming periodic maintenance and road improvement.

Box 5.1. **Planning process for transport infrastructure in Indonesia** *(cont.)*

Stakeholders are consulted during the planning process. The Spatial Planning Law 26/2007, for example, mandates public participation when designing a city master plan. There are also regular reviews through the annual National Development Planning Conference and the National Origin Destination Survey every five years since 1972. The last Survey was undertaken in 2006 and the next one will be in 2011.

Requirements for all modes of transport are subject to review, and special attention is currently being given to development of a national logistics blueprint aimed at eliminating impediments to efficient inter-modal/multi-modal transport.

6. Water

Has the government evaluated the investment needs in water required to support its development goals? To what extent is the private sector involved in water management, supply and infrastructure financing?

The water and sanitation sector in Indonesia suffers from years of underinvestment, partly as a result of the poor financial condition of most regional water enterprises (PDAMs). Consequently, only 18% of the population currently has sustainable access to safe drinking water. By one estimate, 80 million Indonesians lack access to sanitation, contributing to 100 000 deaths annually. Lack of private investment is often attributed to an uncertain regulatory environment, reportedly owing partly to the desire of the government to avoid an annulment by the Constitutional Court if legislation specifies too large a role for the private sector.[37] As a result, as of 2006 only an estimated 8% of the water supply system in Indonesia was supplied through PPPs.[38]

The government has set itself the goal of reaching 60% coverage of piped water supply in urban areas by 2015 (it is currently around 50%) and 40% coverage in rural areas in the same timeframe. Likewise, the evaluation of the investment needs in water to achieve Millennium Development Goal (MDG) targets has been conducted and programmed for all provinces up to 2015. The National Action Plan on Clean Water, issued by the Ministry of Public Works, elaborates the MDG targets to increase the percentage of the population with sustainable access to safe drinking water to 62% by 2015, with 10 million new connections targeted.

Under regional autonomy, primary responsibility for implementation rests with local governments, but the central government provides extensive financial and technical support. For rural areas, funding is channelled to community groups. For cities, incentives are being provided for strengthening municipal water utilities and stimulating local investment. The Water Supply Development Supporting Agency established in 2005[39] oversees the water supply at a national level, acting as promoter and mediator in the PPP process. At the same time, it is neither the contracting agency nor the regulatory body. There is currently no regulatory body for the sector, but the regulations allow for the formation of a regulatory body upon agreement between the parties involved.[40]

The Water Resources Law (7/2004) governs the sector and, under Article 40, allows for the private sector to participate through concessions granted by the local government. The government envisages that nearly 70% of infrastructure investment over the 2010-2014 will need to be financed through PPPs, corporate social responsibility contributions from the private sector and community participation. The schemes currently in place have not brought significant investment relative to national needs, as private sector involvement in water services is still limited. Some projects have nevertheless been arranged using the PPP scheme (supply and distribution sector and also infrastructure financing). For some PDAMs, involvement of the private sector so far has been for smaller investments, and involved supplementary services such as a trade credit mechanism.

The government has actively sought ways to develop the water sector further, including.

- A Presidential Decree (29/2009) regarding Interest Subsidy and Guarantee Support for National Banking to Support Water Supply Development Investment.
- A Regulation of the Finance Minister (120/2008) on the settlement of state receivables associated with PDAMs, as a way to improve their financial viability.
- Enforcement of a reward and punishment system for PDAMs, especially through the provision of incentives for sound PDAMs. The incentive scheme involves a grant of IDR 1 million per connection within the criteria of economically weak households and operationally sound PDAMs. The incentive amount is planned to be doubled.

Notes

1. World Bank (2004), p. 124.
2. OECD (2008), p. 71.

3. OECD (2008), p. 69.
4. *www.itu.int*.
5. Established under Presidential Regulation 42/2005 (following upon Presidential Decree 81/2001), the KKPPI or *Komite Kebijakan Percepatan Penyediaan Infrastruktur* includes the Co-ordinating Ministry, Bappenas, the Ministers of Home Affairs, Finance, Energy and Natural Resources, Public Works, Transport and Information and Communication, as well as the State Minister for SOEs and the Secretary of the Cabinet.
6. USAID (2009), p. 21.
7. Prior to the law, PLN's status was PKUK (*Pemegang Kuasa Usaha Kelistrikan* – Electricity Business Authority) which held monopoly power. The new law changes that status into PIUKU (*Pemegang Ijin Usaha Kelistrikan* – Electricity Business Licence Holder) whose work is targeted at meeting the needs of the general public.
8. PPPs involved either Build-Operate-Transfer (BOT) or Build-Operate-Own (BOO) schemes.
9. Lee and Findlay (2005), p. 344.
10. Young *et al*. (2005).
11. *www.marketresearch.com/product/display.asp?productid=2229969*.
12. Wattenaga *et al*. (2008), p. 21.
13. In particular, as of 2007, foreign investment exceeded the ceilings in Excelcomindo Pratama (70%), Hutchinson CP Telecom Indonesia (100%) and Natrindo (90%). Indosat is also majority-owned by foreign investors, although no single investor has a controlling stake.
14. Ministerial Decree 31/2003.
15. Rasyid (2005), p. 77.
16. Wattenaga *et al*. (2008), p. 23.
17. KPPU (2004), p. 24.
18. Lee and Findlay (2005), p. 361.
19. Wattenaga *et al*. (2008), p. 24.
20. LPEM-FEUI (2007).
21. Since power purchase agreements at the time were denominated in dollars, the massive devaluation of the rupiah meant that PLN could no longer honour its obligations.
22. OECD/IEA (2009), p. 561.
23. ADB (2005), p. 18.
24. An estimate by the Director of Planning of PLN, as reported in BKPM (2008), p. 14.
25. The Constitutional Court was established in 2003 with the power, among other things, to review the constitutionality of statutes.
26. Lower level regulations are reviewed by the less activist Supreme Court.
27. If the local government sets a lower price, however, they are expected to pay part of this subsidy.

28. OECD (2008), p. 69.
29. Dian Ariffahmi and Muhammad Al Azhari, "Indonesia sets January deadline for new land regulation", *Jakarta Globe*, 13 November 2009.
30. *Jakarta Post*, 30 October 2009.
31. Molnar and Lesher (2008), p. 28.
32. PT KA was charged by the government for using the track and in turn received a fee for infrastructure maintenance and operation, as well as a subsidy for second class passenger travel.
33. "Government to allocate Rp 19t for railway revitalisation", *Jakarta Post*, 23 April 2009.
34. *www.gulfnews.com*
35. *http://goodnewsfromindonesia.org/2009/10/01/massive-railway-development-for-sumatra-island/*
36. The sector is governed by the Aviation Law 1/2009 which replaces the Law 15/1992.
37. Mohammad Mova Al' Afghani, "Indonesia needs a strong water services law", *Jakarta Post*, 31 August 2009.
38. *http://pppportal.blogspot.com/2008/11/water-and-sanitation-sector-review.html*, based on a KKPPI Sector Review (2006).
39. Presidential Regulation 16/2005
40. *http://pppportal.blogspot.com/2008/11/regulatory-bodyin-water-and-sanitation.html*, based on a KKPPI Sector Review (2006).

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Chapter 6

Financial Sector Development

Weakness of the financial sector was one of the principal causes of the depth and duration of the crisis in Indonesia in the late 1990s. The chapter describes measures taken by the government to strengthen the banking sector and develop the domestic capital and bond markets. FDI policies in the financial sector are also reviewed. Through restructuring and regulatory improvements, the banking system has improved its health and performance, as evidenced by its ability to withstand the recent global financial crisis. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

Developed financial sectors provide payment services, mobilise savings and allocate financing to firms wishing to invest. They reduce firms' reliance on internally generated cash flows and money from family and friends – giving them access to external equity and debt, something that smaller firms in particular often lack. They allow entrepreneurs to grow their businesses, even though they have little money themselves. Well-functioning financial sectors also impose discipline on firms to perform, driving efficiency, both directly and by facilitating new entry into product markets. And they create opportunities for firms and households to manage risks. As a result, financial sector development has the potential to lead to faster growth in productivity and output.

Weaknesses in the Indonesian financial sector were one of the principal causes of the depth and duration of the crisis in Indonesia in the late 1990s. Through restructuring and regulatory improvements, the banking system has improved its health and performance, as evidenced by its ability to withstand the recent global financial crisis. Nevertheless, the domestic financial market still does not fully meet the needs of the corporate sector: Indonesia's financial sector is relatively small and dominated by banks, compared to other major economies in Asia. Loan expansion has been low in relation to the country's economic size. The availability of long-term financing in Indonesia is still limited as the banking sector has been risk-averse and Indonesian institutional investors have not become a major source of long-term capital. To address these issues, the government has been promoting financial market diversification, developing the domestic capital and bond markets and strengthening institutional investors in Indonesia. A continuing review of regulations would be useful to expand financial services without compromising banks' soundness.

Indonesia first began to open to foreign banks in the late 1980s, a process which accelerated considerably during the Asian crisis when foreign investors were allowed to own 99% of the shares in a local bank. Foreign banks represented almost one half of bank assets in 2008. The rest of the banking sector is dominated by state-owned banks, and local private banks represent only 7% of the sector. Policies to ensure a level playing field for banks regardless of the ownership structure – state-owned, foreign-owned or domestically private owned – are in place and should be maintained.

Over the past decade, the government has taken several steps to improve the performance of the financial sector, including: partially divesting its shares in local banks; granting independence to Bank Indonesia (BI) and

strengthening its supervisory powers; improving prudential regulations; facilitating further consolidation and capitalisation; setting up co-ordination mechanisms among the central bank, the Ministry of Finance and other bodies with regulatory authority; and expanding credit information through a newly-created Credit Bureau. BI has been making steady progress in strengthening commercial banks by increasing the minimum capital requirements and promoting consolidation of smaller banks under the Indonesian Bank Architecture (API) programme since 2004.

1. Financial sector regulation

What process does the government use to evaluate the capacity of the financial sector, including the quality of its regulatory framework, to support effectively enterprise development? What steps has the government taken to remove obstacles, including restrictions on participation by foreign institutions, to private investment in the development of the financial sector?

State-owned banks have a dominant position in Indonesia's financial sector

As in much of the rest of the developing world, Indonesia's financial sector is dominated by the banking sector which is in turn dominated by state-owned banks (SOBs). There were four SOBs[1] accounting for 38.6% of total banking assets in December 2009. These SOBs were originally set up to channel subsidised credits to specific sectors of the economy that the government considered too important socially to leave solely to private sector financiers. Later, they became the main vehicle for providing liquidity credit[2] through Bank Indonesia for priority projects. Supported by booming oil revenues, liquidity credit dominated the assets of commercial banks (mostly SOBs). The government has intervened strongly in banking operations by setting a preferential interest rate for each sector since 1969, controlling deposit rates and imposing a ceiling on lending of all commercial banks in 1974. Given the repressed deposit rates and ample credit available from BI, domestic savings mobilisation stayed very low.

Deregulation of the banking sector started in the mid-1980s

Deregulation of the banking sector started in 1983 with a series of reforms to remove the credit ceiling, liberalise interest rates[3] and reduce entry constraints for new banks. Most notably, the October 1988 Policy Package opened up the banking sector to limited foreign competition[4] for the first time in two decades and eased the requirements for establishing branches in

Indonesia. In 1992 the Banking Law eventually eliminated all legal distinctions between private banks and SOBs except for the ownership status, promising a level playing field for commercial banks.

Deregulation triggered the entry of a vast number of private banks, mostly established by business groups to finance projects of affiliated firms. The number of private banks jumped to 203 in 1996 while the number of SOBs remained at seven. The share of assets held by private banks increased from about 20% in 1981 to 59% in 1996. This increased competition and extremely aggressive growth of the banking sector occurred without adequate prudential regulation and supervision, and credit quality rapidly deteriorated.

The sub-optimal regulatory framework made Indonesia's banking sector vulnerable to shocks. Although prudential regulations were introduced by BI in 1991 and incorporated in the Banking Law of 1992,[5] BI functioned as a development agent rather than a regulatory and supervisory body free from political intervention. SOBs, operating under an implicit government guarantee, had neither the incentive nor the capacity to conduct proper credit analyses and manage risk. Political intervention was high as key positions in SOBs were filled by government officials from the Ministry of Finance (MOF) or BI. Without properly implemented corporate governance practices, private banks owned by conglomerates were extensively engaged in lending to related business groups,[6] often violating the legal maximum lending limit.

The Asian crisis triggered a major restructuring of the banking sector

The Asian financial crisis revealed the fundamental weakness of Indonesia's banking sector, which could not weather the serious shocks to the financial system. The process of restructuring the banking sector involved closure, mergers, nationalisation through the Indonesia Bank Restructuring Agency (IBRA) and recapitalisation with government funds. The government incurred the major cost of restructuring which was financed by issuing government bonds of IDR 644 trillion by end-2000. The number of SOBs increased from 7 to 28 and the state share in total bank assets expanded from 37% to 78% by recapitalising 19 major banks and taking over another 4 banks after the crisis.

The regulatory framework for the banking sector was heavily criticised then reformed. The independent status and authority of BI were strengthened by amending and enacting laws[7] which consolidated bank licensing and supervision powers in BI,[8] increased penalties for non-compliance with financial regulations and clarified BI's independent status. BI's mandates were clarified, including: to determine and apply monetary policy, to supervise and regulate banking institutions, and to provide, regulate and safeguard the liquidity of financial payments. BI's supervisory function was improved by introducing a risk-based supervision system to complement the existing

compliance-based system, more frequent checks on bank performance,[9] stricter enforcement of regulations[10] and enhanced capacity. To promote good corporate governance, BI issued regulations to strengthen the legal lending limit[11] and to impose a fit and proper test on each bank's controlling shareholders and management.[12] Bank exit policies were strengthened and have become part of BI's responsibilities. An explicit deposit insurance scheme has been developed as part of the financial safety net, replacing a blanket guarantee scheme. The Indonesian Deposit Insurance Corporation (LPS), established in 2004, has become the country's deposit insurer.[13] Many commercial banks reformed their internal risk management systems and strengthened their capacity to identify risk exposure, manage and mitigate risks. They also apply the "four eyes principle"[14] in granting loans and use enhanced credit scoring techniques.

Later in the restructuring process, the government started privatising SOBs and divesting government shares of re-capitalised private banks. In 2002-2003, four banks[15] taken over by the IBRA were privatised by offering a majority shareholding to foreign private investors, and two SOBs[16] divested minority shareholdings by offering shares to the public. The restructuring of the banking sector drastically reduced the number of banks from 239 in 1996 to 138 in 2003, and four SOBs were merged to form the largest national bank, Bank Mandiri. The number of private banks affiliated with business groups which flourished before the crisis was down from 58 to 16 by closure (28), nationalisation (10) and recapitalisation (4). As of December 2009 there were 121 banks in total.

In 2004 BI announced the Indonesian Bank Architecture (API), a comprehensive framework for the Indonesian banking system which outlines the direction and development strategy of the banking industry for the next 5-10 years. It adopts the Single Presence Policy (SPP), which prevents one shareholder from owning controlling stakes in multiple banks,[17] as the main driver to shape a new banking industry.[18] According to the SPP, bank owners with multiple controlling stakes are required either to divest stakes, to establish a holding company, or to merge banks.[19] It is expected to facilitate further bank consolidation and capitalisation, which together constitute the main focus of the API.[20] BI has also set policies to raise the capital adequacy of banks by raising the minimum Tier 1 capital to IDR 100 billion for all commercial banks and has provided incentives for banks that choose to merge as part of their consolidation strategy.[21]

Banks have become more robust against shocks but have been slow to lend for investment

Through restructuring and regulatory improvements, Indonesia's banking system has improved its health and performance. The average capital

adequacy ratio has been maintained above 15%[22] in recent years and non-performing loans accounted for 3.8% in gross at end-2008.[23] Furthermore, BI has been making progress in implementing the Basel II principles of risk-based supervision. From January 2010, all commercial banks have been required to meet the capital requirements of Basel II by adopting the standardised approach to credit risk and the basic indicator approach to operational risk under Pillar I. BI's risk-based supervision framework has been enhanced under Pillar II. BI plans to amend its regulations to meet disclosure requirements including the new accounting standards under Pillar III.

The recovery of lending from the banking sector has been slow, especially for lending to the corporate sector, since corporate sector restructuring lagged behind that of banks. The loan to deposit ratio fell from above 100% before the Asian financial crisis to 45% in 1999, and has never recovered to the pre-crisis level.[24] Banks have held government bonds and Bank Indonesia Certificates in place of loans on the asset side. Given the deteriorated investment climate, banks have channelled more of their credits to consumption or working capital than to new investment. The share of consumption credits increased from 14% in 2000 to 30% in 2009. Sources of long-term lending in the banking sector are limited as more than 90% of deposits have short-term maturities of less than 6 months.

Policies to stimulate healthy bank intermediation have been in place to address the above issues. Prudential regulations have been adjusted to encourage bank lending. For example, the legal lending limit for SOEs working on infrastructure projects has been raised to 30% of bank capital; and a risk-weight attached to lending to productive small business which is guaranteed by state-owned credit insurers has been lowered. Banks have been provided incentives to increase their loan to deposit ratios as far as they meet the prudential regulations. As a result, lending in 2008 showed strong growth of over 30% over the previous year.

The stability of the financial system is a shared responsibility of BI, MOF and LPS

While BI supervises the banking sector, the Ministry of Finance (MOF) is responsible through the Bapepam-LK for regulating the rest of the financial sector, including non-bank financial institutions, the capital market, and pension and insurance companies. The authority of Bapepam was enhanced in 2005 when its responsibility was expanded to cover regulation of non-bank financial institutions in addition to capital market regulation. To co-ordinate policies and discuss systemic issues in the financial sector, the Co-ordinating Committee on Financial System Stability was set up to make joint decisions among the Minister of Finance, Governor of BI and Chairman of LPS; and the

Financial System Stability Forum was established in 2005 to support the Committee to co-ordinate and exchange information.

In the wake of the global financial crisis in 2008, strengthening financial system stability has become an urgent task for the government. A draft law on the Financial System Safety Net is currently in preparation, laying out the objectives to establish and maintain financial system stability through regulation and supervision of financial institutions and the payment system as well as crisis prevention and resolution.

The establishment of an independent financial services authority (*Otoritas Jasa Keuangan*; OJK) to which monitoring and supervision responsibilities would be transferred from BI and MOF has been under consideration since the idea was introduced in the amendment to the Bank Indonesia Law in 1999. Given the difficulties in merging two financial market regulators, the Parliament postponed the establishment of OJK from 2002 to 2010 under the amended Banking Law of 2003.

Indonesia's financial sector has been open for foreign investors for over 20 years

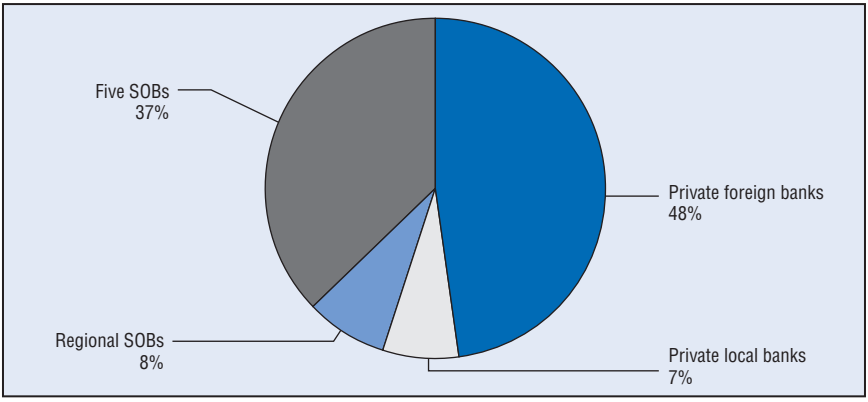
Indonesia's banking sector has been open to foreign investors since 1988 and was liberalised further after the Asian crisis. Currently foreign banks can establish a branch or a representative office, establish a new bank in joint venture with local firms up to 99% foreign equity ownership, or acquire up to 99% of total equity in Indonesian banks.[25] The regulations on the location of branches outside Jakarta and capital requirements were equalised for both domestic and foreign banks in 1999,[26] but the right to establish a branch or representative office is limited to large foreign banks with good performance records.[27] Employment of expatriates is limited to certain positions in a bank including commissioner, director, executive and expert/consultant.[28]

The foreign presence in the banking sector increased after the Asian crisis as four large banks sold after recapitalisation by the government were purchased by consortia of foreign investors.[29] The asset share of foreign-affiliated banks including foreign owned joint-venture banks and branches amounted to 31% in 2002, up from 8.5%[30] before the crisis. Since foreign-owned banks, are on average larger than domestically-owned banks, the foreign bank share in total bank assets amounted to 48% in 2008 (see Figure 6.1).

