Analysing Indonesia’s Foreign Direct Investment Policy Framework

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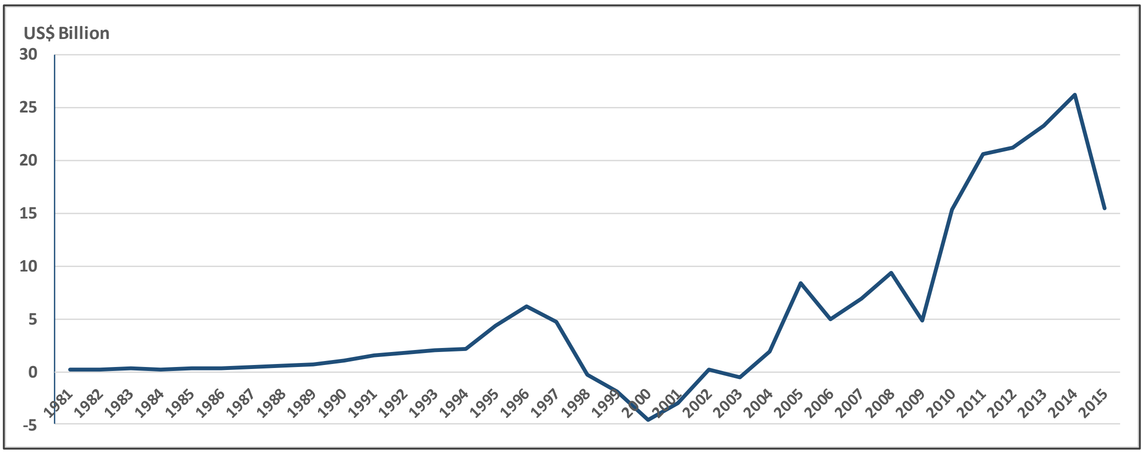
Introduction

Possessing several location advantages ranging from large market size, plentiful natural resources, rising middle-income class and strategic location, Indonesia has been acknowledged as one of potential foreign direct investment (FDI) destinations in Asia (Otsuka et al. 2011, p. 1). On the other hand, UNCTAD (2002) argues that a country could not only rely upon its location advantages to attract foreign investors, a framework consists of regulations and policies designed to enhance the investment climate is essential (pp. 4-5). Indonesia's investment framework is mainly derived from Law 25/2007 on Investment which mainly regulates principles, policies and procedures to invest in Indonesia, both for domestic and foreign investment. By analysing Indonesia's FDI policy framework which includes core FDI policy, supplementary policy and outer-ring policy, this paper argues that Indonesia's FDI policies are effective to attract FDI. However, there are rooms for improvement, especially in (1) the existence of non-tariff barriers which tend to create protectionism, therefore contradictory to liberalisation of FDI, and (2) the provision of tax incentives to attract FDI.

Review: The growth and role of FDI in Indonesia's economic development

Figure 1 **FDI inflows into Indonesia 1981-2015**

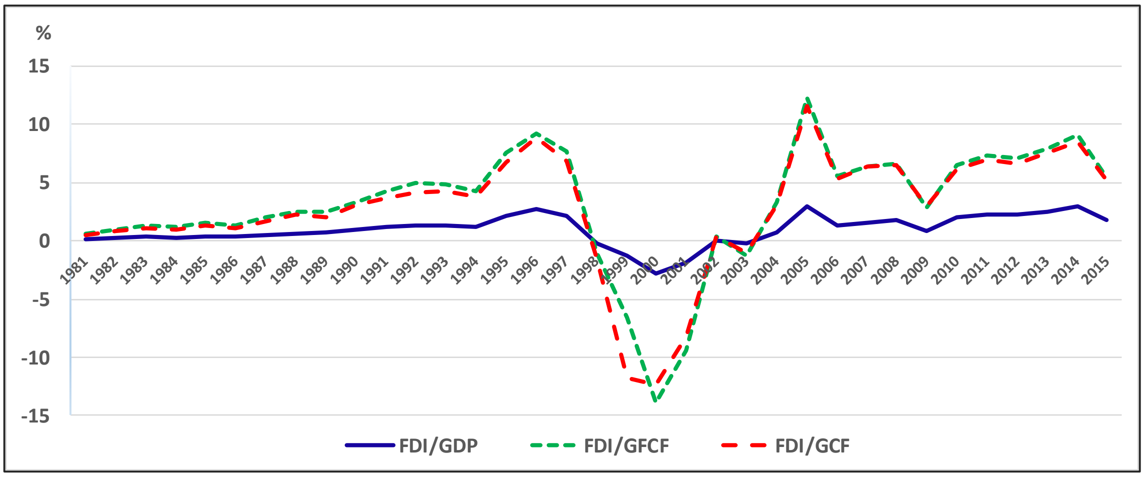


Source: World Bank (2016).

For the last three decades, the growth of FDI inflows into Indonesia has been in increasing trajectory as shown in Figure 1. The most notable point was the dramatic increase of inward FDI flows after the enactment of Law 25/2007 on Investment. According to

Lindblad (2015), this law strongly supports FDI by (1) allowing a foreign company to be 100 percent foreign-owned, (2) providing more fiscal incentives for foreign investment and (3) streamlining investment procedures (p. 229). However, as an impact of Asian Financial Crisis in the late 1990s, Indonesia also suffered negative FDI inflows during the period of 1998 to 2003. According to UN (2007), negative FDI inflows occur when the value of disinvestment by foreign investors exceeds the value of newly invested capital (p. 344). Gray (2002) states that the crisis has brought different effect to Indonesia compared to the other Asian countries, because while the other countries such as Malaysia, Thailand, Philippines and Republic of Korea experienced a sharp contraction of FDI inflows, Indonesia was the only country which suffered negative FDI inflows (p. 3). According to Athukorala and Hill (2010), this condition was a result of economic disruption which was exacerbated by political turbulence that occurs due to the fall of the Soeharto regime, so the foreign investors were looking for alternative investment locations (p. 41).