Development of the capital market is encouraged by Bapepam-LK

The number of listed companies in Indonesia has been growing steadily since the late 1980s (Figure 6.2). Nevertheless, the capital market in Indonesia

Figure 6.1. **Asset share of commercial banks, 2008**

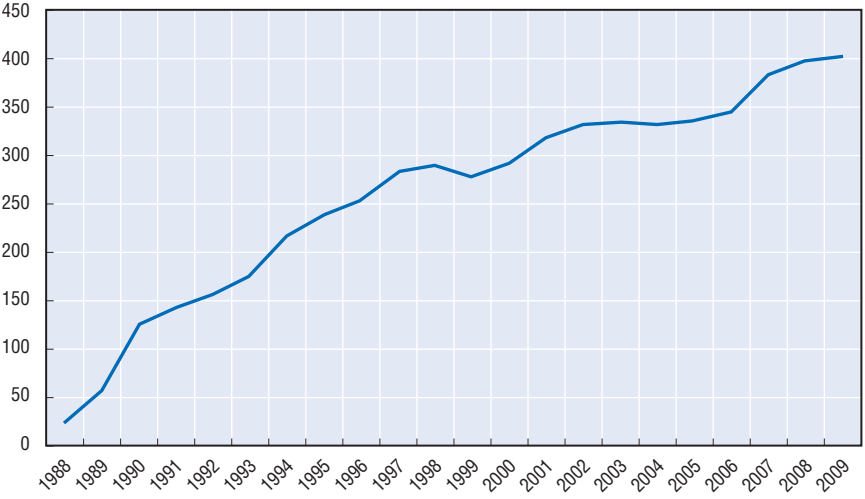


Note: Private Foreign Banks include 10 branch offices, 16 joint venture banks and 23 foreign-acquisitioned banks.

Source: Bank Indonesia (2008b), *Bank Supervision Report 2008*.

Figure 6.2. **Listed companies in Indonesia, 1988-2009**

Number



Source: *World Development Indicators*.

is still small compared to OECD countries and other regional peers, serving a limited selection of domestic corporations. Although it has grown rapidly in recent years, its size in relation to GDP (about 36% in 2009) is lower than other major economies in the region. Market concentration is high and liquidity low. While there were 383 companies listed on the Indonesia Stock Exchange in

2007, the top ten accounted for 48% of the market capitalisation and 47% of total trading turnover. Even if a company chooses to list shares on the capital market, it is unlikely to sell a significant portion of its shares to the public. Some large Indonesian companies are dual-listed in domestic and foreign stock exchanges.[31] Cumulative equity issuance reached 10% of total corporate financing in 2007.

Bapepam-LK under MOF regulates the capital market and non-bank financial institutions. Measures have been taken to strengthen the market structure, enhance investor protection and upgrade regulations as consistent with international norms in the capital market. It imposes a set of disclosure requirements on listed firms including implementation of good corporate governance.

Foreign investors play a major role in Indonesia's capital market. Foreign transactions have accounted for more than half of all transactions on the Jakarta Stock Exchange (JSE)[32] in recent years and foreign institutions owned 41% of total market capitalisation at the JSE in 2002-2007. A number of foreign securities companies, mostly in joint ventures with local securities companies, operate in Indonesia.[33] To reduce the high volatility and increase market depth, the government has implemented measures to attract domestic investors through developing a community trust in the capital market.

The insurance and pension sectors have not yet developed to channel long-term finance

Insurance is the second largest financial sector after banking. Total assets of insurance companies accounted for about 5% of GDP in 2008 while the non-bank financial sub-sector accounted for less than one-fifth of total financial assets. After the Asian crisis, a number of new insurance companies entered the market, including foreign ones. The foreign equity ownership ceiling is currently set at 80% for insurance companies. The insurance sector has lagged behind the banking sector in terms of consolidation and capitalisation. While the government has increased the minimum capital requirement for insurance companies several times, it has not been strictly enforced.

The pensions market is dominated by state-owned funds, including *Asabri*, *Jamsostek* and *Taspen* and closed to foreign investment. Under the new social security law, their dominance may increase. Despite their access to long-term assets, pension funds are heavily invested in short-term government bonds and bank deposits.

Bapepam-LK, as the regulator of non-bank financial institutions, has introduced measures to strengthen their capital structure, facilitate exit of

insolvent ones and promote good corporate governance principles among pension funds.

The domestic financial market needs to be made more attractive

The domestic financial market has not fully met the needs of the corporate sector. Foreign financing, including foreign loans and offshore bond issuance, has been a significant source of corporate financing, accounting for 47% of total financing sources of non-financial corporations in 2007 (IMF, 2008). While domestic bank loans have accelerated in recent years and in 2007 exceeded total foreign loans in corporate financing, the domestic bond market has absorbed only a small proportion of bonds issued by Indonesian corporations.

Compared to other major economies in the region, Indonesia's financial sector lacks depth and is dominated by banks.[34] Despite its dominance in the financial sector, representing 79% of the entire financial system, Indonesia's banking sector has remained small by asset size in relation to GDP. In 2008 total banking assets as a percentage of GDP of 44% was smaller than others in the region including China, Malaysia, Philippines, Singapore and Thailand.

To boost corporate loans, especially for SMEs and infrastructure projects, BI has gradually been relaxing banking regulations since the mid-2000s. Legal lending limits have been raised for commercial banks under certain conditions;[35] provisions against loans to SMEs have been reduced; and more flexibility in lending has been allowed. As an institutional framework and system to ensure sound risk management and good corporate governance are put in place for both lenders and borrowers, these changes in regulation make sense.

2. Bankruptcy proceedings, collateral use and credit information

What laws and regulations are in place to protect the rights of borrowers and creditors and are these rights adequately balanced? Is a registry system in place to support the use of property as collateral and to expand business access to external sources of credit? What data protection and credit reporting laws have been enacted to facilitate the flow of information and improve financial sector stability, thereby enhancing the investment environment?

Creditor rights were strengthened after the Asian crisis by amending the bankruptcy law

The bankruptcy law was amended in 1998 with a view to making it easier for creditors to exercise their rights in bankruptcy cases.[36] The law established a special commercial court to handle bankruptcy cases. Under the bankruptcy

law, liquidation claims can be brought against a debtor who has two or more creditors if the debtor has failed to pay at least one matured debt.

In 2004 another amendment to the bankruptcy law clarified the definition of debt, and protected insurance and pension businesses and SOEs from bankruptcy petitions.[37] The establishment of the commercial court has greatly improved the transparency of bankruptcy proceedings as it is required to conduct open hearings and to make decisions available to the public in writing.

Indonesia does not have a registry system for collateral

The legal basis for using moveable and immoveable property as collateral exists in various Indonesian laws including the Civil Code and laws on capital markets, mortgages, fiduciary guarantees and shipping. The concept of a registration system for collateral is also contained in various Indonesian laws.[38]

Indonesia does not have a centralised registry system to trace whether a property is used as collateral. Rather, collateral registration is made by various institutions, depending on the type of collateral: a mortgage is registered at a land office of the National Land Agency, a fiduciary guarantee at a fiduciary registration office under the Ministry of Law and Human Rights, and a warehouse receipt at the Registration Centre. These registration mechanisms are deemed to provide legal certainty for the use of property as guarantee or collateral of debtors' liabilities. Financial institutions typically withhold certificates of ownership when a property is used as collateral for loans.

Recovering collateral in full in cases of borrower defaults may nevertheless still be difficult and time-consuming through the Indonesian court system, due to the fragmented or incomplete registration and information on collateral.

Since 2006, financial institutions can have access to collateral information through the Debtor Information System housed at BI which collects data on individual loans from participating financial institutions. The system enables financial institutions to find whether a particular property has been used as collateral by a debtor.

A Credit Bureau was established to facilitate information flows among financial institutions

The Law on Bank Indonesia (6/2009)[39] mandates BI to develop an inter-bank information system. As part of activities under the Indonesia Banking Architecture, BI established a Credit Bureau[40] in 2006 to collect, record and distribute credit/loan information known as the Individual Debtor Information (IDI) History which displays all information related to the repayment history during the last 24 months on all credits/loans.[41] Data are

submitted by the members of the Credit Bureau to BI's Debtor Information System electronically on a monthly basis.[42] The IDI History can be accessed by any financial institutions with BI's approval for the purpose of analysing credit risk. An individual or company can request its own IDI History to verify the information. The Credit Bureau has been continuing to improve data quality, update its infrastructure and widen coverage for users and reporters to meet the needs of stakeholders.[43]

BI requires each bank to maintain a list of customers who have written bad cheques. BI collects the lists from all banks and consolidates it into the national black list of customers accessible to all banks.

The Credit Bureau is managed by BI and is currently limited in coverage, particularly for relatively small transactions[44] which are dominated by SMEs. There are a few private enterprises providing business information services including credit risk information in Indonesia. The availability of reliable credit information is expected to facilitate credit expansion, especially to SMEs, as it reduces credit risk, transaction costs and reliance on collateral. Further improvement of credit information services in the country would be beneficial for better risk management by financial institutions as well as for the development of SMEs. The development of the credit information industry, including private sector participation, requires the introduction of the necessary legal framework. BI is mandated under the Law[45] to undertake this task.

Notes

1. Bank Mandiri, Bank Rakyat Indonesia, Bank Negara Indonesia, and Bank Tabungan Negara. Bank Ekspor Indonesia obtained a new status as the Export Finance Agency and was excluded from SOBs in 2009.
2. Bank Indonesia provided refinancing at a subsidised interest rate for credit extended to certain borrowers. This refinancing was limited only to SOBs and selected private banks satisfying certain minimum criteria.
3. Liberalisation of lending and deposit rates as well as the removal of the lending ceiling was announced by the government in its first financial liberalisation package of 1983. State-owned enterprises were allowed to place a maximum 50% of their deposits at private banks.
4. Foreign banks faced higher entry conditions as the minimum capital requirement was twice as high as for domestic banks, half of all loans were required to go to the export sector, branches were limited to two in each of six cities, and majority foreign-owned banks could not borrow from SOBs.
5. The Law provided for administrative sanctions against non-compliant banks, criminal penalties for bank managers and employees, a legal lending limit of 20% of the bank's capital on intra-group lending, and a division of roles between the central bank and the Minister of Finance for supervising unsound banks.

6. Prior to the crisis, 42 business group-affiliated banks accounted for 38% of all commercial bank assets.
7. Amendment to the Banking Law in 1998 and enactment of Law 23/1999 on the central bank, replacing a 1968 Law.
8. Previously, bank licences were issued by the Ministry of Finance.
9. BI has placed on-site supervisory teams at major banks to ensure sound banking and risk management practices since 2000.
10. BI Regulation 1/6/1999 requires banks to appoint compliance directors responsible for ensuring compliance with existing regulations. BI established a banking investigation special unit to uncover violations of banking rules.
11. BI Regulation 2/16/2000.
12. BI Regulation 5/25/2003. A fit and proper test should be conducted on bank owners, directors, commissioners and controlling shareholders.
13. Law 24/2001 on deposit insurance companies. The blanket guarantee system introduced in 1998 and managed by IBRA was gradually phased out and replaced by a partial guarantee system managed by LPS.
14. The four-eye principle is a concept applied to risk management and internal control and means that important decisions are not allowed to be made by an individual person.
15. Bank BCA (taken over by Farindo Investment), Bank Niaga (taken over by Commerce Asset, Bhd), Bank Danamon (taken over by Asia Financial/Temasek), and Bank BII (taken over Sorak Korea).
16. Bank Mandiri divested 20% and Bank BRI divested 41%.
17. A controlling shareholder is a legal entity, an individual or a business group holding 25% or more of the bank's shares and with voting rights; or holding a bank share less than 25% but showing evidence of direct or indirect control over the bank.
18. BI Regulation 8/16/PBI/2006. All banks are required to comply with the SPP by December 2010.
19. The SPP applies to commercial banks and is not intended to affect the ability of foreign banks to open a branch and a joint-venture bank. An exemption from the SPP is allowed in a case of a share holder controlling two banks, one of which is a joint venture bank.
20. It envisages more bank capitalisation by increasing the minimum core capital requirement to IDR 100 billion by the end-2010 and the capital adequacy requirement to 12%.
21. PBI 9/12/PBI/2007 on incentives for bank consolidation.
22. The CAR was around 17% as of June 2009 according to BI's statistics. BI refined the calculation of bank capital through the issuance of PBI 10/15/PBI/2008 regarding the CAR for commercial banks. Under this regulation, banks are obliged to calculate their risk-weighted assets based on credit, operational and market risk (BI, *Banking Supervision Report* 2008).
23. BI (2008), *Banking Supervision Report 2008*.
24. The loans to deposits ratio in 2007 was 69% (BI, *Annual Report 2008*).

25. Previously this limit was set at 85%. The regulation is restated in BI Regulation 11/1/PBI/2009 on Commercial Banks.
26. Before 1999, branches of foreign banks were limited to a maximum of 10 big cities. This location restriction no longer applies (Rajenthran, A. (2002), p. 14). The minimum requirement is IDR 3 trillion in paid-up capital for all commercial banks and branches of foreign banks.
27. To be able to establish a branch, a foreign bank has to be one of the 200 globally largest banks by assets and rated with a minimum A by Standard & Poor's or Moody's. For a representative office, foreign banks have to be ranked in the 300 globally largest banks by assets.
28. BI Regulation (9/8/PBI/2007) on employment of expatriates and the transfer of knowledge programme in the banking sector. Only a few positions, namely those in the human resources and compliance divisions, are not available for expatriates.
29. They are: Bank Central Asia of the Salim Group, Bank Danamon of the Danamon Group, Bank Niaga of the Tirtamas Group and Bank International Indonesia of the Sinar Mas Group.
30. Ten wholly foreign-owned branches accounted for 3.5% of total assets while 31 joint venture banks accounted for 5% of total assets.
31. Bapepam-LK revised its regulation in 2010 to remove the requirement for an Indonesian company to obtain approval before listing in a foreign stock exchange. In return, the company listing in foreign stock exchanges is required to adhere to the International Financial Reporting Standard and the International Accounting Standard and to include a statement in its prospectus on the risks investors may face due to the different laws and tax differences.
32. The Jakarta Stock Exchange merged with the Surabaya Stock Exchange and changed its name to the Indonesia Stock Exchange in 2007.
33. Currently, 36 joint venture securities companies are registered at Bapepam-LK.
34. World Bank (2006b).
35. In 2005, BI raised the legal lending limit to 30% for commercial banks financing infrastructure and projects providing public services. In 2007, the BI agreed to relax the legal lending limit for banks which can provide a consolidated risk management consultation. In 2008, the BI again announced a plan to raise the limit for banks no less than 40% of which are owned by public shareholders.
36. Government Regulation 1/1998 replaced the earlier bankruptcy code which was passed by the Dutch colonial authorities in 1905. The amendment was one of the conditionalities agreed with the IMF.
37. Only the Minister of Finance can file for a bankruptcy petition of these entities; BI can file for a bank; and the Capital Market Supervisory Board can file for a security company, the stock exchange, a guarantee clearing institutions, or a central securities depository.
38. Law 4/1996 on mortgage, Law 42/1999 on fiduciary guarantees and Law 9/2006 on systems of warehouse receipts.
39. It amended Law 23/1999.
40. *Biro Informasi Kredit* (BIK).
41. BI Regulation 9/14/PBI/2007 on Debtor Information Systems clarified the details.

42. All commercial banks, rural banks with total assets over IDR 10 billion during 6 consecutive months, and non-bank credit card providers are mandatory members while rural banks with smaller assets, non-bank financial institutions and co-operatives can become voluntary members. Currently there are 777 reporting members including 127 commercial banks, 646 rural banks and 4 financing companies.

43. It is planned to include the subscribers of public utility companies in the SID data source.

44. Only loans over IDR 50 million are reported to the Credit Bureau.

45. Article 32 of the Law on BI mandates it to manage the Credit Bureau and enhance the scope of information involving non-bank financial institutions. BI can also approve other parties to manage the information.

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Chapter 7

Public Governance

The fall of the Suharto regime has generally improved conditions affecting the quality of governance in the country, promoting freedom of media and civil society activities. At the same time, a democratic and decentralised system might have caused corruption to spread into lower government levels and political parties. This chapter describes the measures taken by the government since anti-corruption was made a top priority by President Yudhoyono. The chapter also provides an overview of Indonesia's regulatory reform framework. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

Regulatory quality and public sector integrity are two dimensions of public governance that matter critically for the confidence and decisions of all investors and for reaping the development benefits of investment. While there is no single model for good public governance, there are commonly accepted standards to assist governments in assuming their roles effectively.

Before 2004, major regulatory reform in Indonesia was carried out in response to economic shocks. The current government has been intensifying reform efforts through a series of presidential instructions. Reform-minded heads of government institutions have also undertaken voluntary initiatives to reform their institutions. Indonesia also has a regulatory framework to formulate laws and regulations through the National Legislation Programme. Nonetheless, the scope of reforms has tended to be limited. Without a centralised regulatory oversight body with "whole of government" responsibility for regulatory policies as well as a systematic mechanism to evaluate and monitor the development of laws and regulations, Indonesia has a great inventory of laws/regulations which are often overlapping, inconsistent, or conflicting.

As mandated in the new Medium-Term Development Plan (2010-2014), the government is taking the initiative to address the above issue. It will inventory, review and simplify laws and regulations at both central and local government levels, supported by stakeholder consultations and awareness campaigns. Business sector and civil society groups have been actively participating in this work by contributing analyses, assisting local governments, and making recommendations.

Decentralisation initially complicated the regulatory environment due to the lack of capacity/awareness at local level and co-ordination between central and local governments, but these constraints have gradually been removed as the central government has further clarified the authority of local governments and provided more guidance.

The fall of the Suharto regime has generally improved conditions affecting the quality of governance in the country, promoting freedom of media and civil society activities. On the other hand, a democratic and decentralised system might have caused corruption to spread into lower government levels and political parties. President Yudhoyono has made anti-corruption a top priority of the government and these efforts have been widely recognised.

Legislation and institutions to eliminate corruption and promote the integrity and accountability of government officials have been strengthened since 2001. Various governmental institutions, including law enforcement agencies, have adopted a code of ethics/conducts for their staff and enhanced internal controls. The transparency of government activities has been ensured by enacting the Law on Freedom of Information.

Indonesia's Corruption Eradication Commission (KPK) and Corruption Court have been active in enforcing the anti-corruption law. They have gradually gained professional credibility and popular support, while KPK has struggled to establish a *modus operandi* with other powerful law enforcement agencies.

1. Regulatory reform framework

Has the government established and implemented a coherent and comprehensive regulatory reform framework, consistent with its broader development and investment strategy?

The Asian crisis generated internal and external pressures on the government to reform a wide range of laws and regulations. Reform challenges were unprecedented, given the highly uncertain political environment and the magnitude and multi-dimensional character of reforms including political and administrative reforms to transform the country's governance structure away from an authoritarian, highly-centralised system. Parallel reforms in different sectors and at varying levels complicated implementation, causing regulatory uncertainty and undermining investor confidence.

Regulatory reform efforts have been limited in scope

While regulatory reform is stated in principle in the government's development plans, successful implementation takes strong commitment and political will, sufficient capacity to implement, and co-ordination among different ministries and at different levels of government. In Indonesia, most reform initiatives have been taken up at an institutional level, led by a highly reform-oriented head of the institution. For example, the Ministry of Trade is reviewing all regulations affecting the operation and development of firms in 14 industry sectors. Civil service reforms such as the introduction of a performance-based remuneration system, salary increases and merit-based recruitment procedures have been conducted at their own initiative in various

offices including the National Audit Board (BPK), the Ministry of Finance and the Judicial Office.

Many regulatory reforms have been introduced via presidential instructions (*Inpres*) since 2003. They have been limited in scope, applying to specific sectors or objectives, and are assigned to respective government ministries/departments. There has been neither a systematic framework to develop, monitor and evaluate laws/regulations nor a centralised regulatory oversight body with "whole of government" responsibility for regulatory policy. As a result, Indonesia has a huge inventory of laws/regulations which are often overlapping, inconsistent, or conflicting.

The National Medium Term Development Plans lays out a five-year development strategy

Indonesia's development strategy is formulated in its five-year National Medium-Term Development Plans which provide direction to priority reform areas. Regulatory reform has had a prominent place in the government's development strategy. Priority reform areas in the Plan for 2004-2009 included 1) legal reform to establish a mechanism for review and reform of laws and regulations and improve transparency in legal enforcement and 2) better public services delivery by enhancing transparency, openness and accountability of the civil service. The current Plan for 2010-2014 states that the objective is to enhance human resources quality including information and technology capacity towards a more competitive economy. Regulatory reform for improving the investment climate is also an important focus of the Plan and is co-ordinated by the Co-ordinating Ministry for Economic Affairs.

Bappenas plans to conduct a comprehensive regulatory review

As part of the groundwork of regulatory reform initiatives mandated by the current Plan, Bappenas and related agencies are taking the initiative to inventory, review and simplify laws and regulations at both central and local government levels, supported by stakeholder consultations and awareness campaigns. A Directorate for the Analysis of Laws and Regulations, newly created under Bappenas, is currently developing a regulatory analysis model and will publicise the importance of regulatory reforms among government agencies. These activities include identifying and analysing problematic laws and regulations as well as preparing an action plan of regulatory reform in co-ordination with sectoral ministries. The action plan will be periodically monitored and evaluated. In July 2009, Bappenas organised a seminar entitled "Creating Legal Certainty through Regulatory Reform" as part of the awareness campaign to engage various stakeholders. At the seminar, the government officially introduced its national regulatory reform plan for the first time.

Some independent regulatory bodies have a mandate to review government regulations

Several regulatory agencies, such as the Competition Commission (KPPU)[1] and the Corruption Eradication Commission (KPK), conduct reviews of government regulations and policies in their respective jurisdiction and areas of expertise if necessary in supporting their tasks and functions. The government may also set up an *ad hoc* task force to review certain regulations.

2. Co-ordination across government

What mechanisms are in place for managing and co-ordinating regulatory reform across different levels of government to ensure consistent and transparent application of regulations and clear standards for regulatory quality?

Formation of laws/regulations is governed by the national legislation programme

The government has a formal law/regulation making framework through the National Legislation Programme (*Prolegnas*) which encompasses all sectors including investment. Provisions of the *Prolegnas* are stipulated in Law 10/2004 on the formation of laws and regulations and Presidential Regulations 61/2005 on procedures for the formation and management of *Prolegnas*. Law 10/2004 lists procedures for formulating laws and regulations, which includes: initial planning, preparation of an academic paper, drafting of legal texts and deliberation in Parliament. The drafting guidelines in the Law serve to ensure clear and transparent law-making among government agencies. At every step, stakeholder consultations are compulsory.

The Ministry of Law and Human Rights, through the Directorate General of Legislation Regulation, has conducted annual training on the formulation and design of laws and regulations for officials from various government agencies. The training has enhanced the capacity of these government agencies in this area. To support and complement the drafting guidelines stipulated in Law 10/2004, the Ministry has also completed a guideline on harmonising, integrating and strengthening the formulation of laws and regulations[2] as well as a practical guidebook on drafting local government laws and regulations. The latter is widely disseminated among local governments.

Decentralisation caused co-ordination problems between the central and local governments

The big bang decentralisation programme in 1999 caused new regulatory challenges (Box 7.1). Political and administrative power was devolved to local

Box 7.1. **Decentralisation in Indonesia**

After the fall of the Suharto regime in 1998, Indonesia implemented a big-bang decentralisation programme by enacting two laws in 1999: on regional government (22/1999) and on the fiscal balance between the regions and the central government (25/1999, implemented in 2001). The central government decentralised most functions and resources to regencies and municipalities (*kabupaten* and *kota*) rather than to provinces. Indonesia's administration structure has 33 provinces headed by governors as the first-tier local governments. Under provinces, there are 349 regencies headed by regents and 91 municipalities headed by mayors as the second-tier local governments. A range of services under the second-tier local governments' responsibilities expanded from a limited set of construction projects, maintenance of local infrastructure and regulation of firms to include education, health, public works, communications, environmental regulations and police.

The local government structure was made more accountable to the local population. All of Indonesia's public officials from the President down to all governors and regents/mayors are now directly elected in contrast to the previous system of central appointment. The Regional House of Representatives is empowered to approve annual local budgets and local laws/regulations.

Under a new fiscal formula, local governments receive general purpose block grants from the central government, which are generally higher for local governments to meet the expanded range of responsibilities. 25% of the national budget was set aside for block grants with 90% of these allocated to all *kabupaten* and *kota* and 10% to all provinces. Constraints on local governments' ability to raise revenues through local taxes and levies were removed by Law 24/2000. In response, many local governments introduced new regulations or recycled old regulations to impose taxes and levies.

Two decentralisation laws were replaced in 2004 by Law 32/2004 and Law 33/2004 which strengthened central government control over local government staff and budgets. While power was shifted from the local legislative to the local executive, direct election of the heads of local governments was introduced, but the allocation of functions and responsibilities among centre, province and regency/city levels has not been well-defined.

Empowered by regional autonomy, new regional governments (regencies and municipalities) were formed, increasing the number of regional governments from 292 in 1998 to 440 in 2009. Dis-economies of scale due to the excessive splitting of regions have become a concern and the weakened status of provinces may need to be reconsidered to facilitate co-ordination among regencies and cities.

governments without a clear mechanism to co-ordinate legislation and implement laws. It led to a more uncertain regulatory environment for business as economic regulations were rapidly introduced or re-activated[3] at the local level. The division of responsibilities and functions between the central and local governments was not understood clearly; and local governments generally have a low capacity to manage public spending and establish a regulatory environment conducive to business.

A business survey found that about 85% of sampled local regulations are incomplete, inconsistent or distort local economic activities.[4] Despite central government regulations[5] to clarify user fee categories which can be introduced by local governments, many new local user charges do not meet the principle set in the regulations. Many local governments see new user charges/taxes as a source of revenues rather than reasonable charges to finance specific public services. Some local regulations are redundant or obstruct the free flow of goods, services and persons between districts. These local taxes and charges disproportionally burden smaller firms, especially in the trade and services sector.

Reviews of local regulations are continuing

With a proliferation of new local regulations, corrupt practices have also increased at the local level, adding to business costs. Microeconomic studies have found evidence that the number of licences imposed by local governments is positively correlated with the amount of bribes paid by firms and the correlation is higher in poorly funded local jurisdictions.[6]

Aware of the problem, the government has targeted various measures at local governments. For example, an investment climate reform package in 2006 included policies to harmonise central and regional regulations. The Ministry of Home Affairs (MoHA) has evaluated local government regulations and draft regulations and recommended the revocation of 1 123 local regulations (with 1999 others targeted for revocation) because of inconsistency with higher-level laws/regulations and estimated harm to the local investment climate. The State Ministry of Co-operatives and Small/Medium Enterprises has also submitted to the MoHA many recommendations to revoke local regulations identified as a constraint on SME development. The Committee for the Monitoring of Regional Autonomy Implementation (*Komite Pemantauan Pelaksanaan Otonomi Daerah*; KPPOD), which is an independent body responsible for monitoring and evaluating all local government regulations, has also facilitated amending or revoking problematic local regulations by reporting them to the MoHA.

The Law on Regional and Local Taxes and Levies (28/2009) was enacted to clarify and limit the discretion of local governments to introduce new taxes and levies. It is expected to solve the problem of the multiplication of new taxes and levies at local level without due consideration being given to the business climate.

3. Regulatory impact assessments

To what extent are regulatory impact assessments used to evaluate the consequences of economic regulations on the investment environment? Are the results of these assessments made public on a timely basis?

Given a large inventory of regulations which are often redundant, mutually conflicting and with a distortionary effect on economic activities, there is a demonstrable need for more regulatory impact assessments.

Use of Regulatory Impact Assessment (RIA) is still limited

Without a central unit responsible for regulatory impact assessments (RIAs), regulatory assessment has been at the sole initiative of government agencies. Since a multilateral donor project provided training to officials, the Ministry of Trade has adopted RIAs as a tool to review its regulations. The Ministry has conducted two RIAs on rattan and cocoa, and launched pilot RIAs in various policy areas such as domestic trade, import and export, bonded zones, the National Single Window, and regional regulations related to trade. Since significant power to make regulations has been transferred to local governments through decentralisation, the need for RIAs may be higher at local government level. Several agencies have been working with local governments to introduce and institutionalise a RIA process in their ordinary operations.[7]

Despite positive developments in regulatory reform, RIA has not yet taken root as part of the ordinary working of the Indonesian civil service, and governments do not carry out large-scale and systematic regulatory reviews due to capacity constraints. Although Law 10/2004 promotes the basic principles[8] commonly shared with the RIA process, it has not ensured an efficient and consistent development of laws and regulations. It has yet to be seen whether Bappenas' plan for national regulatory reform will transform Indonesia's regulatory review process.

4. Public consultation

What public consultation mechanisms and procedures, including prior modification, have been established to improve regulatory quality, thereby enhancing the investment environment? Are the consultation mechanisms open to all concerned stakeholders?

The Law on Formulating Laws and Regulations (10/2004) gives the legal right for the general public to participate in the government's regulation-making process. Article 53 of the Law stipulates that the public has the right to give its opinions orally or in writing on draft laws and draft regional/local regulations. Furthermore, the Law instructs all stakeholders to be engaged in all stages of formulating laws and regulations.

At the drafting stage, an inter-ministerial committee is formed, inviting participation by relevant stakeholders such as political and civil society groups, academics, experts and practitioners. A draft law/regulation prepared by the inter-ministerial committee is then distributed through the internet, print media or electronic media to obtain feedback from the public. Dissemination of the draft law/regulation is also conducted through seminars and focus group discussions. At the deliberation stage, public hearings are held in accordance with the rules and regulations of Parliament.

Decentralisation has generally made local governments more accountable and responsive to local communities' needs and demands. Some local governments have introduced *Forum Komunikasi*, or communication fora, between the government and the private sector as a formal mechanism to hold regular consultations on key economic policy issues.

Indonesia's private sector has been active in criticising the cost of doing business due to government regulations. The private sector is best positioned to know the impact of regulations on business and has a strong interest in promoting advocacy regarding policies and regulations affecting them to the government. The Indonesian Chamber of Commerce and Industry (KADIN) and non-governmental research organisations such as KPPOD regularly analyse government regulations and publish annual business surveys on local economic governance.[9] This information serves as public pressure on local governments to improve their regulatory environments. However, most business associations in the country, except for a few at national level, have not developed the capacity to conduct effective policy advocacy by making arguments based on a cost-benefit analysis and presenting proposals tailored to each government agent.

5. Removing red tape

To what extent are the administrative burdens on investors measured and quantified? What government procedures exist to identify and to reduce unnecessary administrative burdens, including those on investors? How widely are information and communication technologies used to promote administrative simplification, quality services, transparency and accountability?

The government has been keen to reduce the administrative burdens on investors. One of the most popular measures of these burdens is the number of steps and time taken to establish a business as used in the World Bank's *Doing Business* ranking. Indonesian government officials have been closely involved in compiling the *Doing Business* indicators. Ministries and government departments interact regularly with private business to obtain opinions on business constraints due to government red tape. However, the Indonesian government does not seem to have its own independent procedure for monitoring and measuring administrative burdens.

E-governance has been recognised by the government as an effective tool for improving efficiency and transparency and minimising corruption in public service delivery. President Wahid issued a presidential decree[10] in 2001 to promote the concept of e-governance for improving governance, government transparency and accountability, citizen participation, public services delivery and inter-connection within government. Although successive presidents have also supported the concept, application is still at the initial stage and is currently limited to customs services and government procurement[11] at the national level and public services in a few advanced cities.

6. International anti-corruption and integrity standards

To what extent have international anti-corruption and integrity standards been implemented in national legislation and regulations? Do penal, administrative and civil law provisions provide an effective legislative and regulatory framework for fighting corruption, including bribe solicitation and extortion as well as promoting integrity, thereby reducing uncertainty and improving business conditions for all investors?

Fighting corruption has been made a top priority of the government

Corruption has been a major concern for businesses in Indonesia for a long time. Although it is more than a decade since the end of the Suharto regime, which was associated with rampant corruption at the top government level, Indonesia still suffers from the negative international image in terms of corruption. Transparency International ranked Indonesia 111th out of 180 in its 2009 *Corruption Perception Index*. At the same time, however, this represents a clear improvement from 126th position in 2008 and the 143rd in 2007 and is ahead of regional peers such as the Philippines and Vietnam.[12]

The 1998 regime change did not necessarily bring a dramatic reduction in corruption although the fall of the Suharto regime has generally improved conditions affecting the quality of governance. One of these conditions which

contributes greatly to public governance is freedom of the press and civil society activism which has enhanced the role of the public as a powerful watchdog over government actions. It has been supported by the enactment of Law 11/2008 on freedom of public information. On the other hand, a democratic and decentralised system might have caused corruption to spread into lower government levels and political parties.

Although all administrations since Suharto have carried out measures to tackle corruption, they have not had a visible impact on corruption. Under President Yudhoyono, fighting corruption has been given a higher priority as his election campaign strongly focused on anti-corruption. President Yudhoyono announced national anti-corruption policies[13] leading to the formulation of a National Action Plan on the Eradication of Corruption (RAN-PK) for 2004-2009. The National Development Planning Agency (Bappenas) disseminated the RAN-PK among provinces and local governments and facilitated the formulation of Regional Action Plans on the Eradication of Corruption, engaging various stakeholders from communities, academia and local NGOs. High-profile anti-corruption campaigns were also carried out. To follow up on the RAN-PK, the government is currently developing a National Strategy for the Eradication of Corruption (2010-2025). Anti-corruption has been given a high priority again in the Medium-Term Development Plan for 2010-2014.

President Yudhoyono created a Co-ordinating Team for Eradicating Criminal Corrupt Acts in 2005 to accelerate the investigation and prosecution of big corruption cases. The team consisted of officials from various law enforcement bodies including the Attorney General's Office (AGO), the Police and the Financial and Development Supervisory Body and was authorised to collect information from all government agencies and SOEs.

Indonesian legislation is being harmonised with international standards

The Law on Eradicating Corruption (20/2001) is the main piece of anti-corruption legislation in Indonesia. Amending Law 31/1999, it expanded the definition of corruption to 30 types of criminal activities and criminalised both active and passive corruption in the public sector as well as extortion and money laundering. The Indonesian Penal Code also includes provisions for identical bribery offences. The government subsequently enacted Law 30/2002 on the commission for eradication of corruption and Law 15/2002 on money laundering.

Indonesia ratified the UN Convention against Corruption (UNCAC) in 2006. Since Indonesia decided to modify its domestic anti-corruption legislation after ratification of the Convention rather than the other way round, there remain some gaps between UNCAC and domestic anti-corruption laws. The government has conducted exercises to map these gaps including application of the self-assessment checklist for UNCAC and analysis

conducted by the Corruption Eradication Commission (KPK). One major gap identified is the absence of a criminal offence of bribery of officials of foreign countries and public international organisations. Although not mandatory by UNCAC, criminalisation of corruption in the private sector is also considered as a gap to be addressed by the government.

Since ratification, the government has continued to strengthen the legal framework for anti-corruption by enacting the Law on the Protection of Witnesses and Victims (13/2006) and the Law on the Corruption Court (46/2009). The government has also prepared a bill on asset recovery, as well as bills to amend the law on anti-money laundering, and to amend the law on the eradication of corruption which will criminalise bribery of foreign officials of international organisations as well as bribery in the private sector. Once enacted, the amendment to the anti-corruption law is expected to fill the major gaps between domestic legislation and UNCAC.

During 2009, the Indonesian government began to co-operate closely with the OECD Working Group on Bribery in International Business Transactions, in particular by regularly participating in Working Group meetings as an *ad hoc* observer. Indonesia also actively participated in the Working Group on Bribery's celebration of the 10th anniversary of the entry into force of the OECD Anti-Bribery Convention[14] on 9 December 2010 by taking part in a colloquium of major emerging economies on the fight against foreign bribery. The OECD Secretariat visited Indonesia in May 2010, and this will be followed by a technical seminar on the OECD Anti-Bribery Convention and the Working Group on Bribery's system for monitoring implementation of the Convention.

Efforts are underway internally to promote the integrity of government officials

The government recently passed Law 37/2008 establishing an ombudsman and Law 25/2009 on public services which requires the government to develop minimum service standards for public services. If the public finds any government agency unsatisfactory in meeting minimum service standards, they can complain to the ombudsman.[15] The government agency receiving complaints through the ombudsman is required under the law to respond within a specified timeframe.

The national law also promotes the integrity of local government officials. For example, Law 32/2004 on local government states that state officials, civil servants, and village heads are prohibited from making decisions or taking action to benefit or harm any candidates during an election campaign.

Several government offices have taken up their own initiatives to improve the integrity and performance of officials. Their efforts include developing a code of ethics for staff, reforming compensation schemes, and strengthening internal

and external control mechanisms. All three law enforcement agencies in the field of corruption – the Police, the Attorney General's Office (AGO) and KPK – have developed a code of conduct for their staff.[16] In addition, the Police require each officer to sign an integrity pact as a promise to perform duties in a professional manner and to prevent corruption, collusion and nepotism in executing each task. AGO has developed minimum professional standards[17] which ensure that prosecutors have sufficient capacity to perform their duties. The Supreme Court has developed a code of conduct backed by disciplinary punishment in co-ordination with the Judicial Commission. Various other government agencies with investigative or supervisory authorities have also developed their own internal codes of conduct in recent years, including the Directorate General of Taxes, the Indonesian Financial Transaction Reports Analysis Centre (PPATK), Bank Indonesia, Bapepam-LK and the Audit Board (BPK).

The Law on Freedom of Information (14/2008) increases the transparency of government activities. Full implementation of the law is expected by 2010. The Commission of Information is to be established to hear appeals from the public on access to particular information. Ahead of the national legislation, some local governments have already issued regional regulations to guarantee access to government information and community participation in development planning and budgeting within their respective jurisdiction.[18] In response, community members in several regencies have formed a committee to oversee implementation of the regulation. The Chief Justice of the Supreme Court has also issued a decree[19] to ensure the freedom of information on court activities.

7. Enforcing anti-corruption laws and regulations

Do institutions and procedures ensure transparent, effective and consistent application and enforcement of laws and regulations on anti-corruption, including bribe solicitation and extortion and integrity in the public services? Have standards of conduct by public officials been established and made transparent? What measures are used to assist public officials and to ensure the expected standards are met? Are civil society organisations and the media free to scrutinise the conduct of public officials' duties? Are whistle blower protections in place?

The Corruption Eradication Commission is the main anti-corruption agency

Established in 2003, the Corruption Eradication Commission (KPK) is the main anti-corruption agency.[20] KPK has five Commissioners who are selected by the House of Representatives from candidates presented by the President

and can serve for a maximum of two four-year terms. Investigators and prosecutors are seconded from the Police and the AGO. The 540 staff (end-2008) are selected according to professional criteria using the services of independent consultants.

KPK's main functions are to examine, investigate and prosecute corruption cases in the public sector[21] as well as to carry out corruption prevention activities including reviewing the wealth reports submitted by state officials, examining reports on gifts, and organising anti-corruption education programmes/campaigns. KPK is given the power to use a large array of investigating tools including wire tapping, travel bans, temporary halts on financial and trade transactions and other forms of contracts, temporary annulments of permits/licences/concessions and blocking of financial accounts.

From 2004 to 2008, KPK received and reviewed 31,790 complaints from the public, out of which 3% were followed up by KPK and the rest were sent to other government agencies for follow up or are awaiting more information from reporting agencies. In 2008, KPK conducted 70 preliminary investigations, 53 investigations, and 43 prosecutions.[22] It is independent from political pressures and receives regular funding. KPK has recovered a large amount of state funds as a result of its operations: from 2005 to June 2009, the amount of state funds recovered or prevented from potential loss amounted to some IDR 3.7 trillion.

While it has been criticised in the past for focusing on small-scale, easy to handle cases, a number of high-profile convictions, including 17 members of Parliament, 5 minister-level officials, the national police chief, and the former Bank of Indonesia governor, have improved the image of KPK. KPK has gained popularity among the public *vis-à-vis* other law enforcement agencies in the country.

KPK also provides advice and recommendations on the rules and procedures of various government agencies with a view to preventing corruption. For example, KPK led an advocacy campaign for civil service reform, made a recommendation to the Parliament on measures to improve the tax collection system, and assisted local governments to strengthen integrity in administration. KPK has also conducted anti-corruption education programmes for senior officials and disseminated anti-corruption information via the media and school education programmes.

In 2009, KPK fended off threats to its authority and its continued existence from various quarters. In addition, two bills put at risk the powers of KPK and the effectiveness of the Corruption Court. In September 2009, the second bill was passed, with the result that KPK kept its powers, but the balance of judges on panels in the Corruption Court was altered from a majority of *ad hoc* judges to a majority of career judges.

The Corruption Court has gained credibility in handling cases

The Corruption Court was established under the same law as KPK. It is responsible for examining all the cases brought by KPK and the only court authorised to handle corruption cases in the country. It is currently located in the District Court of Central Jakarta but has nationwide jurisdiction. Under the new Law on the Corruption Court (46/2009), a Corruption Court should be established in each provincial capital (and, in the case of DKI Jaya province, at the city level as well) within two years of enacting the law. The Court consists of a mix of career District Court judges appointed by the Chief Justice and *ad hoc* judges appointed by the President. Its decisions can be appealed in the High Court and ultimately in the Supreme Court. So far it has gained high credibility in handling corruption cases. KPK's conviction rate has been 100%. However, there are concerns that the Corruption Court will not be as effective now that the proportion of *ad hoc* and career judges has been changed.

Other institutions have also been established

The **Commission to Audit the Wealth of State Officials** was established in 2001 based on Law 28/1999 which requires public officials[23] to disclose assets and agree to periodic audits. It was absorbed into KPK's Prevention Department in 2003. While compliance with the reporting requirement has been low, the president's instruction to mandate submission of wealth reports to the KPK has increased the compliance rate. The number of submissions from mandatory reporters more than doubled between 2004 and 2008 as KPK held a number of sessions with government officials on completing wealth reports. Most government officials have also published their reports in the State Gazette. KPK has disclosed the wealth reports of high-ranking government officials.

The **National Ombudsman Commission** (*Komisi Ombudsman Nasional*; KON), established in 2000 by presidential decree,[24] is another institution responsible for corruption prevention. It reports directly to the President. KON consists of 11 members and can initiate investigations in response to reports received from the general public on irregularities in the public sector and conduct studies on ways to improve public service delivery. Since its legal basis was a presidential decree, not a law, and it was severely under-funded, its capacity was limited. Without the power to prosecute or penalise, it can only make recommendations to the government which are often not followed up. Some local governments also established a local ombudsman body which plays a mediating role between the public sector and those who are not satisfied with the performance of public services.

Law 37/2008 on the Ombudsman is intended to strengthen the role of KON by transforming it into a new independent organisation, the Ombudsman of the Republic of Indonesia (*Ombudsman Republik Indonesial*). The jurisdiction

of the Ombudsman RI has been expanded to include oversight of public services administration not only of government agencies and SOEs but also of private enterprises which provide some forms of public services or receive government funds. The Ombudsman RI is given investigative power without prior notice and can impose administrative sanctions and disciplines for non-compliance.

The **Indonesian Financial Transaction Reports Analysis Centre** (PPATK) was established under the Law on Money Laundering (15/2002).[25] The law criminalises money laundering activities and obliges financial services providers to report suspicious financial transactions to the Centre which then forwards the substantive case to the Police or AGO after screening.

Due to Indonesia's efforts to join other countries in eradicating money laundering, Indonesia was removed from the Financial Action Task Force's blacklist in 2006 after being on the blacklist since 2001. The government has prepared another amendment to the anti-money laundering law in 2008 to increase sanctions.

The **Audit Board of the Republic of Indonesia** (*Badan Pemeriksa Keuangan*; BPK) is the sole external audit authority in the country with an independent power to investigate state financial management and accountability. It can initiate investigations and publishes findings on its website. In 2006 the President enacted a law[26] to expand its jurisdiction to cover audits of central and local governments, SOEs and the judicial system. BPK's findings are followed up in accordance with the certain procedures stipulated in Laws 15/2004 and 15/2006.

The government has enacted Government Regulation 60/2008 to strengthen internal audits. The regulation covers the roles and functions of government internal auditors including the **Financial and Development Supervision Body** (*Badan Pengawas Keuangan dan Pembangunan*; BPKP), the inspectorate general of ministries, and the inspectorate of local governments. The internal auditors have a wide range of responsibilities including preparation of control plans and programmes, review, evaluation, monitoring, and other audit activities in all government institutions.

The state's financial management has been reformed to support good governance in the era of regional autonomy. It concerns not only funds but also the entire state's wealth and all the resulting rights and liabilities that may arise. The government has enacted a series of regulations[27] in this regard.

KPK must share responsibility for preventing corruption with other agencies…

The **Attorney General's Office** (AGO), particularly its Public Prosecutor's Office, can investigate and prosecute corruption cases. AGO provides

information on on-going cases handled by the office via its website. From 2004 to 2009, the amount of state funds recovered by AGO totalled IDR 13.3 trillion (USD 18 million). While the AGO has been perceived by the general public as corrupt, an Attorney General launched an AGO Reform Agenda in 2005 whose objectives included strengthening of oversight and supervision of public prosecution services among others. The reform is generally considered to have improved the quality and transparency of AGO's case management system.

The **Police** have been carrying out criminal investigations of corruption cases since before the enactment of various anti-corruption laws. Its National Corruption Crime Directorate deals with corruption in government agencies, SOEs, financial institutions and international development projects. In the past the Police were criticised for corruption and were reported to demand illegal payments from firms and individuals for security arrangements. To address these problems, it has implemented reform programmes, adopting internal codes/rules of conduct and strengthening the enforcement of the internal control and discipline.[28]

The Indonesian judiciary system judges corruption cases bought by AGO and the Police, and those appealed against KPK decisions. Aware that the judicial system is the most important institution to ensure the rule of law in the country, the government has emphasised judicial reform. Judicial reform was also initiated by the Supreme Court which released "Blueprints for the reform of the Supreme Court in Indonesia" in 2003 and established a co-ordinating team to implement reform internally.

As the three above-mentioned institutions have been considered to be corruption-prone, three commissions (*i.e.*, Judicial Commission,[29] Attorney Commission[30] and Police Commission[31]) were established in 2004 to monitor conduct of their respective officials. Power struggles between law enforcement agencies and newly established monitoring bodies have been intense.

... and co-ordination among these agencies has been a challenge

As there have been various law enforcement agencies in the country with overlapping mandates to handle corruption cases, coordination among these agencies has been a challenge and competition for power has revealed weakness in the institutional framework. Before KPK, seven anti-corruption bodies were instituted by the Indonesian government, but none could withstand pressures from other government agencies. KPK has succeeded in exerting sufficient authority and gaining credibility and popular support against the other powerful government agencies.

KPK has a mandate to co-ordinate anti-corruption efforts with other agencies and power to take over investigations/prosecutions from the Police or

AGO under certain conditions. It has signed a bilateral MOU on co-operation with various agencies including the AGO, the Police, PPATK, the Ministry of Administrative Reform (MenPAN), MOF, and KPPU. Nonetheless, KPK's authority has been challenged by other government agencies which have resisted KPK's efforts to eliminate corruption.[32] A challenge still exists to establish an optimal balance between KPK and other law enforcement agencies that would not only ensure swift co-operation in KPK's operation but also maintain KPK's independence.

Civil society groups and the media have been active in criticising corruption in the public sector

Since the fall of President Suharto, the role of civil society and the media has expanded dramatically. Participation of communities is promoted in creating a corrupt-free government by anti-corruption laws.[33] The President also issued Government Regulation 71/2000 on implementation procedures for community participation and the provision of awards in prevention and eradication of corruption which stipulates that the public is entitled to seek, obtain and provide information and opinions to relevant authorities regarding corruption cases.

Several government agencies have adopted their own mechanisms to receive information and complaints on performance from the public. For example, the Police issued an administrative guidance to respond to public complaints in 2004. The AGO operates a website[34] through which the public can report suspected corruption cases as well as problematic conduct of AGO officials. Communities can also provide inputs on judges' performance and conduct through Judicial Commission.

The number of NGOs has shot up and many of them are engaged in issues of good governance and anti-corruption.[35] A national network of NGOs active in anti-corruption issues, the *Jaringan Nasional Gerakan Antikorupsi* (GeRAK), has been formed to increase synergies and the influence of NGO members in advocacy and public awareness efforts. The media has been also very active in publicising corruption cases involving government officials.

An Agency for Witness and Victims Protection has been established to protect whistleblowers

The Law on Witness and Victim Protection (13/2006) to protect witnesses and whistleblowers in various criminal cases provides a comprehensive set of protections for witnesses who testify in courts. Witnesses, victims and whistle-blowers cannot be prosecuted for civil or criminal charges based on reports and testimony given in the past. The Law was made operational in 2009 when the Agency for Witness and Victims Protection commenced work.

KPK is also obliged under the law[36] to provide witness and whistleblower protection for those who provide reports and information on corruption cases.

Public procurement system has been reformed to eliminate bribe payments

Public procurement is one of the most corruption prone areas in the government administration in any country and was associated with the highest bribe payments in Indonesia according to the Bribe Payers Index by Transparency International in 2002. Efforts to strengthen the county's public procurement system have been supported by the government which introduced presidential regulations and developed an e-government procurement system.

Government procurement reform started with the issuance of the Presidential Regulation 80/2003 which stated that public procurement should be carried out on the basis of transparency, open and fair competition, economy and efficiency. Entry barriers to public procurement were significantly removed by reducing licence requirements.[37] Tenders are made public in newspapers or on the Internet at the national level. A national procurement office was set up and training and certification programmes were provided to procurement officers. An integrity pact among stakeholders in public procurement is now found in various regions. Building on past reforms, the government is planning to raise procurement regulations from presidential regulations to the status of national laws. However, without any mechanism to monitor the assets of government procurement officials, corrupt practices, especially collusion between bidders and government officials, are still considered to be a problem. Indonesia is not a party to the WTO agreement on public procurement.

8. Reviewing the effectiveness of anti-corruption laws

Do review mechanisms exist to assess the performance of laws and regulations on anti-corruption and integrity?

KPK regularly surveys and analyses the progress in fighting corruption

KPK is the main agency in the country responsible for studying anti-corruption regulations. It conducts periodic surveys to measure the integrity of public sector institutions, analyses other government institutions with a view to improving governance, and researches domestic laws/regulations which are prone to corruption. Administrative management of

government institutions evaluated by KPK includes: internal control/supervision of various government departments, taxation services at the Directorate General of Tax, management at the State Treasury Office, and planning of the National Budget.

Two assessment techniques – the Anti-corruption Initiative Assessment and the Corruption Impact Assessment – are currently being tested with MOF: the former is used to assess whether an institution has adopted an effective system and mechanism to prevent corruption internally while the latter is used to review laws and regulations in terms of their impact on corruption. It has conducted a study on the domestic legal framework, identifying gaps against the UNCAC obligations/standards.

There are two formal mechanisms to review laws including anti-corruption laws

There are two formal mechanisms available in Indonesia to review laws. One is a judicial review mechanism in which certain parties in accordance with the Law on the Constitutional Court (24/2003) can bring a request to review the constitutionality of certain laws to the Constitutional Court. The other is a law revision mechanism within Parliament in accordance with the Law on Formulating Laws (10/2004). Most reviews have been conducted with the latter mechanism, and a revision of the Law on eradication of corruption is on-going.

9. International anti-corruption initiatives

Is the government a party to international initiatives aimed at fighting corruption and improving public sector integrity? What mechanisms are in place to ensure timely and effective implementation of anti-corruption conventions? Do these mechanisms monitor the application and enforcement of the anti-corruption laws implementing the conventions?

As a signatory since 2006, Indonesia has been harmonising its legislation with the UNCAC

Indonesia is the fourth country in Asia to ratify the United Nations Convention against Corruption,[38] signifying its commitment to co-operate internationally in fighting corruption. The government formed an UNCAC implementation team and a team for amending the anti-corruption law to harmonise the legislation with the UNCAC. Indonesia has voluntarily participated in the UNCAC Pilot Review Programme.

Indonesia has joined a wide international network of agencies and initiatives fighting corruption

Indonesia has signed formal co-operation agreements with a large number of anti-corruption agencies overseas including in Yemen, China, South Korea, Nigeria, Vietnam, Brunei Darussalam, Malaysia, Singapore, Thailand and the United States. KPK is also engaged in various multilateral anti-corruption initiatives including the APEC Anti-corruption taskforce, the ADB/OECD Anti-corruption initiative, the ASEAN Multilateral Co-operation on Anti-corruption, the ASEAN Senior Official Meeting on Transnational Crimes, the International Association of Anti-corruption Authorities, the Anti-corruption Authorities Forum, the Southeast Asia Parliamentarians against Corruption, Interpol, the Asia/Pacific Group Money Laundering and the FATF expert forum.

The ADB/OECD Anti-corruption initiative was launched in 1999 to curb corruption and counter its negative effects on political stability, welfare, economic development, and international trade and investment. It is currently supported by 28 governments in the region and Indonesia joined the Initiative in 2001 by endorsing the ADB/OECD Anti-corruption Action Plan for Asia and the Pacific. Since then Indonesia has been represented in the Steering Group via KPK and has committed to implement its priority reform programmes under the Action Plan.

Notes

1. Article 5 (e) of Law 5/1999 on the prohibition of monopolistic practices and unfair competition assigns KPPU with the task of giving suggestions and considerations on government policies affecting monopoly practices and unfair business competition.
2. They constitute the Ministry's priority programme for 2010.
3. The central government abolished many local level taxes and charges in 1998 by enacting Law 18/1997.
4. KPPOD, USAID and Asia Foundation (2007)
5. Law 34/2004 on local taxes and local user fees.
6. Henderson, J. V. and A. Kuncoro (2006).
7. The Asia Foundation, the TAF, and GTZ have assisted local governments to conduct RIAs, gain capacity in RIA and institutionalise the RIA process.
8. The principles for formulating laws and regulations under the Law are: clarity in the objective of the law and regulation, an adequate institutional framework, compatibility between the type and the substance of the law and regulation, sufficient implementation capability, effectiveness and usefulness of the law and regulation, clarity and transparency.
9. KPPOD, USAID and Asia Foundation (2007).
10. Presidential Decree 6/2001 on ICT Development and Usability in Indonesia.

11. *http://www.pengadaannasional-bappenas.go.id/eproc/app*.
12. TI's corruption perception index measures perceptions of public sector corruption using available surveys of experts and business leaders in the past two years. It reflects subjective views of respondents. The data from surveys differ widely in methodology and completeness from country to country, making interpretation of any aggregated results from various surveys difficult.
13. Presidential Instruction 5/2004 on accelerating the eradication of corruption.
14. The full name of the Convention is the "Convention on Combating Bribery of Foreign Public Officials in International Business Transactions".
15. Complaints can be also directed to the public services provider, the House of Representatives, or Regional House of Representatives.
16. The Police code of ethics is given under the Chief of Police Regulation 7/2006; the AGO's code is set in the AG's Regulation PER-067/A/JA/07/2007; and the KPK adopted a code of conduct under the KPK Chief's Decree KEP-06/P.KPK/02/2004.
17. The AG's Regulation PER-066/A/JA/07/2007.
18. Examples include: Kebumen regency's Regional Regulation 53/2004 on community participation in public policy, Solok regency's Regional Regulation of transparency in government conduct and community participation, and Magelang regency's Regional Regulation 10/2004 on public consultation mechanisms.
19. Chief of the Supreme Court Decree 144/KMA/VII/2007.
20. Law 30/2002.
21. Under the Law 30/2002, corruption cases under KPK's jurisdiction are those involving law enforcement officers, government executives, or other parties connected to acts of corruption committed by law enforcement officers or government executives; having attracted the attention and the dismay of the general public; or involving state losses of at least IDR 1 billion.
22. KPK (2008), *Annual Report* 2008.
23. Government officials obliged to report their wealth are: staff in the state supreme institutions, staff in the state high institutions, ministers, governors, judges, staff under the regulation and legislation in force, and other staff having strategic functions under the regulations and legislation in force.
24. *Keppres* 44/2000.
25. Amended by Law 25/2003.
26. Law 15/2006 on the Audit Board.
27. The Laws on the State Finance (17/2003), on State Reserves (1/2004), and on the Audit of State Financial Management (15/2005).
28. The Police adopted the Police Code of Conduct in 2003, the Police Investigator's Code of Ethics in 2006 and an internal rule for the use of force in police operations in 2009. It has also established specific divisions responsible for enforcing internal discipline.
29. Law 22/2004 on the establishment of the Judicial Commission. The Judicial Commission supervises judges in high courts and refers serious cases to the Supreme Court after reviewing.
30. *Keppres* 18/2004 on establishing the Attorney General Commission.

31. *Keppres* 17/2004 on establishing the National Police Commission.
32. For example, the Supreme Court has openly challenged KPK's authority to investigate corruption cases by disregarding summons of the Chair of the Supreme Court and requesting a Constitutional Court review of the Law which established KPK.
33. Law 28/1999 on clean and corruption-, collusion-, and nepotism-free state administration; Law 20/2001 on eradicating corruption; and the Law 30/2002 on the commission for corruption eradication.
34. *www.kejaksaan.go.id*.
35. The most prominent civil society groups working on anti-corruption issues include Indonesia Corruption Watch, Indonesia Society of Transparency.
36. The Law on the Corruption Eradication Commission (30/2002).
37. A formal barrier to international enterprises still exists as procurement work with a value below IDR 50 billion is not available for international enterprises.
38. Law 7/2006 on ratification of the United Nations Convention against Corruption.

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Chapter 8

Other Aspects of the Policy Framework for Investment

This chapter examines other policy areas shaping Indonesia's investment climate, including trade and tax policies, corporate governance, and policies for promoting responsible business conduct. The chapter is structured around the questions set out in the Policy Framework for Investment (PFI). Each section is preceded by the relevant PFI questions, which serves as general context for consideration of the main policy areas.

1. Trade policy

Policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment.

Indonesia's trade policies have been liberalised through agreements and unilaterally. The government has supported the Doha Development Round and an APEC review suggests that Indonesia could largely meet the Bogor Goals of free trade by 2020. The Indonesian economy has also become more integrated with its neighbours as a result of continuing regional liberalisation. But although the direction of change in policies has been clear for much of the past decade, WTO commitments in terms of both tariffs and market access in services often remain below the actual level of openness, adding to uncertainty for potential investors and sectoral ministries retain considerable discretion to impose non-tariff barriers. The government has nevertheless largely resisted protectionist responses in the current crisis, as shown in the OECD-UNCTAD-WTO monitoring reports to the G20.

What recent efforts has the government undertaken to reduce the compliance costs of customs, regulatory and administrative procedures at the border?

What steps has the government taken to reduce trade policy uncertainty and to increase trade policy predictability for investors? Are investors and other interested parties consulted on planned changes to trade policy?

How actively is the government increasing investment opportunities through market-expanding international trade agreements and through the implementation of its WTO commitments?

How are trade policies that favour investment in some industries and discourage it in others reviewed with a view to reducing the costs associated with these distortions?

To what extent do trade policies raise the cost of inputs of goods and services, thereby discouraging investment in industries that depend upon sourcing at competitive prices?

If a country's trade policy has a negative effect on developing country exports, what alternative means of accomplishing public policy objectives

has the government considered, taking into account the dampening effect that such a restrictive trade policy also has on investment?

To what extent does trade policy support and attract investment through measures that address sectoral weaknesses in developing countries (*e.g.* export finance and import insurance)?

The government has reduced constraints on trade and streamlined border procedures

The Indonesian government has been pursuing various efforts to reduce constraints to trade and streamline border procedures. Expediting import and export processes has been a priority in recent years. A range of initiatives has reduced the compliance costs of customs, regulatory and administrative procedures through efficiency improvements and the development of new systems.

Customs Reform

The Indonesian Customs reform and modernisation programme since 2002 has aimed at improving trade facilitation and anti-corruption measures while keeping proper border control to secure cargo and prevent smuggling. A Customs Reform Acceleration Team was set up in 2006 to encourage further reforms. The team identified four major problem areas: effective organisation; system efficiency and procedures; human resources; and remuneration.

The Indonesian Customs has developed the concept of a Modern Customs Office to reduce corruption and policy misalignment, improve staff competence and integrity, promote accountability and deliver quality services. This concept is intended to be consistent with good governance principles and provide a fast, efficient, responsive and transparent service. Integrity is promoted through the selection of appropriate well-paid professional staff in line with expected performance improvements and with the reduction of corrupt, collusive and nepotistic behaviour.

Since the launch of the Modern Customs Office in 2007, the authorities report a large decrease in corruption. Indonesian Customs has been commended by stakeholders and the media for its good governance practices and has received awards. By June 2009, 105 existing Customs Service Offices had successfully been transformed into Modern Customs Offices, with 18 others targeted by 2010.

As a member of the World Customs Organization, the Directorate General of Customs and Excise (DGCE) put in place a basis for modernising and simplifying procedures based on the principles of the Revised Kyoto Convention and the SAFE Framework of Standards. In February 2009, the WCO

Diagnostic Mission conducted an assessment based on the Convention and the SAFE Framework and concluded that considerable progress has been made by Indonesian Customs in implementing and developing modern customs principles. In order further to improve services, Indonesian Customs has since 17 January 2010 provided 24 hour/7 days a week services at four major ports.

Ministry of Trade (MOT) Initiatives

The **Indonesian National Single Window** (INSW) was launched in November 2007 as part of the platform to be integrated in the ASEAN Single Window. It has been adopted in stages, with expanded coverage at each stage. The system contributes to establishing better accountability and transparency in customs procedures and improves customs relationships with other government agencies involved in the import clearance process. It is now in operation nationally and mandatory in the country's five main ports/airports.[1]

The INSW manages all types of export-import licences, data and information related to the handling of customs documents and the release of goods. The system integrates processes and information flows between internal systems (customs, licensing, port/airport, and other systems related to customs documents handling and goods release) automatically.

The system improves transparency and accountability in customs procedures, as well as relationships between Customs and other government agencies involved in import clearance. It is part of the government's plan to provide an electronic system that will eventually link all government institutions. To ensure implementation, officers have to follow procedures specified in the Customs System Operation Procedures and Key Performance Indicators, while businesses are obliged to follow conduct as signed in the Client Service Charter.

To Support the INSW, starting in December 2009, the DGCE implemented the Integrated Customs Services Area (*Kawasan Pelayanan Pabean Terpadu*, KPPT) in the Jababeka Area as a pilot project.

Since 2009, every Indonesian importer must have an **Importer Identification Number**.[2] A database has been established through the use of an online application system which allows importers to obtain updated Identification Number data, thus identifying the legality of the importer number easily, quickly and precisely. By 31 September 2009, 17 339 importer numbers had been integrated in the online application system. The system has been integrated into the INSW.

A **Single Exporter Identity Number** system is needed to minimise fraudulent practices in international trade, identify the needs of exporters and comply with bilateral and international trade agreements. As with imports, the MOT intends to develop an online database of exporters accessible by investors and all stakeholders so that the authorities can monitor the activities of

Indonesian exporters. The MOT has up to now had difficulty obtaining firms' export performance reports through the issuance of a commodity export notification and on the basis of foreign exchange earnings, which ultimately affects its ability to monitor and evaluate the activities of Indonesian exporters.

The **Trade Service Unit** (UPP), inaugurated on 5 March 2007, is an integrated trade licensing service for both domestic and foreign applicants and provides a multitude of licences. It aims to reduce the time and cost needed for licensing and registration from between 5-15 working days previously to an expected 1-5 business days.

INATRADE, an electronic licensing (e-licensing) system for export and import activities, since 17 December 2007, allows applications for import licences to be obtained electronically, although supporting documents such as recommendations from relevant technical agencies and photos must still be submitted in person to the MOT. The INATRADE system has been integrated with the INSW system that has been mandatory for import licensing in Tanjung Priok Port since the end of 2008 and has allowed for the electronic issuance of 33 out of a possible 78 licences. It was expected that by the end of 2009 all types of import licence could be processed through INATRADE and later incorporated in the INSW.

The government has reduced trade policy uncertainty

The government is committed to increase predictability and certainty to make the country more attractive to investors. The MOT has minimised regulatory changes and has compiled an inventory of trade regulations on its website. The MOT and other agencies have actively conducted stakeholder consultations through which stakeholders' interests and concerns are considered and often incorporated in implementing regulations.

The government is obliged to maintain effective lines of communication, consultation, and co-operation with both domestic and foreign investors when introducing new policies that may affect investment and trade and has become more open to feedback and suggestions to improve, modify or revoke existing laws and regulations. The Indonesian Chamber of Commerce and Industry and certain representatives of foreign chambers in Indonesia have participated actively in policy formulation.

For transparency purposes, the government continues to improve the notification obligation, as well as fully to support the G20 measures on trade policy transparency.

Indonesia pursues a triple-track strategy in its trade diplomacy

Indonesia follows a triple-track strategy in international trade relations: multilateral (under WTO auspices); regional (centred on ASEAN and between

ASEAN and dialogue partners); and bilateral trade and investment agreements. At a multilateral level, the government supports the Doha Development Round and reports that it has adopted and implemented policies to ensure full and effective implementation of the Uruguay Round outcomes within the agreed timeframe in a manner consistent with the letter and the spirit of the WTO Agreement. Indonesia has made commitments in several service sectors under the General Agreement on Trade in Services (GATS), including in finance, telecommunications, tourism and construction. Indonesia's existing regulations are much more open than its WTO commitments. Bound tariffs are still several multiples of actual applied tariffs, leaving ample policy space to raise them without contravening WTO obligations.

Indonesia is committed to implementing APEC's target of open and free trade for developing country members by 2020 on a voluntary and non-binding basis, as set out in the 1994 Bogor Declaration. Based on the APEC Individual Action Plan (IAP) Peer Review in 2009, Indonesia is on a trajectory to achieving the Bogor Goals by 2020. The APEC study makes reference to major tariff reductions both as part of the Tariff Harmonisation Programme and through trade agreements.

As a member of ASEAN, Indonesia is a signatory to a 2007 accord to establish the ASEAN Economic Community. Under the ASEAN framework, Indonesia has been party to several free trade agreements (FTAs) signed between ASEAN members and other countries in the region: Australia-New Zealand, China, Japan and South Korea. The agreement with Japan entered into force on 1 January 2008 for many ASEAN countries and has just been ratified by the Government of Indonesia. ASEAN-China and ASEAN-ANZ entered into force on 1 January 2010.

The government signed a broad Economic Partnership Agreement with Japan in August 2007 which included provisions for, *inter alia*, technology transfer and the temporary migration of certain categories of Indonesian workers (*e.g.* nurses) to Japan. Other bilateral FTAs are under consideration, including with Australia, India and Turkey.

Trade policies – like other policies – are subject to stakeholder consultation

Trade policies – like other policies – are subject to stakeholder consultation. Regulatory impact assessments are also conducted to analyse the effect of the regulation, but the method has not been fully internalised. In practice, there have been cases where certain sectoral incentives have disadvantaged other sectors.

A National Team on Exports and Investment Promotion (PEPI) was established in 2006.[3] It is chaired by the President and its members consist of

ministers and some heads of government agencies. In addition to formulating investment and export-promoting policies, PEPI also reviews and resolves strategic problems encountered in the process of improving exports and investment. PEPI has been assigned to undertake cost-benefit analyses of the net impact of sectoral trade policies. PEPI has helped to overcome trade obstacles and is expected to be revitalised under the new administration.

An Export Guarantee Agency has been set up

In the area of trade finance, the government enacted Law 2/2009 (October 2009) to establish a specialised agency to help finance, guarantee and insure qualified Indonesian exports. The Export Guarantee Agency, which transforms an existing Export Bank of Indonesia, has now become operational and will provide semi-sovereign guarantees on certain export products and activities.

2. Tax policy

To fulfil their functions, all governments require taxation revenue, but the way in which revenues are raised crucially affects the business climate. The level of the tax burden and the design of tax policy, including how it is administered, directly influence business costs and returns on investment. Sound tax policy enables governments to achieve public policy objectives while also supporting a favourable investment environment.

Foreign-owned companies incorporated in Indonesia receive the same tax treatment as domestic companies. The Indonesian tax system differentiates between tax residents and non tax residents. Companies incorporated or domiciled in the country are tax residents subject to taxes on worldwide income, while companies not incorporated or domiciled in the country but earning income from or operating in Indonesia are non-tax residents subject to taxes only on Indonesia-source income. The withholding tax rates for non-tax residents are mostly set at 20%, above the 15% rates prescribed for tax residents. Branch offices owned by non-residents are subject to an additional profit tax of 20%, making the effective branch company tax around 40%.[4] Tax residents from treaty partner countries may enjoy treaty benefits including reduced withholding tax rates between 5-15% as well as reduced branch profit tax rates. Exemption is granted if branches re-invest their profits in the form of shares in a newly established company within one year.

The government has a regular review mechanism to monitor the tax burden on enterprises. The Director General of Taxes (DGT) maintains a strategic plan on tax administration which sets out the objectives, action plans and key performance indicators for a 5-year period. The plan is based on the

past performance of tax collection and administration. It is used as a framework for DGT to monitor its policies and performance and is evaluated every three months. The actual tax burden on businesses is one of the factors analysed.

Decentralisation since 1999 has spawned many local taxes and user charges. To overcome the problems, in September 2009, the government enacted a law[5] to limit the taxing authority of local governments. The law prescribed a closed-list of 46 types[6] of taxes chargeable by local governments. Local governments are prohibited from collecting any taxes and charges other than those on the list. The new law is expected to provide more certainty in the local business environment than the previous law, which allowed local governments *carte blanche* in imposing taxes.

The government regularly reviews fiscal incentives for investments

The government reviews fiscal incentive policies regularly against their expected objectives which may include attracting investments, developing micro, small and medium enterprises (MSMEs) and fostering economic growth in poorer regions. Proposed fiscal incentives are evaluated by DGT by analysing their effect on tax burdens of enterprises and revenue collection and organising consultations. For investment and trade incentives, a working group set up under PEPI can serve as an inter-ministerial forum to analyse, discuss and decide on a proposal on specific incentives put forward by sectoral ministries/departments (see Chapter 3 for investment incentives).

Business surveys and academic research often confirm that fiscal incentives are not one of the most important determinants for attracting investments. Many incentives end up subsidising investments which would have been made even without incentives, create rent-seeking opportunities and complicate tax administration. Indonesia itself has provided some examples of ineffective tax incentives in the past. The government is, hence, aware of the limitation of using the tax policy alone to influence investment decisions; and has emphasised more important areas such as macroeconomic stability, infrastructure and public governance.

The OECD *Checklist for FDI Incentive Policies* lists policy choices for consideration in designing investment incentives. Incentives should be transparent to maximise their intended effects, reduce incentive-related tax planning opportunities and facilitate cost-benefit analyses. Since incentives in one country may affect others, international co-operation can be beneficial. Adherents to the OECD *Declaration on International Investment and Multinational Enterprises* are committed to make incentives as transparent as possible and to conduct consultations and reviews.

Tax incentives are available to assist MSMEs and poor regions and for industrial policies to promote activities or sectors. The new Income Tax Law

(36/2008) reduced the corporate income tax rates from 30% to 28% in 2009 and further down to 25% in 2010; and provided an additional 5% rate discount for publicly listed companies that have at least 40% of shares traded in the local stock exchange market. Since the new Law has made Indonesia's corporate tax rate competitive in the region and reduced the corporate tax burden, it may be appropriate now to review the effectiveness of specific fiscal incentives.

The government has provided tax incentives for investments in certain business sectors and regions. Currently Government Regulation 1/2007[7] determines a list of business sectors and regions eligible for investment incentives which reflect the country's strategy to develop specific industries in certain regions. Indonesia also has area-based incentives as part of regional development schemes: for example, all businesses in an Integrated Economic Development Area (KAPET) can benefit from the same tax facilities as those provided under GR 1/2007.[8]

A new law on special economic zones (SEZ)[9] enables the government to provide a comprehensive package of incentives including the same standard investment incentives to a specific area. Instead of pre-determining industrial sectors or areas eligible for incentives, the SEZ scheme is more flexible and demand-driven.

Design and implementation of tax incentives have been improved to minimise opportunities for unintended tax planning. The criteria for incentives are clearly stated in government regulations and a mechanism for administering the provision of incentives has been strengthened. DGT has been active in issuing new regulations/guidelines to avoid the abuse of tax incentives or specific exemptions by tightening the requirements for granting tax incentives and exemptions. For example, DGT Regulations[10] in November 2009 tightened the procedures required to benefit from reduced withholding tax rates by imposing additional forms to be endorsed by the tax authority in the relevant entity's own jurisdiction.

Estimates of the impact of tax incentives on the national budget are carried out annually by the government and the continuation of certain tax incentives is possible only if the budgetary impacts are justified *vis-à-vis* potential benefits. The current government regulation[11] to provide fiscal incentives for investment includes a clause to mandate evaluation of the regulation within two years of implementation.

Tax administration has become more efficient

A series of tax administration reforms were carried out after the Asian economic crisis and are continuing. These reforms aim to increase the level of tax compliance, improve the quality of tax administration services and

strengthen the integrity of tax officers. In particular, as of the end of 2008, the government had streamlined and automated the business process, introduced a new directorate to manage human resources and transformed 331 modern tax offices throughout the country. They have contributed not only to raising revenues significantly[12] but also to improving the investment climate.

Indonesia has concluded 59 bilateral tax treaties

Indonesia has expanded its tax treaty networks to 59 double taxation avoidance treaties already in force and is currently negotiating with more countries as of January 2010 (Annex E). General provisions in the tax treaties intend to eliminate double taxation and reduce the withholding tax rate applied on passive income to 5%-15% instead of 20% as a general rule. Exchange of information between treaty parties is promoted to assist in administering tax policies.

In addition to co-operating with other countries to counter abusive cross-border tax strategies, the government has strengthened its domestic regulations to prevent abusive cross-border tax planning practices such as transfer pricing. These efforts have included: applying thin capitalisation; strengthening anti-avoidance rules,[13] and upgrading disclosure requirements for taxpayers on transactions with related parties. These measures are generally consistent with the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

Follow up on tax policies reform

Although the government has improved tax structures and administration, continued efforts are required to reduce excessive tax burdens and streamline tax administration. One step could be to develop answers to the relevant questions in the *Policy Framework for Investment* (PFI) and to design a roadmap for investment-related tax reform. This could be done in cooperation with the OECD Centre for Tax Policy and Administration (CTPA) using the detailed guidance on the PFI's Tax Chapter which CTPA has developed as a contribution to the *PFI User's Toolkit*.

3. Corporate governance

The degree to which corporations observe basic principles of sound corporate governance is a determinant of investment decisions, influencing the confidence of investors, the cost of capital, the overall functioning of financial markets and ultimately the development of more sustainable sources of financing. Improved corporate governance can lead to higher productivity and therefore faster economic growth.

What steps have been taken to ensure the basis for a corporate governance framework that promotes overall economic performance and transparent and efficient markets? Has this been translated into a coherent and consistent regulatory framework, backed by effective enforcement?

How does the corporate governance framework ensure the equitable treatment of shareholders?

What are the procedures and institutional structures for legal redress in cases of violation of shareholder rights? Do they function as a credible deterrent to such violations? What measures are in place to monitor and prevent corporate insiders and controlling owners from extracting private benefits?

What procedures and institutions are in place to ensure that shareholders have the ability to influence the company significantly?

By what standards and procedures do companies meet the market demand for timely, reliable and relevant disclosure, including information about the company's ownership and control structure?

How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable to the company and its shareholders? Does the framework also recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises?

What has been done, and what more should be done in terms of voluntary initiatives and training to encourage and develop a good corporate governance culture in the private sector?

Has a review been undertaken of the national corporate governance system against the OECD Principles of Corporate Governance? Has the result of that review been made public?

How is the ownership function of state-owned enterprises (SOEs) structured to ensure a level playing field, competitive market conditions, and independent regulation? What are the processes in place to ensure the state does not interfere in day-to-day management of SOEs and that board members may effectively carry out their role of strategic oversight, rather than to serve as a conduit for undue political pressure? How are SOEs effectively held accountable to the government, the public, and to other shareholders (if any)?

Indonesia has made progress in establishing a corporate governance framework

In the past decade Indonesia has made progress in developing a corporate governance framework based on its concept of Good Corporate Governance (GCG). GCG principles were first introduced into law in 1995 but were not supported by the necessary institutional arrangements before the Asian economic crisis. Since then, internal calls for reform have been supported by external pressure and the elements of a corporate governance structure have been put in place. The key remaining task is to strengthen implementation and enforcement of measures to ensure corporate transparency and accountability.

Corporate governance problems were a major contributor to Indonesia's economic collapse in 1997-1998. During the 1990s, a weak institutional environment allowed corporate groups linked to banks to borrow excessively at low cost. Concentration of ownership was the highest in Southeast Asia: ten families controlled over half the corporate sector. Firms were able to disguise their financial position, overstate profitability and continue to operate even after they were no longer financially viable.[14]

IMF loans to Indonesia were conditional, *inter alia*, on improvements in corporate governance, including for state-owned enterprises. In 1999, the Indonesian government signed a Letter of Intent with the IMF that encouraged the establishment of an institutional framework to ensure the implementation of the GCG principles. It then established a National Committee on Corporate Governance Policy (KNKCG) to recommend national GCG principles. In its Letter of Intent to the IMF of January 2000, the Indonesian government set out a programme that included adopting a new code of corporate governance, as well as strengthening capital market regulation at the Securities and Exchange Commission (Bapepam) and improving the oversight of nonbank financial institutions by the Ministry of Finance.

Many Indonesian companies are family controlled. Weak rules on independence of non-executive directors, related party transactions and takeover protection for minority shareholders, suggest that many of them are still run for the benefit of their controlling shareholders. Insider trading and market manipulation are commonplace, surveillance and enforcement are weak and the legal process cumbersome.

Progress could be made with proper implementation and enforcement of the new Company Law (2007) and the revised Corporate Governance Code (2006), which draws on the OECD *Principles of Corporate Governance*. Harmonisation of Indonesia's national accounting and auditing standards with international standards would also be an important step forward.

Box 8.1. **Laws, regulations and rules on corporate governance in Indonesia**

Company Law [1/1995]

Capital Market Law [8/1995]

Good Corporate Governance Code 2006

Indonesian Financial Accounting Standard

Good corporate governance implementation for regular banks including state banks

State-Owned Enterprise Law [19/2003]

Company Law [40/2007]

The 2007 Company Law enshrines principles of Good Corporate Governance

In principle there are three main inter-related pillars influencing GCG implementation: the state (consisting of legislative, executive, judicial and non-structural institutions), the private sector and society as a whole. The main regulatory measure to ensure good corporate governance is the Company Law enacted in 2007 that replaced the previous Law of 1995 which had first introduced GCG principles. The 2007 Law stipulates a two board system consisting of a Board of Directors and a Board of Commissioners. GCG principles of transparency, accountability and fairness also feature in the 1995 Capital Market Law and in regulations governing state-owned enterprises (SOEs) and banking. Since 2001 all listed companies have been required to have an independent commissioner and an audit committee.

Corporate governance guidelines were first published in 2001

The National Committee on Corporate Governance Policy creates general and sectoral codes and publishes best practices of corporate governance and technical guidelines for a whistle-blowing system (issued in 2008). The Committee published General Guidelines on Good Corporate Governance in 2001[15] and Corporate Governance Guidelines for the Banking Industry (2004) and for insurance and reinsurance companies (2009), as well as Guidelines on the Effective Appointment of Independent Commissioners and Establishment of Audit Committees in 2004. In 2004, the Committee was renamed the National Committee on Governance Policy (KNKG) and its remit was extended to include the public sector.

In 2006 KNKG revised the 2001 Guidelines, renaming them the Good Corporate Governance Code.[16] The Code focuses more strongly on disclosure

and transparency, while continuing also to promote accountability, responsibility, independence and fairness. It specifies a clearer role for the state, business and society in implementing GCG principles and includes general guidelines for implementing business ethics. To support the Board of Commissioners, the Code stipulates setting up audit, risk policy, nomination and remuneration, and corporate governance committees. It is aimed at empowering corporate management through strengthening directorship, risk management, internal audit/control, communication and corporate social responsibility. Corporate responsibilities are imposed towards stakeholders other than shareholders, including employees, business partners, the community and consumers. There is a new requirement for companies to issue a Statement of Implementation of GCG principles and practical guidelines for such implementation. The Statement must be included in the company's annual report and the company must disclose and justify any failure to implement the principles.

As well as government-initiated undertakings, there are several non-governmental organisations whose main purpose is to establish, monitor and improve the implementation of GCG principles, including the Forum for Corporate Governance in Indonesia,[17] the Centre for Good Corporate Governance,[18] the Indonesian Institute for Corporate Directorship, the Indonesian Institute of Corporate Governance, *Ikatan Komite Audit Indonesia* and the Indonesian Society of Commissioners. In addition, the Indonesian Chamber of Commerce and Industry has drafted a roadmap of GCG implementation in Indonesia.

GCG certification of directors and commissioners is available, but not yet compulsory

A training and certification programme in GCG principles has been instituted for directors and commissioners by the Indonesian Commissioners and Directors Institute (*Lembaga Komisaris dan Direksi Indonesia*, LKDI). LKDI has 241 members drawn from directors and commissioners of SOEs and private enterprises. Under the auspices of KNKG, LKDI has been promoting change agents in corporations that have consistently exercised GCG principles since 2001. Other educational institutes and training agencies also participate in the programme. Directors and commissioners are not yet required to have GCG certification, but the government considers that there is a need to introduce such a requirement. The government intends to develop systems, structures and processes that will encourage improvements in corporate culture. As a longer term measure, the government intends to support the inclusion of modules on ethics and governance in basic education up to tertiary level.

Sanctions to enforce GCG regulations are currently only available in the financial sector

The enforcement of regulations for implementing GCG principles does not yet include effective sanctions, except in the banking sector and in capital markets, where the Capital Market and Financial Institutions Supervisory Body (Bapepam-LK) can impose sanctions for violations of administrative law or its implementing regulations committed by any party that has obtained a permit, approval or registration from Bapepam. Sanctions imposed by Bapepam can include: written warning, fines, cancellation of business activities, freezing of business activities, revocation of a business licence, cancellation of the agreement and cancellation of registration. Delays in reporting can incur a fine from IDR 1 million per day up to a total of IDR 500 million.

In its 2004 Report on the Observance of Standards and Codes (ROSC) in Corporate Governance in Indonesia[19], the World Bank recognised that Indonesia had put in place an "elaborate system of formal corporate governance rules" which, in several respects, "may not be substantially different from OECD countries". However, it also noted that actual corporate governance practices often fall short of the recommendations of the OECD Principles. The challenge, it said, now lies in "raising awareness and increasing effectiveness of implementation and enforcement of legislation and regulations to improve the corporate culture and practices". Since the 2004 ROSC, there has been a major development of corporate governance in Indonesia. For example, there have been revisions to several regulations concerning internal audits and annual reports which require companies to report on GCG implementation.

The 2007 Company Law is designed to ensure a level playing field for shareholders

The 2007 Company Law replaced a 1995 Law and aims to provide more comprehensive regulation to accommodate the urgency of GCG in Indonesia's increasingly dynamic and modern business environment. Under the 2007 Law, the corporate structure of a Limited Liability Company (*Perseroan Terbatas*, or PT) consists of three main bodies: the general shareholders meeting (GSM), the board of directors (BOD, the executive board) and the board of commissioners (BOC, the supervisory board). These three bodies share equivalent and proportional roles and functions in the company, with no one body higher than the others.

A major exception to the "one share, one vote" provision is the *dwiwarna*[20] share in privatised state-owned enterprises, for example Bank Mandiri, the minerals producer Antam, and the former telecommunications duopolists Telkom and Indosat. This "golden share" held by the government

enjoys veto rights with respect to the election and removal of directors and commissioners and to amendments to the articles of association.

The existence of *dwiwarna* stock is based on shareholders' agreement and is subject to applicable rules and regulations. The aim is to ensure legal certainty for the government as a minority shareholder in the company. With the ownership of *dwiwarna* stock, the government has the right to determine the composition of the Board of Directors, the extent of capital and the dismissal of the Board. Since the privatised strategic SOEs in which the government retains *dwiwarna* stock are public listed companies, their operation must be conducted in accordance with capital market rules, sectoral regulations and the principles of Good Corporate Governance. The government's current policy is to maintain controlling stakes in future privatisations of strategic SOEs to avoid using *dwiwarna* shares.

Legal redress is available for shareholders if their rights are violated

Every shareholder is entitled to submit a civil claim with the district court against the company if it is alleged to have harmed the shareholder unfairly and without a reasonable excuse as the result of decisions by the GSM, or the Boards of Directors and Commissioners. Every shareholder with at least 10% of voting shares can submit a civil derivative claim with the district court against members of the Board of Directors alleged to have harmed the company by a fraudulent or negligent act [Article 97(6)]. There are no special courts to litigate or challenge matters related to corporate governance and no bodies which are empowered to mitigate or arbitrate disputes.[21] However, Bapepam can apply sanctions on any party that violates the rules, as noted above.

Minority shareholder protection is covered by the Company Law, which stipulates that every shareholder is entitled to demand that the company buy his/her shares at a fair price if the shareholder disagrees with a corporate action detrimental to the interests of shareholders or of the corporation such as an amendment to the Articles of Association, the transfer or pledge of company assets exceeding 50% of net value, or a merger, acquisition, consolidation or spin-off.

Every shareholder representing at least 10% of total shares with voting rights can submit a request to the district court to appoint independent experts to investigate the corporation if it or the Boards of Directors or Commissioners have caused harm to shareholders, the corporation or to a third party due to an allegedly unlawful act.

Any issuance of new shares in conjunction with a GSM resolution to increase the capital of a corporate entity must first be offered to each existing shareholder in proportion to the number of shares he/she owns.

The Company Law accommodates the principle of "piercing the corporate veil" which states that shareholders will lose limited liability status if they are found to have deliberately used the company for their own benefit. In such a case, the "corporate veil" of limited liability will be lifted and the shareholders' liability will extend to their individual liability.

Although an Advocacy and Protection Institute of Proxy Investors (LAPPI) and an Indonesian Capital Market Arbitration Body (BAPMI) have been established, the role and function of LAPPI have not yet been exercised effectively.

Regulations for disclosure have been promulgated

Shareholders have the right to use the GSM to obtain information. Companies must create a list of shareholders in accordance with regulations. They must provide all information relating to the company – excluding genuinely confidential information – to shareholders on a timely and regular basis. This information must be provided to all shareholders regardless of the type of shares owned. Companies must provide accurate information on the conduct of the GSM. Shareholder rights are also protected by a Bapepam rule stating that the Audit Committee chairman shall be an independent commissioner.

Similar provisions govern the capital market in accordance with a Bapepam-LK regulation which requires that a GSM approving a public offering must also decide the maximum number of shares that will be issued to the community and empower the BOC to declare the number of shares issued in the public offering.

Disclosure standards and procedures are set out in a regulation of the Chairman of Bapepam-LK which stipulates that shareholders with more than 5% of shares must submit a report to Bapepam-LK on their ownership and any changes to it that have occurred within 10 days of the transaction concerned. The disclosure of information relating to stock classification is via financial statements and annual reports which must be published immediately. Another activity that promotes the quality and implementation of corporate governance is the Annual Report Award, a collaborative activity conducted since 2002 by seven organisations (Bapepam, BI, the Indonesian Stock Exchange, the Tax Office, IAI, the SOEs Ministry and KNKG).

The Bapepam Regulation on disclosure requires every public company or issuer to submit to Bapepam-LK all information or material facts that may affect the value of issued stock and the investment decisions of investors. Information includes good corporate governance practices, the remuneration of directors and commissioners, a description of the company's internal control and audit system, details of the risks and risk management efforts,

and the corporate social responsability (CSR) activities related to the community and the environment. Such information must also be publicly disclosed not later than two working days after the IPO proposal is approved.

Every public company or issuer is required to submit an annual financial report to Bapepam including the balance sheet, profit and loss account, changes in equity holding, cash flow statement and other required financial reports. Every issuer must submit information to Bapepam if it conducts a transaction containing any conflict of interest or that changes its business.

The Board of Directors of a company is advised by a Board of Commissioners

The Board of Directors (BOD) must act as a representative of the company and is responsible for negligence in managing the company. The Board of Commissioners (BOC) supervises the general approach of management and advises the BOD. The BOC oversees and provides advice to the BOD in managing the company in accordance with the company's purposes and objectives. The BOC consists of one or more members.

The World Bank has assessed Indonesia's corporate governance framework

Indonesia's corporate governance framework was assessed in 2004 by the World Bank, in co-operation with Bapepam-LK and the IMF, under the Reports on Observance of Standards and Codes (ROSC) for Corporate Governance (World Bank, 2004). The World Bank assessment is somewhat out of date, especially bearing in mind the enacting of the new Company Law in 2007, but, as it used the OECD *Principles of Corporate Governance* as the benchmark, it nevertheless provides a helpful reference. In 2009 this programme was continued through the ROSC Financial Services Assessment Programme, which covers corporate governance practices in Indonesia. Completion of this programme is scheduled for 2010.

The OECD has not conducted its own review of Indonesia's corporate governance framework, although some type of review could be explored. The OECD's work with Indonesia on corporate governance takes place primarily through regional initiatives, notably the Asian Roundtables on Corporate Governance and the Asia Network on Corporate Governance of State-Owned Enterprises. Since 1999, the Asian Roundtable has played an important role in the region, gathering senior decision-makers committed to understanding current corporate governance problems and providing policy options to address them. The Roundtable relies on analytical work and open dialogue based on practical experience. Over the years, it has developed an Asian consensus on realistic goals and recommendations for action, to which

Indonesia has actively contributed, notably the Asian White Paper on Corporate Governance (OECD, 2003) and the Guide on Fighting Abusive Related Party Transactions in Asia (OECD, 2009b).

Indonesia is still facing several challenges in its efforts to improve corporate governance, notably in enhancing the capacity of its regulators and improving the protection of shareholders' rights and board responsibilities in practice. There is a strong demand for deepening the dialogue between the OECD and Indonesia. A bilateral programme on corporate governance is being explored.

Indonesia already benefits from access to dialogue on key corporate governance policy challenges, both in global and regional fora. Most recently, Indonesia has been an observer in the OECD Steering Group on Corporate Governance and its Working Group on Privatisation and Corporate Governance of State-Owned Assets. Also, the Global SOE Network provided an opportunity to benefit from the experience of countries around the world with respect to transparency and accountability issues, and other SOE governance reforms. Most recently, the Asian Roundtable on Corporate Governance provided an opportunity to compare in-depth the policy framework and practices on related party transactions in Indonesia with its neighbours in India and China. Improvements on these and other corporate governance issues help Indonesia to create a better climate for investment and develop more active capital markets, contributing to its economic growth and financial stability.

State-owned enterprises are included in Indonesia's corporate governance framework

State-owned enterprises (SOEs) are defined in the SOE Law (19/2003) as business entities all or most of whose capital is owned directly by the state. The Law distinguishes between enterprises in strategic sectors in which government intervention is needed and companies that have established limited liability to become more efficient, profitable and professional. SOEs that undertake public offerings must comply with the Capital Market Law.

SOEs are required to comply with sectoral and technical regulations in exactly the same way as other companies. For example, SOEs not using state funds for the procurement of goods and services are exempt from government procurement procedures so that they can be more efficient and not lose business momentum. A decree by the Indonesian Minister for State-Owned Enterprises stipulates that all companies owned by the state have an obligation to use the Code of Good Corporate Governance as a basic operational supplement.[22]

Several legal provisions have been designed to restrict government intervention in SOE management and ensure that SOEs can operate independently. The appointment of the Board of Directors in SOEs is

conducted by independent consultants through a fit and proper test mechanism, as stated in the SOE Law. The length of service of Boards of Directors and Commissioners in these firms is limited to two periods. Board members (BOD and BOC) of SOEs are prohibited from joining or campaigning for political parties at both central and local government levels.

SOEs are required to have a Statement of Corporate Intent which expresses the company's commitment to shareholders in a contract that emphasises the strategies and efforts of the BOD and the BOC in managing the company. This is applied on an annual basis in the form of management contracts that contain key performance indicators to be achieved within one year and are submitted along with the work plan and the company budget.

To promote SOE accountability, the government has disseminated GCG information to all 141 SOEs. The government periodically employs independent parties to monitor GCG implementation. SOE BOCs are supported by several committees, including an Audit Committee, a Risk Management Committee and a Committee on Remuneration and Nomination. The number of SOEs that have an independent commissioner is increasing.

The Ministry of State Owned Enterprises requires SOEs to set up committees to support boards in performing their functions. The first notion of enforcement was by produced a 2002 Ministry Decree on Audit Committees that established the procedure and structure concerning SOE board audit committees. However, not all SOEs were at this time obliged to establish audit committees. Audit committees were mandated for publicly-listed SOEs, those in the financial and banking sectors, SOEs being prepared for privatisation and those with assets over IDR 1 billion.

In 2006, the Ministry of State Owned Enterprises replaced this with a new decree under which every SOE must have an adequately-structured audit committee. The new decree also refined committee procedures and further defined the committee's duty to support the board. However, recent evidence suggests that even though the decree gives appropriate guidelines concerning audit committee duties, some committee members still find it difficult to define and separate their duties from those of the internal and external auditors.

Some SOEs, particularly the publicly-listed companies, have moreover established specialised board committees in areas such as risk management, remuneration and corporate governance. Not all enterprises have been able to establish the specialised committees other than audit committees.

4. Policies for promoting responsible business conduct

Public policies promoting recognised concepts and principles of responsible business conduct (RBC), such as those recommended in the OECD *Guidelines for Multinational Enterprises*, help to attract investments that

contribute to sustainable development. Such policies include: providing an enabling environment which clearly defines the respective roles of government and business; promoting dialogue on norms for business conduct; supporting private initiatives for RBC; and participating in international co-operation in support of RBC.

RBC entails above all compliance with laws such as those on respecting human rights, environmental protection, labour relations and financial accountability, even where these laws are poorly enforced, and also responding to societal expectations communicated by channels other than the law, *e.g.* intergovernmental organisations, within the workplace, by local communities and trade unions, via the press. Private voluntary initiatives addressing this latter aspect of RBC are often referred to as corporate social responsibility (CSR).

A reform drive after the fall of the Suharto regime has led Indonesia to strengthen its legal framework on protecting basic human rights and labour (union) rights by amending domestic legislation and ratifying relevant international conventions. Greater democracy has encouraged civil society groups and the media, contributing to better enforcement of basic human and labour rights as well as labour and environmental standards. Ultimately, the capacity, integrity and efficiency of the judicial system need further improvement to ensure that violation claims are fairly prosecuted.

Indonesia has enshrined RBC principles in several recent laws including in the Investment Law. Although details are to be developed in implementing regulations, it demonstrates Indonesia's strong will to promote RBC. The government has also been encouraging enterprises to embrace RBC principles in their core business strategy and investment. Reform efforts here should be deepened and awareness raised that adoption of RBC principles is more than an additional cost to comply with laws and regulations.

Awareness of RBC/CSR has gradually been increasing among enterprises, albeit from a low base. It is partly because civil society groups have not developed as strong watchdogs of enterprises' conduct, and consumer awareness has not been high enough to influence business conduct. Government efforts to promote disclosure of RBC/CSR activities have been commendable as disclosure is an important step to mobilise public pressures. Further guidance to enterprises in terms of the quality standards of disclosure and development of a system to check the quality may be useful.

The government has already experimented with various measures to strengthen a business case for RBC, especially in the areas of environmental protection. Exchange of experience and good practices at international fora such as corporate responsibility roundtables hosted at the OECD within the

framework of the OECD *Guidelines for Multinational Enterprises* would be valuable.

> How does the government make clear for investors the distinction between its own role and responsibilities and those ascribed to the business sector? Does it actively assume its responsibilities (*e.g.* by effectively enforcing laws on respecting human rights, environmental protection, labour relations and financial accountability)?
>
> What steps does the government take to promote communication on expected responsible business conduct to investors? How does the government endeavour to protect the rights framework that underpins effective communication?

The legal framework for human rights protection has been strengthened since 1998

After the end of the Suharto regime, a drive began to reform legislation in order to recognise and protect basic human rights. Multinational enterprises operating in Indonesia brought in RBC practices which were adopted by their headquarters in response to international expectations. Indonesia's legal framework at the time only weakly protected these rights, and hence the government has devoted much effort to address this weakness by reforming domestic laws and ratifying international laws.

In 1999, Indonesia enacted the Law on Human Rights (39/1999) which states that the principal responsibility for protecting, promoting, upholding, and fulfilling human rights lies with the government. The Law also has provisions for setting up the National Commission on Human Rights[23] which conducts research, disseminates, monitors and mediates human rights issues as well as the Human Rights Court[24] which hears and rules on cases of gross violations of human rights. While other legislation also refers to human rights in specific areas, the enactment of the Law on Human Rights demonstrated the government's commitment to improve the country's human rights protection framework.

The government subsequently enacted Law 40/1999 to guarantee freedom of speech from any government interference. The Indonesian constitution was amended repeatedly between 1999 and 2002 to strengthen basic human rights, especially the fourth amendment to the Constitution in 2002 which expanded the coverage of human right protection under Article 28.

Ratification of international instruments on human rights has also accelerated since 1998, including all five remaining ILO Core Conventions; the

Convention on Economic, Social and Cultural Rights, and the Convention on Civil and Political Rights in 2005, as well as the ASEAN Declaration against human trafficking in 2004.

More players are active in enforcing human rights in Indonesia but improvements are still needed

Government institutions dealing with human rights have expanded from only the National Commission on Human Rights under the Suharto regime to a number of departments with a section to handle human rights issues. Since the transition to a fully democratic system, private sector actors such as NGOs and academic institutions have also proliferated across the country to raise the voice of civil society on a wide range of issues including basic human rights. Hence, the institutional and community infrastructure to enforce the legal provisions has improved.

Despite the strengthened legal and institutional framework for human rights protection, there still remains a gap between the human rights objectives stipulated in legislation and the actual practices on the ground, and enforcement needs further strengthening. There have been cases where the effectiveness of the National Commission on Human Rights has been undermined by disagreements with the Attorney General's Office which is responsible for prosecution. Ultimately, the integrity and efficiency of the judicial system headed by the Supreme Court need improving to ensure the fair treatment of human rights claims.

Stronger environmental protection has recently been legislated

Indonesia has developed domestic legislation on environmental protection in response to international movements. Indonesia's main environment law has been Law 23/1997 on environmental management which supports the principles of environmentally sustainable development and promotes the precautionary principle, inter-generational equity and the polluter-pays principle. The government has also adopted sector specific laws on forests (41/1999), water resources (7/2004), coastal areas and small islands (27/2007), and fisheries (31/2004). The effectiveness of the environmental law has been questioned on the basis that in only a few cases have the courts ruled in favour of the victims of environmental damage.

In September 2009, the government passed the Law on Environmental Management (32/2009) to replace an earlier 1997 law. The new Law upgrades the authority of the Ministry of Environment by giving it the power to issue environmental licences for large-scale, priority projects, to revoke environmental licences, to arrest and detain persons in co-ordination with the Police, and to sue persons or companies for causing a loss to the state. It also

increases sanctions on environmentally-damaging activities and stipulates sanctions for government officials who issue licenses or undertake supervision inappropriately or illegitimately. While an existing government regulation (27/1999) requires an enterprise to conduct an environmental impact assessment, the new Law mandates central and regional governments to prepare a strategic environmental assessment. Implementation of this new environmental law may take time while the government prepares implementing regulations.

The Indonesian government has been active in joining international efforts to tacke the climate change challenge since it hosted the United Nations Framework Conventions on Climate Change 13th Conference in Bali. A series of planning documents[25] have been prepared by the government to set the targets and measures for a greener economic growth (see Box 8.2).

Box 8.2. **Indonesia's green growth policies**

To join the global effort to fight climate change, President Yudhoyono has announced a target of carbon emission reduction by 26% by 2020 in a "business as usual" scenario and by up to 41% with international support. Climate change challenges have been being mainstreamed into Indonesia's development planning documents such as the Medium-Term Development Plan and legislation. The government issued the National Action Plan to Combat Climate Change in 2007 as a long-term framework for government action, created the National Council on Climate Change in 2008 to coordinate climate change policies among ministries and prepared the Indonesia Climate Change Sectoral Roadmap in 2009. The emission reduction target was registered at the UNFCCC in 2010 as its voluntary contribution.

In 2009, The Ministry of Finance published a Green Paper which outlines Indonesia's strategies for economic and fiscal policies to reduce carbon emission in the most cost effective manner. The main strategies include:

A strategy for the energy sector to introduce a carbon tax on fossil fuel combustion and gradually remove energy subsidies. Complementary measures to promote energy efficiency and the adoption of low-carbon technology will be introduced. The use of geothermal sources of energy will be particularly supported by the government as Indonesia is host to 40% of the world's geothermal resources. Under the government's second 10000 MW crash programme, geothermal generating capacity is expected to make up 40% of the total additional capacity by 2014. Most of the geothermal generating capacity is to be implemented by private-sector independent power producers. Policies to achieve the target on geothermal power

Box 8.2. **Indonesia's green growth policies** *(cont.)*

generation have been introduced in recent years and more are expected. For example, the Ministry of Energy and Mineral Resources allowed a maximum benchmark price of USD 9.7 cents per kWh for the purchase of geothermal power by PLN in its 2009 Guidelines. The typical tariffs have been less than half this amount. The Ministry of Finance also provides tax concessions for renewable energy projects.

A strategy for the land use changes and the forestry sector to encourage regional government efforts to mitigate climate change via an inter-governmental transfer mechanism. Co-operation among sector ministries will be sought to align various incentives with the green policy goals. The bulk of near-term emission reductions are expected to come from land use changes, forestry and peat emissions as Indonesia emits large amounts of carbon and emission reductions can be cost-competitive in these areas. Since many authorities related to land use and forestry management are under the control of local governments, a role for local governments is important in mitigating climate change through land use and forestry management policies. A Regional Incentive Mechanism will be set up to reward regional governments' successful actions to mitigate climate change.

A strategy for international carbon finance to create broad-based carbon market mechanisms and ensure adequate returns for Indonesia's emission reductions. The government aims to attract more carbon finance inflows into the country from both public and private sources. For this purpose, the government will be actively engaged in international discussions to develop carbon market mechanisms such as a funding mechanism for reducing emissions from deforestation and forest degradation.

A strategy for institutional development to strengthen internal capacity to analyse, co-ordinate and review policies on climate change. While the Ministry of Finance is central to climate change policies, many government departments are also involved in policies which have a bearing on carbon emissions. To avoid overlap and inconsistencies in formulating and implementating policies, the government needs stronger capacity and a co-ordinating mechanism.

Indonesia has ratified a number of international agreements on environmental protection including the Conventions on Biological Biodiversity and on International Trade in Endangered Species, the International Tropical Timber Agreement, the Ramsar Convention on Wetlands, the UN Framework Convention on Climate Change and the Kyoto Protocol, the Vienna Convention for the Protection of the Ozone Layer, the

Convention to Combat Desertification, the Basel Convention, the Nuclear Test Ban Treaty, the Convention on the Law of the Sea, and the International Convention for the Prevention of Pollution from Ships.

Enforcement of environmental standards at local level faces challenges

While Indonesia has adequate legal instruments to protect its environment, enforcing environmental laws and standards has been problematic. Under the former environmental law, none of the central government agencies, including the Ministry of Environment, were given the power to enforce environmental standards. While the new law strengthens the enforcement power of government agencies by giving them authority to introduce a wider range of instruments such as an environment license and an environmental tax, the implementing regulations are yet to be issued. Although local governments have been given a comprehensive mandate to provide environmental services since decentralisation, their performance in conforming to national environmental legislation is reported to have been generally weak without strong enforcement pressures and incentives from the central government.

Labour union rights are improving

While Indonesia has been a member of the ILO since 1950, the legal and institutional framework required to uphold fundamental labour rights was not well established before 1998. Under the Suharto regime, labour movements including activities of labour unions[26] were highly constrained. The government only recognised one state-controlled union, the All Indonesian Labour Union. Prior approval was required to hold strikes and lock-outs, and any labour disputes were handled by the government, not settled by a voluntary arbitration process or independent courts.[27]

As part of legal reforms to address human rights protection since 1998, Indonesia has pushed to raise labour rights protection to a level consistent with international standards. Indonesia adhered to the ILO Declaration on Fundamental Principles and Rights at Work in 1998 and ratified the five ILO core conventions during 1998-2000.[28] The other three core conventions[29] were signed earlier. As a result, Indonesia became the first country in Asia to ratify all eight core conventions in 2000.

Consistent with the ILO Convention on freedom of association and protection of the right to organise, Indonesia enacted the Law on Labour Unions (21/2000) to guarantee workers' rights to form or join a union. Preventing trade union formation is penalised with a fine or imprisonment under the law. Onerous requirements previously imposed when forming a union were repealed. The greater freedom of association provided by the legislation, along with broader

policy shifts, have transformed the system from a single union sponsored by the government into a multiple union system free from strict government control. Union activities can be easily organised and have contributed to higher enterprise compliance with basic labour laws and standards.

Ninety union federations and three major confederations account for over 80% of all union membership. Plant-level unions have the right to collective bargaining, as far as they can recruit or mobilise the support of a majority of the workforce, and workers in the private sector have the right to strike with a 7-day advance written notification when a mediation process does not resolve problems. All trade unions have to be registered with the Ministry of Manpower and inform the government of nominations and changes in their governing bodies. In practice, strikes are prohibited in the public sector, in essential services, and in enterprises serving the public interest.

While union activities have increased, many unions and employer groups are not representative and weak in their capacities to bargain and negotiate. The vast majority of Indonesia's labour force is not yet organised, with a unionisation rate of 14% of the formal sector labour force (ITUC, 2007). A culture of collective bargaining is not yet firmly established, as reflected in the small number of collective labour agreements existing in the country.

The Manpower Law consolidated labour regulations and strengthened labour protection

The Manpower Law (13/2003) consolidated labour regulations found in various laws and regulations and further strengthened labour protection. The Law reiterates workers' right to join and form a union and continues to provide for basic labour rights, including prohibition of discrimination, the right to develop job competence, prohibition of child labour,[30] protection of female workers,[31] the right to receive occupational safety and health protection, and the right to strike and to lock-outs.[32] It also sets standards on regular and overtime working hours and compensation, minimum wages, leaves/holidays, termination payments, and a wage scale for workers absent for legitimate reasons. It obliges all enterprises to provide appropriate human resources development and vocational training for their employees.

Furthermore, the Law increases protection of employees by limiting the use of fixed-term contracts and sub-contracting,[33] making termination of employment more difficult with higher compensation[34] and prior approval requirements[35] from the government, and requiring all enterprises with more than 10 workers to create a set of enterprise rules and regulations[36] in consultation with labour representatives which clarify the rights and obligations of both employers and workers, working conditions, and enterprise discipline/rules of conduct.

Legislative reforms to protect labour rights continue

The government enacted the Law on the Settlement of Industrial Relations Disputes (2/2004) to establish an operational system of free and effective collective bargaining and has created an Industrial Relations Court, replacing the tripartite committee system established in 1957 for settling industrial disputes. In 2007, it enacted a Law on the Elimination of Trafficking (21/2007) which prohibits all forms of human trafficking and prescribes imprisonment for up to 15 years. The law for the first time adopted an internationally acknowledged, comprehensive definition of human trafficking in domestic legislation.

A large proportion of workers are in the informal sector and hence do not benefit from the provisions and protection under the labour regulations. A challenge is to extend labour rights protection to those in most need in the informal sector. Increasing labour market flexibility by reviewing the existing regulations may go some way towards correcting this dual labour market structure (see Box 8.3).

Box 8.3. **The Labour Market and the Investment Climate in Indonesia**

The OECD *Economic Assessment of Indonesia* (OECD 2008) devoted one chapter to the question of how to improve labour market outcomes. Labour market policies play an essential role in shaping the business climate and can help to explain both job creation in the formal and informal sectors and the extent of FDI in labour-intensive industries, particular those which are export-oriented. This box summarises the findings in OECD (2008).

The return of economic growth in Indonesia has not been accompanied by sufficient job creation in the formal sector to absorb new entrants into the labour market, resulting in persistently high unemployment, particularly among the young. At the same time, Indonesia's former dynamism in labour-intensive manufacturing has waned, as evidenced by the poor performance both in manufacturing exports and in attracting FDI into the export-oriented manufacturing sector. The OECD assessment attributes this under-performance largely to a tightening of employment protection legislation (EPL) through both the rise in the real minimum wage after 2001 and the provisions of the Manpower Act of 2003.

The Manpower Act 13/2003 consolidates previous legislation and renders the labour code more transparent and systematic. It contains several provisions with implications for the restrictiveness of EPL. In particular, it requires employers to seek authorisation from the local Manpower Department for dismissals, establishes severance payments for layoffs and

Box 8.3. **The Labour Market and the Investment Climate in Indonesia** *(cont.)*

limits the scope for flexible work arrangements such as temporary work, fixed-term contracts and sub-contracting. At the same time, the value of the minimum wage has risen sharply in real terms, especially in 2000-2003 and is now very high relative to the median wage, compared to OECD member countries. The minimum wage is now set by local governments.

The combined effect of these changes is to make Indonesia's labour code more restrictive than many of its regional peers, as well as OECD members. Indonesia ranks 149 out of 183 in terms of the costs and difficulties in employing workers according to the *Doing Business* indicators. In terms of the rigidity of employment index, Indonesia ranks behind most of the ASEAN region, as well as China and India based on *Doing Business*. The OECD EPL index also finds Indonesia to be more restrictive than most of the OECD area, particularly with respect to procedures and delays before giving notice. Because Indonesia performs relatively better in terms of collective dismissals, however, its overall ranking on the EPL index places it ahead of seven OECD members*.

Mindful of the role that EPL in Indonesia plays in its social protection programmes, the OECD Assessment recommends efforts to make EPL more flexible for both regular and temporary workers while at the same time building effective social assistance programmes. The report also argues that setting a high minimum wage is a poor instrument for alleviating poverty because it is not binding in the informal sector where most Indonesian workers are employed. It therefore suggests that the minimum wage could be capped by increases in measured value added per worker. It also argues that there is still considerable scope for simplifying the procedures for dismissals which are very time-consuming. Lastly, efforts to boost human capital, such as through the education system, labour training and skill certification, could help to tackle informality in the labour market which is one of the root causes of precariousness and poverty.

* Based on data for 2006-2007.

Source: OECD (2008), *Indonesia: Economic Assessment, OECD Economic Surveys*.

Indonesia has enshrined RBC principles in legislation

Recently Indonesia has been rapidly incorporating corporate social responsibilities (CSR) in its legislation. The Company Law (40/2007) made CSR an obligation for companies operating in the natural resource sector. The Law requires all companies to include the implementation of corporate social and environmental responsibility in their annual report (Article 66), and all companies in natural resources to implement corporate social and environmental responsibility (Article 74). To be in compliance with Article 74,

a company has to budget and account for activities on corporate social and environmental activities as a corporate cost, and non-compliance may be penalised by sanctions in accordance with the relevant sectoral laws.

Although Indonesia's corporate sector objected to the legal obligation of CSR,[37] the Constitutional Court concluded that the CSR clause in the Company Law is in compliance with the Constitution. The business sector argues that the CSR clause should be included in sectoral laws not in the Company Law.

The Law on Mineral and Coal Mining (4/2009) mandates CSR activities for mining companies in the areas of environmental protection and community and human resources development. A mining licence holder is obliged to apply good mining techniques and principles, develop and empower the local community, and comply with environmental capacity limits. Applying good mining techniques and principles includes: carrying out the terms of mining occupational safety and health, promoting mining operational safety, managing and monitoring the mining environment including reclamation and post-mining activities, conserving mineral and coal resources, and managing mining waste to meet the standard quality of the environment prior to disposal. A company applying for an exploration licence has to submit a development and empowerment plan for communities in consultation with the government and communities while a company applying for a production operation licence also has to submit a mining reclamation and post-mining management plan including deposit funds; an occupational safety and health plan; a plan to use domestic goods, services and technology; and a training plan for domestic workers. The Law also promotes employment of local personnel, procurement of domestic goods and services, and partnerships with local communities and businesses (Article 106 and 107). Use of local or national mining services companies is mandatory for mining licence holders; and mining services providers are in turn required to give preference to local contractors and workers. Administrative sanctions may be imposed for violating these obligations.

The Investment Law (25/2007) obliges every investor to apply the principle of good corporate governance, to implement corporate social responsibility, to respect the cultural traditions of the community around the location of its business activities, and to comply with all provisions of laws and regulations (Article 15) – although, there is no sanction specified for violating these obligations.

Although the government has actively encouraged CSR through laws and regulations, the lack of implementation details for these legal obligations may hamper a clear understanding of business responsibilities among stakeholders. Responsible business conduct goes beyond complying with laws and regulations and cannot be assured only by requiring enterprises to budget

the costs of CSR activities, as CSR is not equivalent to enterprise philanthropy. Hence, the government may wish to clarify what is required under Indonesian laws and regulations under the concept of CSR as well as to encourage responsible business conduct through means other than laws and regulations.

SOEs are obliged to contribute towards SME and community development

The State Ministry of SOEs mandates all SOEs to implement a small enterprises programme as well as an environmental establishment programme.[38] The small enterprises programme should be designed to empower small enterprises by providing soft loans, free training opportunities on business skills and subsidies to participate in international trade exhibitions. The environmental establishment programme is meant to support community development and can take the form of community infrastructure projects, education and health services, and aid for natural disasters. The budgets for these two programmes are decided at the General Meeting of Shareholders, with an after-tax allocation for each programme set at 2% of after-tax earnings.

Enterprises also voluntarily promote RBC in Indonesia

Several business initiatives promote RBC in Indonesia. Indonesia Business Link was formed in 1998 by foreign enterprises operating in Indonesia to promote ethical business practices. A Corporate Forum for Community Development was founded in 2002 by corporate managers who conducted community development programmes to exchange information/knowledge among members and upgrade skills and competence in community development.

In the chemical industry, a corporate voluntary initiative, Responsible Care, has been successfully in use in Indonesia since 1994. Its members are committed to improve safety, health and environmental performance of their operations and products and to communicate with stakeholders about their products and processes. The National Committee for Responsible Care Indonesia was established in 1997 and supported by the Director of Chemical Industry at the Ministry of Industry and Trade.

The National Centre for Sustainable Reporting[39] was launched in 2005 by five major Indonesian organisations, namely the Indonesian Management Accountants Institute, the Indonesian-Netherlands Association, the National Committee on Governance, the Forum for Corporate Governance in Indonesia and the Public Listed Companies Association. It provides training and education courses in sustainability management, CSR and sustainability reporting; management consultancy in implementing CSR policies; research

and surveys regarding the status of sustainability practices in Indonesia; and develops and disseminates standards/guidelines on sustainability practices.

Awareness of RBC standards and principles is increasing among enterprises and communities

Awareness among Indonesian enterprises of RBC standards and principles has been gradually increasing albeit from a low base. The number of registered ISO 14001 certificates in Indonesia reached 381 by the end of 2006 – the fourth largest among ASEAN member economies after Thailand, Singapore and Malaysia. The number of Indonesian enterprises signing up to the Global Compact jumped from only two in 2004 to 108 in 2009. The number of Indonesian enterprises making reports in the GRI reporting framework increased from zero in 2005 to 22 in 2009. But only one Indonesian enterprise participated in the Carbon Disclosure Project in 2009.

While a number of NGOs have been formed, some of whom are active in CSR,[40] voluntary initiatives by enterprises are not well supported by strong watchdogs or stakeholder groups. Consumer awareness is also not high enough to influence business conduct by increasing the risk of decreasing sales on products and services provided by enterprises which are found to operate irresponsibly.

> Does the government ensure that an adequate framework is in place to support the financial and non-financial disclosure that companies make about their business activities? Is this framework flexible enough to allow scope for innovation, for tailoring practices to the needs of investors and their stakeholders?

Disclosure is mandatory for both limited liability and public companies

The requirement for reporting or disclosing financial and non-financial information is covered under various laws. The Company Law instructs companies to include a report on implementing corporate social and environmental responsibility in their annual reports as well as a standard financial report. The annual report should be reviewed by the Board of Commissioners and be submitted to the GSM within six months of the end of each fiscal year. It must be made available for inspection by shareholders from the date of the GSM invitation. Indonesia is ahead of many OECD and non-OECD countries in making non-financial reporting compulsory.

Bapepam-LK has, since 2006, required publicly-listed companies to include activities related to environmental and social responsibility in an

annual report.[41] Since then, several enterprises have submitted separate reports on corporate social responsibility and sustainability. These reports are then made public. To improve the quality of information disclosure of annual reports, Bapepam-LK has started issuing an Annual Report Award since 2002 in partnership with the Ministry of State Owned Enterprises, the Directorate General of Taxes, the Jakarta Stock Exchange, the Indonesian Accountant Association and the National Committee on Governance.

Disclosure is still relatively weak in Indonesia

Various studies indicate that non-financial reporting and disclosure are relatively low in Indonesia.[42] While CSR reporting has been made mandatory for all limited liability companies, implementing regulations to clarify the standards of the CSR reports and the sanctions for non-compliance are not available. Supporting infrastructure such as CSR report auditing and minimum reporting standards may need to be developed. Disclosure is an important step to mobilise public pressure on business conduct but ineffective if the quality of reports is not assured and companies use it only as a public relations tool.

How can the government support companies' efforts to comply with the law?

Reputational programmes reward compliance with environmental laws and standards

The government initiated the Clean River Programme[43] in 1989 to reduce water pollution caused by manufacturing industries. The programme relied on the voluntary involvement of firms declaring in writing their commitment to improve wastewater treatment performance and to comply with wastewater standards. Firms in the programme submit samples of liquid discharges for monitoring to the Environmental Impact and Management Agency (Bapedal) as well as regional environment offices. The programme was extended from 8 to 13 provinces with participation of 1 275 factories by 1994. A similar programme on air pollution control was initiated in 1996. However, the programmes failed to achieve a significant reduction in pollution partly because a company's commitment is not legally binding and the details are not published.

As a follow-on activity, the first major public disclosure programme in the developing world, the Programme for Pollution Control Evaluation and Rating (PROPER), started in 1995 by the Bapedal. The programme devised a five-colour coding system to evaluate the performance of wastewater management of

enterprises and publicised the results. The Bapedal selected major polluters of rivers as compulsory programme participants[44] while the programme was also open for voluntary participation. The programme's coverage expanded from the single area of water pollution to include air pollution, hazardous and toxic waste management, implementing environmental impact assessments, environmental management systems, resources conservation and community development/participation. Hence, the programme evaluates performance of corporate environmentally responsible conducts beyond compliance with the laws.

The programme started with 187 enterprises in 1995 and currently includes 503 enterprises (254 enterprises in manufacturing, infrastructure and services industry, 102 in agro- and forestry industries, and 147 in mining, energy, oil and gas industries). The PROPER is evaluated to have succeeded in improving the performance of participating enterprises, especially those with initially poor environmental records (Lopez, Sterner and Afsah, 2004). It has gained good international recognition and has been emulated by other countries as a model of alternative compliance instruments and public disclosure programmes.

The government has prepared guidelines on complying with human rights principles. For example, Indonesia launched the Equal Employment Opportunity Guidelines in 2005 which constitute a practical tool for private enterprises in implementing the principles of equal treatment of men and women at work.

How does the government through partnership (*e.g.* by participating in the development of standards that lower costs of adopting responsible business policies) and through promotion (*e.g.* by improving the information on responsible business practices to customers and the public) help to strengthen the business case for responsible business conduct?

Indonesia has been involved in ISO social responsibility standardisation activities since 2005. The Indonesian National Standardisation Body has established the National Mirror Committee on social responsibilities consisting of experts representing government, business, labour, consumers and civil society.

The government awards enterprises, groups or individuals for their dedication to environmentally-friendly management practices under the *Kalpataru* programme and provides subsidised credits in partnership with banks to encourage investment in environmental protection such as cleaner

production technologies, pollution prevention/reduction equipment, and environmental management certificates.

The Ministry of the Environment encourages voluntary compliance instruments, such as environmental standardisation and the development of environmentally friendly technologies. In 2004 the Ministry established the Centre for National Cleaner Production to facilitate the development and implementation of cleaner production. The Indonesian Ecolabel Scheme was also launched in 2004 to certify three categories of products for meeting certain environmental criteria.

The business case for RBC can become stronger in a democratic society

The shift to a fully democratic society has had a large impact on the environment where RBC is adopted and promoted in the country. Community demands on enterprises to respect basic human and labour rights and compensate for environmental damages have been adding to the business case for RBC. The government can help civil society groups and communities to play an effective watchdog role in monitoring business conduct. For example, the Ministry of the Environment has promoted the introduction of an environmental education programme in the school curriculum in collaboration with the Ministry of Education as well as disseminating environmental information to the public through its website and in partnership with civil society groups.

Investors and fund managers place an increasing importance on RBC-related performance of enterprises in making their investment decisions. Indonesia launched its first socially responsible investment index in 2009 which is owned by the Kehati Biodiversity Foundation and calculated and maintained by the Indonesia Stock Exchange to help investors to select enterprises with RBC acceptable performances.

Does the government participate in inter-governmental co-operation in order to promote international concepts and principles for responsible business conduct, such as the OECD Guidelines for Multinational Enterprises, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policies and the United Nations Global Compact?

Indonesia has been involved in the development of the international legal and policy framework which underpins business ethics. As a member of the World Commission on Environment and Development (WCED) and a participant in the UNDP, Indonesia has ratified most major international treaties protecting human rights and the environment, including the Rio

Declaration on the Environment and Development and Agenda 21 (see Annex F).

The Global Compact was launched in Indonesia by the Employer's Association of Indonesia (APINDO) in 2004 which set up a team to familiarise the business community with the Compact's principles through training and workshops. Since 2006 the Indonesian Marketing Association has promoted the Compact. As a result, the number of Indonesian enterprises signing up to the Global Compact increased from only 2 in 2004 to 108 in 2009 which even exceeds the number in Japan, South Korea, Thailand and Malaysia.[45]

Indonesia is engaged in regional initiatives to co-operate in areas related to RBC. For example, it participates through the Ministry of Environment in the Asian Environmental Compliance and Enforcement Network – a regional network of national and sub-national environmental agencies to improve environmental compliance and enforcement in Asia. Other regional co-operation has taken place with the ASEAN Occupational Safety and Health Network, the Asian Productivity Organisation, and the Asia Pacific Occupational Safety and Health Organisation.

Notes

1. Tanjung Priok, Soekarno-Hatta, Tanjung Emas, Tanjung Perak, and Belawan.
2. Minister of Trade Regulation 45/M-DAG/PER/9/2009 on Importer Identification Numbers.
3. Presidential Decree 3/2006.
4. Article 26 of the Income Tax Law (2009).
5. Law 28/2009 on Regional and Local Taxes and Levies (effective in January 2010). This law replaces Law 18/1997 as amended by Law 34/2000.
6. They are 5 taxes for provinces and 11 taxes and 30 charges for sub-provincial level governments (i.e., districts and cities).
7. Amended by Government Regulation 62/2008.
8. The KAPET programme started in 1996 under Presidential Decree 89/1996, later replaced by Presidential Decree 150/2000. Each KAPET status is given by a respective Presidential Decree. There are 14 KAPETs in the country.
9. Law 39/2009 on SEZ.
10. DGT Regulations PER-61/PJ/2009 and PER-62/PJ/2009.
11. Government Regulation 62/2008 amending GR 1/2007 concerning income tax benefits for investment in certain business fields or certain regions.
12. The number of tax payers doubled in the most recent two years.
13. The Income Tax Law contains provisions to prevent the abuse of special purpose vehicles and conduit companies based in a tax haven country.
14. IMF Country Report No. 06/318, August 2006.

15. *http://www.ecgi.org/codes/documents/indon_2001.pdf.*

    and *http://www.acga-asia.org/public/files/IndonesianCode_2001.pdf.*

16. *http://www.acga-asia.org/public/files/Indonesia%20Code%20of%20GCG%202006.pdf.*

17. *http://www.fcgi.or.id/.*

18. *http://cgcg-indonesia.org/.*

19. *http://www.worldbank.org/ifa/rosc_cg_idn.pdf.*

20. "Dwiwarma" means "two colours" in Bahasa Indonesia and is commonly used to refer to the bicoloured (red and white) national flag.

21. Information supplied by the Indonesian government in response to the OECD 2007 Questionnaire on the Corporate-Governance Framework in Asia.

22. Kamal (2008).

23. The National Commission on Human Rights (*Komnas HAM*) was originally established in 1993 by presidential decree. The 1999 law on human rights strengthened the legal status and the independence of the Commission.

24. Law 26/2000 on establishing the *ad hoc* human rights court.

25. National Action Plan for Climate Change (2008), Development Reponse to Climate Change (2008), and Climate Change Sectoral Road Map (2009).

26. Law 21/1954 on collective labour agreements allowed only accredited and registered unions to enter into negotiations on behalf of their members. Furthermore, registration conditions became very strict via Ministerial Decree 1/1975 on trade union registration.

27. Law 22/1957 on labour dispute settlement.

28. The Conventions are on freedom of association and protection of the rights to organise (87), on abolition of forced labour (105), on minimum age for admission to employment (138), on discrimination in respect of employment and occupation (111), and on prohibition and immediate action for elimination of the worst forms of child labour (182).

29. They are Convention No. 100 on equal remuneration, Convention No. 29 on forced labour, and Convention No. 98 on the right to organise and collective bargaining.

30. The minimum age for work is set at 15, but those under 18 attract certain safeguard provisions under the Law.

31. Female workers younger than 18 and pregnant workers with health risk may not be employed for night work. Employers are required to provide female workers working after 11 p.m. with nutrition, security at work and transport.

32. A written notification to the employer/workers and the local government labour administration office is required at least seven days prior to strikes and lockouts.

33. Fixed-term contracts are limited to (a) work to be performed and completed at one time or work of temporary nature, (b) work which can be completed within three years, (c) seasonal work, or (d) work related to a new product, a new activity, or an additional product that is still in the experimental stage. Fixed-term contracts are permitted for a period of no longer than two years and only one renewal of up to one year. Under previous legislation, a maximum period of six years was possible for fixed-term contracts. If any of the requirements for fixed-term

contracts is violated, the contract becomes permanent. Sub-contracting is limited to "non-core" activities of a firm.

34. Legal severance payments were greatly increased.
35. Permission is exempted in cases of *a)* workers on probation, *b)* voluntary resignation, *c)* retirement, and *d)* death of workers.
36. If a collective work agreement is already signed, it is not necessary to create enterprise rules and regulations.
37. In the drafting stage, strong objections from the business sector reduced the coverage of CSR obligations from all enterprises to only those in the natural resources sector.
38. The Minister of State for BUMN Regulations No. KEP-236/MBU/2003 and No. PER-05/MBU/2007.
39. *www.evolusimedia.com/ncsr/*.
40. Public Interest Research and Advocacy Centre, the Business Watch Indonesia, Foundation for Sustainable Development, the Association of Philanthropy Indonesia, the National Centre for Sustainable Reporting, and the National Committee on Governance.
41. Decree 134/BL/2006 on the obligation to submit an annual report for listed firms and public companies.
42. Chapple and Moon (2005), Hartanti (2003 and 2007).
43. *Program Kali Bersih*; PROKASIH.
44. Participation is based on four criteria: a large environmental impact, considerable environmental pollution and destruction, public listing, and export orientation from three industries.
45. The number is based on business participants including both active and non-communicating signatories.

ANNEX A

Statistics

Table A.1. **FDI flows into Indonesia**

	FDI flows in Indonesia (USD million)	As a share in FDI flows to the world (%)	As a share in FDI flows to developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980-1984[11]	210.4	0.36	1.13	0.2		
1985-1989[11]	441.8	0.35	1.96	0.5		
1990	1 092	0.53	3.11	1.0	26	9
1991	1 482	0.95	3.73	1.2	22	7
1992	1 799	1.08	3.39	1.3	21	10
1993	2 003	0.90	2.61	1.3	19	7
1994	2 191	0.85	2.11	1.2	25	10
1995	4 419	1.30	3.81	2.2	19	7
1996	6 245	1.60	4.25	2.7	16	8
1997	4 677	0.96	2.45	2.2	25	12
1998	–241	–0.03	–0.13	–0.3	203	166
1999	–1 865	–0.17	–0.82	–1.3	206	169
2000	–4 495	–0.32	–1.75	–2.7	206	169
2001	–2 926	–0.35	–1.36	–1.8	205	168
2002	253	0.04	0.14	0.1	97	64
2003	–508	–0.09	–0.28	–0.2	202	164
2004	1 896	0.26	0.65	0.7	49	25
2005	8 336	0.86	2.53	2.9	26	12
2006	4 974	0.34	1.13	1.3	49	24
2007	6 928	0.35	1.31	1.6	43	21
2008	9 318	0.55	1.50	1.8	43	26
2009	5 300			1.0		

1. Annual average during this period.

Source: BI and WDI

Table A.2. **FDI stocks in Indonesia**

	FDI stocks in Indonesia (USD million)	As a share in FDI stocks in the world (%)	As a share in FDI stocks in developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980	4 559	0.65	1.50	5.8	21	9
1990	8 732	0.45	1.65	7.6	31	13
1995	20 626	0.71	2.42	10.2	25	9
2000	25 060	0.44	1.44	15.2	35	16
2001	15 203	0.25	0.85	9.5	48	24
2002	7 103	0.11	0.40	3.6	63	35
2003	10 328	0.13	0.51	4.4	59	31
2004	15 858	0.17	0.68	6.2	56	28
2005	41 187	0.41	1.51	14.4	43	19
2006	54 534	0.44	1.62	15.0	41	17
2007	79 927	0.51	1.82	18.5	44	19
2008	67 964	0.46	1.59	13.2	43	21

Source: Bank Indonesia and WDI.

Table A.3. **FDI flows by sector (share)**

%

	2004	2005	2006	2007	2008	2009
Primary	**12.7**	**14.8**	**11.2**	**31.9**	**40.6**	**25.8**
Agriculture, hunting and forestry	7.4	0.0	4.6	4.1	2.1	–1.1
Fishing	0.0	0.1	0.1	0.3	–0.3	0.2
Mining and quarrying	5.2	14.7	6.6	27.5	38.7	26.7
Secondary	**44.0**	**63.2**	**34.4**	**34.8**	**24.9**	**32.2**
Tertiary	**11.1**	**18.4**	**42.2**	**32.8**	**32.2**	**42.2**
Electricity, gas and water supply	0.0	2.0	0.0	–0.9	–0.6	1.1
Construction	–0.9	1.6	1.7	2.8	0.3	0.1
Wholesale and retail, repair of motor Vehicles and personal and household goods	–11.3	0.7	7.6	3.1	12.4	1.5
Hotel and restaurant	0.0	0.0	0.1	–0.1	0.2	0.0
Transport, storage and communication	12.0	4.6	12.0	8.6	1.4	36.9
Financial Intermediation	12.3	9.4	20.9	19.3	20.7	3.1
Real estate, renting and business activities	–0.9	0.2	–0.3	–0.1	–2.2	–0.5
Others	32.1	3.6	12.2	0.5	**2.3**	**–0.2**
Total	100	100	100	100	100	100

Source: Bank Indonesia.

Table A.4. **FDI flows by home country (share)**

%

	2004	2005	2006	2007	2008	2009
North America	–29.9	41.1	–11.1	16.0	11.8	3.6
USA	–27.6	41.3	–11.2	15.8	11.7	3.3
Canada	–2.3	–0.2	0.1	0.2	0.1	0.3
Europe	82.5	19.0	41.0	37.8	15.6	13.8
EU	81.5	18.5	40.6	34.8	13.1	6.1
Belgium	–2.3	0.1	0.0	–0.1	0.1	0.0
France	3.4	3.4	4.3	5.5	5.5	5.3
Germany	4.7	5.2	8.6	4.8	1.7	–1.8
Netherlands	65.3	8.1	27.3	25.3	2.1	–13.2
Sweden	0.0	1.2	–0.2	0.1	0.6	–0.2
United Kingdom	10.5	0.6	0.6	–0.8	2.9	8.2
Non-EU	1.0	0.5	0.4	3.1	2.5	7.7
Asia	41.4	37.5	61.5	34.8	18.0	30.2
Japan	–1.6	18.5	21.5	16.2	18.0	18.4
China	15.6	3.6	2.5	1.7	41.6	7.3
India	–0.1	0.0	0.0	–5.0	5.0	0.1
South Korea	12.0	2.9	6.5	3.6	1.1	1.6
Hong Kong, China	3.5	0.6	2.4	1.7	1.1	1.2
Taipei, China	–0.7	0.5	1.2	1.1	0.2	0.3
ASEAN	10.8	10.6	27.6	16.0	34.0	28.3
Malaysia	6.3	1.7	5.6	3.3	8.7	6.4
Singapore	4.4	8.9	21.9	12.1	24.4	20.8
Thailand	0.1	0.0	0.0	0.5	0.9	1.0
Australia	5.1	0.7	7.4	4.5	4.5	5.4
Bermuda	0.0	–1.9	–4.7	0.0	–0.8	–0.1
Cayman Island	0.0	0.0	0.0	0.0	0.0	0.1

Source: Bank Indonesia.

Table A.5. **FDI flow by host region (share)**

%

	2006	2007	2008	2009
Sumatra	15.0	13.5	6.8	7.2
North Sumatra	1.0	1.8	0.9	1.3
Riau	9.8	7.0	3.1	2.3
Jambi	1.6	0.2	0.2	0.4
Lampung	1.9	1.2	0.5	0.3
Java	73.7	82.2	91.2	86.6
Jakarta Capital Region	24.6	45.2	66.8	51.0
West Java	27.1	12.8	17.2	17.9
Central Java	6.3	1.0	0.9	0.8
East Java	6.4	16.3	3.1	3.9
Banten	8.5	6.9	3.2	13.1
Bali and Nusa Tenggara	1.8	0.5	0.6	2.2
Bali	1.7	0.5	0.5	2.1
Kalimantan	8.9	2.9	0.8	2.6
South Kalimantan	1.8	0.6	0.0	1.6
East Kalimantan	6.7	1.5	0.1	0.7
Sulawesi	0.3	0.8	0.4	0.3
Maluku	0.3	0.0	0.0	0.1
Papua	0.0	0.0	0.1	0.0

Source: BKPM.

ANNEX B

Recent Intellectual Property Related Regulations

	Presidential Decree
Patent Exploitation by the Government on Anti-retroviral Medicines	83/2004
Filing, Examination, and the Settlement of Disputes of Trademark Appeal Procedures	20/2005
Establishment of the National Task Force on Tackling IPR Infringements	4/2006
	Government Regulation
Titling, Registering, and Using of Original Variety for Making of Essential Derivation Variety	13/2004
Requirements and Procedures for the Transfer of PVP and the Use of Protected Variety by the Government	14/2004
Patent Exploitation by the Government	27/2004
High Technology Production Facilities for Optical Discs	29/2004
Procedure of Application for Registration of Industrial Designs	1/2005
Consultant on Intellectual Property Rights	2/2005
Organisation, Role and Function of the Trademark Appeal Commission	7/2005
Organisation, Role and Function of the Patent Appeal Commission	40/2005
Procedure of Application for Registration of Lay-out Designs of Integrated Circuits	9/2006
Geographical Indication	51/2007
Types and Tariffs of Non-Tax State Revenues in the Ministry of Law and Human Rights	38/2009

ANNEX C

*Sectors where Foreign Investors Face Specific Restrictions (adapted from the Negative List as set out in Presidential Regulation 36/2010)**

I. Sectors where foreign investors face specific restrictions

Sectors reserved to domestic investors (excluding sectors reserved to SMEs)

- Veneer industry (some types only); supplying and distributing forest plant seeds and seeding.
- Fishing (over 100 GT) in free sea catching areas and over 30 GT in areas more than 12 miles offshore.
- Sea sand mining.
- Private cleaning service; building cleaning service.
- Retail trade (except large-scale supermarkets, minimarkets and department stores).
- Survey services.
- Property/real estate broker: fee or contract based.
- Land transport vehicle rental services (without operator).
- Agricultural, construction and civil engineering and office machine equipment and rental.
- Personal services: laundry, barbershop, beauty, tailor, other.
- Films: production, promotion, technical services, distribution, presentation.
- Recording studio.

* The list is a simplified illustration of the official Negative Investment List and does not necessarily reflect the full sectoral extent of restrictions.

- Passenger transport: bus, taxi.
- Pension fund.
- Smaller banks (BPRs) limited to lending in certain areas, including shariah BPRs.
- Foreign currency trader.
- Labour placement services overseas.
- Traditional medicine business and processing.
- Pharmacy wholesale trade, pharmacies, medicine shop/public pharmacy.
- Basic health service facilities, research centres.
- Health: general medical services clinic, residential health services.
- Health workers: GP, specialist doctor or dentist practice, paramedical and traditional health services.
- Ambulance services.
- Pest control and fumigation services.
- Provider, management and construction of telecom towers.
- Press company.
- Private or subscribed broadcasting agency.

Sectors where foreign equity is restricted (maximum foreign equity share shown on the left)

95%	• Power plants over 10 MW (incl. geothermal, nuclear) • Electricity transmission, distribution and related services • Offshore oil and gas drilling (outside Eastern Indonesia) and onshore oil and gas drilling • Drinking water, toll roads • Multimedia: data communication system service • Telecommunications device testing agency • Trade: direct selling through marketing network developed by business partner
90%	• Geothermal drilling service
85%	• Finance: leasing and non-leasing funding
80%	• Finance: venture capital, general and life insurance and reinsurance, insurance agent, insurance and reinsurance broker, actuary consulting company
75%	• Pharmaceutical: raw material and patent medicine industry
67%	• Construction (using advanced technology, involving high risk or over IDR 1 billion) • Art gallery, art performance building • Health: hospital management services, supporting health services
65%	• Telecommunications: mobile network provider • Multimedia: internet connection service • Health: specialist hospitals, medical and dental clinics, laboratory and medical check-up clinic
55%	• Construction and engineering consulting services
51%	• Nature and ecotourism in forest areas • Hotels (one and two star), guest house and restaurant (if not in violation of local regulations), spas

49%	• Genetically modified crops • Main crop cultivation over 25 ha • Hunting in parks, raising wildlife and plants, coral cultivation • Car maintenance and repair • Film taking studio, film dubbing facility • Other accommodation, restaurants (51% if partnership with SME) • Recreational and entertainment business (51% if partnership with SME) • Bar, café, karaoke (51% if partnership with SME) • Outbound tour operator (51% if partnership with SME) • Sea transport (60% for ASEAN investors for international transport), ferries, lake and river boats • Airport services, non-commercial air transport • Commercial air transport (domestic owner must remain larger than entire foreign capital) • Telecommunications: fixed network provider • Multimedia: telephone internet service, other services not listed above • Manpower: worker placement, labour services provider, work training • Education: non-formal (language, computer, beauty and personality) • Health equipment: calibration, testing, repair • Acupuncture services • Nursing services (51% for ASEAN investors in Medan and Surabaya) • Security: consulting, provision of workers, money and valuables transport, security equipment implantation service, security education and training service, animal provider service • Mail provider

II. Sectors where both foreign and domestic investors face restrictions

Sectors closed to private (domestic and foreign) investment

Culture	• Monuments, museums, historical heritage and residential/traditional environment
Public order, morals	• Chemical weapons production • Gambling and casinos • Alcoholic beverages • Marijuana cultivation
Environment, health	• Harvesting of coral, fishing for species in Appendix I, Convention on International Trade in Endangered Specieis of Wild Fauna and Flora • Certain toxic chemicals • Chlor-alkali industry using materials containing mercury
Public services	• Management and organisation of radio frequency spectrum monitoring and satellite orbits • Inland terminals • Weighing bridges • Vehicle testing • Sailing telecommunications and navigation support facilities • Vessel traffic information systems • Air traffic guidance

Sectors reserved to micro, small and medium-sized enterprises (MSMEs)

Agriculture	• Certain crop cultivation and seeding including plantation for an area less than and equal to 25 hectares • Pig breeding and farming with less than or equal to 125 units, free-range chiken and its cross breeding and farming • Certain plantation products processing below certain capacity as regulated by Ministry of Agricuture
Forestry	• Capturing and propagating plant and wildlife from natural habitat except reptiles • Certain forest plantation business • Swallow's nest business • Saw mill with a capacity less than 2 000 m^3/year • Processing of certain forest products • Rattan processing
Fishery	• Fishing with a ship smaller than 30 GT in the water terriroty up to 12 miles • Fishery processing conducted in an integrated manner
Energy and mining	• Power plant smaller than 1 MW
Industrial sector	• Processing of food from seeds and roots, sago, gnetum gnemon nut and copra • Roots peeling and clearning • Palm sugar • Thread coloring by hand work tools, cloth printing, hand painted batik, knitted cloth, praying clothe, certain traditional handycrafts • Rubber curing • Clay household articles such as pottery • Certain hand tools for handwork and farming • Motorcycle maintenance and repair
Public work	• Small scale construction services using simple technology up to IDR10 billion
Culture and tourism	• Homestay services • Tour agent, tour guide services • Art studio
Communication and informatics	• Community broadcasting agency • Telecom kiosk, cable installation and internet kiosk

Sectors where investors are required to enter into a partnership with MSMEs

Forestry	• Rattan, pine sap, bamboo, resin, eaglewood, shellac and sago business • Bee business • Latex and natural silk business
Fishery	• Rearing and hatchery of marine fish, brackish water fish and fresh water fish • Salt/fish drying, fish smoking • Fishery processing business • Whilesale and export trade of fish products
Energy and mining	• Power plant between 1-10 MW
Industrial sector	• Sweetening and saline fruits and vegetable industry • Copra, Soya source, soy made food and peanuts and cracker • Milk powder and condensed milk • Tobacco drying and processing • Printed batik • Rattan processing • Construction material component, carving handycraft and kitchen ware made from mangrove wood • Essential oil • Construction material made from brick, clay and celamic, goods made from lime and cement • Nail, nuts and bolts, components and spare parts for motor vehicles • Agricultural machinery using medium technology • Maritime tourism, wooden ship and fish catching • Jewelry and gem stone handycrafts • Non-metal recycle goods
Communication and informatics	• Telephone content services, call centre and other telephone value added services

Sectors where private investment is permitted only in certain locations

- Pig farms with over 125 livestock.

Sectors where special permits are required

Sector		*Special requirement*
Forestry	• Capturing and propagating plant and wildlife from natural habitat except reptiles • Taking and distributing coral	Recommnedation by Minister of Forestry
	• Technology development using plant and wildlife genetics	Partnerhsip statement with accredited institution
	• Saw mill with a capacity above 2 000 m^3/year • Certain veneer, plywood, laminated veneer lubmber, wood chip and wood pellet	Recommendation on sustainable raw material supply from Minister of Forestry
Fishery	• Fishery with a ship size above 100 GT in Zone Economic Exclusive Indonesia	Terms and conditions regulated by Minister of Maritime and Fishery
	• Lifting of valuable items from a sunk ship cargo	Recommendation by Minister of Marine and Fishery
Energy and mining	• Radioactive mineral mining	Recommendation by National Nuclear Energy Agency
Industrial sector	• Cigarette industry	Recommendation by Minister of Industry
	• Pulp industry from wood	Raw materials must be from Industrial Forest Plant or imported
	• Valuable paper and money printing • Printing of security documents • Special ink industry	Business license and recommendation by Minister of Industry
	• Cyclamate and saccharin	Requirement by National Agency for Drug and Food Control and Minister of Trade
	• Crumb rubber industry	Recommendation by Minisger of Agriculture
	• Lead smelting industry	Recommendatin by State Minister of Environment and Minister of Industry
Transportation	• Provision and operation of crossing harbour, river and lake harbour	Collaboration with a company appointed by the government required
Communication and informatics	• Public broadcasting agency	Monopoly by state-owned company
Finance	• Commercial and sharia bank, money market broker company	Regulated by Bank Indonesia
Manpower and transmigration	• Agriculture business and fishery in transmigration areas	Transmigration implementation license by Minister of Manpower and Transmigration
Education	• Early, basic, secondary, higher education	Regulated under Law on Naitonal Education System
Health	• Pharmaceutical drug producton and wholesale	Special license by Minister of Health

ANNEX D

Bilateral Investment Treaties Signed by Indonesia

Partner	*Date of signature*	*Date of entry into force*
Algeria	2000	
Argentina	1995	2001
Australia	1992	1993
Bangladesh	1998	1999
Belgium-Luxembourg	1970	1972
Bulgaria	2003	2005
Cambodia	1999	
Chile	1999	
China	1994	1995
Croatia	2002	
Cuba	1997	1999
Czech Republic	1998	1999
Denmark	2007	
Egypt	1994	1994
Finland	2006	2008
France	1973	1975
Germany	1968	1975
	2003	2007
Guyana	2008	
Hungary	1992	1996
India	1999	2004
Iran	2005	
Italy	1991	1995
Jamaica	1999	
Jordan	1996	1999
Korea, North	2000	
Korea, South	1991	1994
Kyrgyzstan	1995	1997
Laos	1994	1995

Partner	*Date of signature*	*Date of entry into force*
Libya	2009	
Malaysia	1994	1999
Mauritius	1997	2000
Mongolia	1997	1999
Morocco	1997	2002
Mozambique	1999	2000
Netherlands	1994	1995
Norway	1991	1994
Pakistan	1996	1996
Philippines	2001	
Poland	1992	1993
Qatar	2000	
Romania	1997	1999
Russia	2007	
Saudi Arabia	2003	
Singapore	2005	
Slovakia	1994	1995
Spain	1995	1997
Sri Lanka	1996	1997
Sudan	1998	
Suriname	1995	
Sweden	1992	1993
Switzerland	1974	1976
Syria	1997	2000
Tajikistan	1994	
Thailand	1998	1998
Tunisia	1992	1992
Turkey	1997	1998
Turkmenistan	1994	
Ukraine	1996	1997
UK	1976	1977
Uzbekistan	1996	1997
Venezuela	2000	2003
Viet Nam	1991	1994
Yemen	1998	
Zimbabwe	1999	

Sources: ICSID, UNCTAD.

ANNEX E

Bilateral Tax Treaties Concluded

Party country	Date of entry into force
Algeria	1 January 2001
Australia	1 July 1993
Austria	1 January 1989
Bangladesh	1 January 2007
Belgium	1 January 1975 and 1 January 2002
Brunei Darussalam	1 January 2003
Bulgaria	1 January 1993
Canada	1 January 1980 and 1 January 1999
China	1 January 2004
Czech Republic	1 January 1997
Denmark	1 January 1987
Egypt	1 January 2003
Finland	1 January 1990
France	1 January 1981
Germany	1 January 1992
Hungary	1 January 1994
India	1 January 1988
Italy	1 January 1996
Japan	1 January 1983
Jordan	1 January 1999
North Korea	1 January 2005
South Korea	1 January 1990
Kuwait	1 January 1999
Luxembourg	1 January 1995
Malaysia	1 January 1987
Mexico	1 January 2005
Mongolia	1 January 2001
Netherlands	1 January 1971, 1 June 1994 and 1 January 2004
New Zealand	1 January 1989
Norway	1 January 1991
Pakistan	1 January 1991

Party country	Date of entry into force
Philippines	1 January 1983
Poland	1 January 1994
Portugal	1 January 2008
Qatar	1 January 2008
Romania	1 January 2001
Russia	1 January 2001
Saudi Arabia	1 January 1989
Seychelles	1 January 2001
Singapore	1 January 1992
Slovakia	1 January 2001
South Africa	1 January 1999
Spain	1 January 2000
Sri Lanka	1 January 1995
Sudan	1 January 2001
Sweden	1 January 1990
Switzerland	1 January 1990
Syria	1 January 1999
Chinese Taipei	1 January 1996
Thailand	1 January 1983
Tunisia	1 January 1994
Turkey	1 January 2001
United Arab Emirates	1 January 2000
United Kingdom	1 January 1976 and 1 January 1995
Ukraine	1 January 1999
United States	1 February 1991 and 1 February 1997
Uzbekistan	1 January 1999
Venezuela	1 January 2001
Vietnam	1 January 2000

Note: As of May 2010.

ANNEX F

International Conventions Ratified by Indonesia

Environment

- Vienna Convention for the Protection of the Ozone Layer (1992)
- Montreal Protocol on Substances that Deplete the Ozone Layer as Adjusted and Amended by the Second Meeting of the Parties (1992)
- International Convention on Civil Liability for Oil Pollution Damage (1978)
- International Convention on Establishment of an International Fund for Oil Pollution Damage (1978)
- International Convention on Trade in Endangered Species of Wild Flora and Fauna (1978)
- UN Convention on the Law of the Sea (1985)
- International Convention for Prevention of Pollution from Ships (1986)
- Convention Concerning the Protection of the World Cultural and Natural Heritage (1989)
- Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal (1993, 2005)
- Convention on Wetlands of International Importance Especially as Waterfowl Habitat (Ramsar Convention) (1991)
- UN Convention on Biological Diversity (1991)
- Kyoto Protocol to the UN Framework Convention on Climate Change (2004)
- UN Framework Convention on Climate Change (1994)
- International Convention for Combating Desertification (1994, 1998).

Human Rights

- Convention against Torture and Other Cruel Inhuman or Degrading Treatment
- Convention on the Elimination of all Forms of Racial Discrimination

- Convention on the Elimination of all Forms of Discriminations against Women
- Convention on the Rights of the Child
- International Convention on Economic, Social and Cultural Rights
- International Convention on Civil and Political Rights
- Convention on the Political Rights of Women
- International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (signed in 2004 but not ratified yet)

Labour

- ILO eight Core Conventions
- ILO Convention No. 19 on Equality of Treatment
- ILO Convention No. 27 on Dock Work
- ILO Convention No. 45 on Employment of Women on Underground Work in Mines of All Kind
- ILO Convention No. 69 on Work on Ships
- ILO Convention No. 106 on Weekly Rest and Paid Leave
- ILO Convention No. 120 on Hygiene in Commerce and Offices
- ILO Convention No. 144 on Tripartite Consultation to Promote the Implementation of International Labour Standards

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