Figure 2 **FDI inflows to GDP, GCF and GFCF ratios in Indonesia 1981-2015**



Source: World Bank (2016).

The importance of FDI inflows' role in Indonesia's economy has been in increasing trend during the last three decades, even though the Asian Financial Crisis has undermined this pattern in the late 1990s. According to Chen (2002), the ratio of FDI inflows to GDP could be used to measure a country's degree of openness or dependence towards capital sourced FDI (p. 325). Prior to the Asian Financial Crisis, the share of FDI inflows to Indonesia's GDP grew from 0.14 percent in 1981 to reach its peak of 2.72 percent in 1996 as shown in Figure 2. Lindblad (2015) notes this period as the important stage of FDI development in Indonesia in which deregulation was the key theme of its economic policy, mainly when the Government allowed 100 percent of foreign equity in establishing joint ventures in 1992 (p. 225). After several years affected by the Asian Financial Crisis, the FDI inflows started to recover in 2004 and US$ 5.2 billion acquisition of HM Sampoerna, a tobacco company, by Phillip Morris International in 2005 (Mapes 2005) has marked the return of Indonesia as one of promising FDI destination country.

Furthermore, FDI has also become a source of external financing for Indonesia's economic development. According to Chen (2002), the share of FDI inflows to gross capital formation (GCF) and gross fixed capital formation (GFCF) show the importance of foreign capital's role in financing a country's development (pp. 325-326). Along with the growing FDI inflows into Indonesia, the role of FDI in country's capital formation has also been in the similar pattern. As Figure 2 illustrates, the FDI/GCF curve is in line with the FDI/GFCF curve and hence two conclusions could be made: (1) real investment in the form of GFCF dominates the GCF other than variable or working capital formation; and (2) most of inward FDI flows into Indonesia is used for fixed capital investment.

Analysis

(1) Core FDI policies

The important factors which are the core of FDI policies include rules and regulations controlling foreign investors to enter and operate, and the standard of treatment given to foreign investors (UN 1998, p. 92). Loosening the strict rules in terms of entry and operation for foreign investors is one of the government's efforts to liberalise the FDI regime in order to attract FDI (p. 131). FDI restrictions by the government are aimed to maintain the freedom of the government to control the important and sensitive industries such as natural resources, energy, utilities, banking industries, for the benefit of economic development. Particularly in developing countries, FDI restrictions are intended to protect uncompetitive domestic producers by providing opportunities for domestic enterprises to build capacity and prepare for the international competition. Government measures that affect the entry and operations of foreign investors are reflected in the admission and establishment requirement which tend to be lenient, but it typically also contain a list of negative investment. Moreover, restrictions on ownership and control of FDI through stock ownership limitation for foreign investors, whether majority or minority in accordance with the type of industries (UNTAC 1996, pp. 174-177). Furthermore, general standards of treatment applying after FDI establishment, notably the national treatment, MFN and fair and equitable treatment, are broadly revealed at the bilateral or regional stages. These standards are aimed to eliminate the discrimination which might be disadvantageous to foreign investors (ibid, p. 182).

The level of openness to FDI is an essential circumstance to attract foreign multinational companies (Lipsey & Sjöholm 2010, p. 9). Indonesia adheres to an open economy that allows international trade and FDI. Based on the principle of independence in which investments made while maintaining the potential of the nation and the country by providing opportunities inflow of foreign capital in order to realise economic growth. Indonesia controls the FDI system in Law 25/2007 on Investment that provides guaranteed protection and legal certainty by prioritising the interests of the national economy based on economic democracy and in accordance with the purpose of the state. This law replaced Law 1/1967 on Foreign Investment and Law 6/1968 on Domestic Investment. The recent Investment Law, which directly combines the investment policy of foreign and domestic investments into single legislation, has conveyed the government's effort to apply standards of treatment.

In addition, the law ensures standards of treatment in Article 3 paragraph (1) d, where the state enforces the principle of treatment services of non-discrimination under the provisions of the legislation, both among domestic investors and foreign investors, and between investors from different countries. The government imposes limitation in terms of entry and operation for foreign investors as stated in Article 12 paragraph (4), which regulates the criteria and requirements of business fields which is close or open for FDI regulated by Presidential Decree. In general, Law No. 25/2007 ensures the investment climate enhancement encompassing improvements in various aspects of both involving foreign investors and domestic investors, the facility for investors, ease of licensing and services, repositioning of Investment Coordinating Board, and the Special Economic Zone (Law 25/2007).

To support FDI policies regarding entry and operations, President Jokowi has established 12 packages of economic policy gradually, within the period of 2015 through 2016. Some of the policy packages specifically aim to increase FDI. Policy package phase X supports the enhancement of the level of openness to FDI. It contains a revised on the negative list of investments that would be more attractive for greater foreign investment in Indonesia. According to this package, there are 35 areas of business which are allowed 100 percent ownership for foreign investors, such as crumb rubber industry, cold storage, tourism (restaurants, bars, cafes), film industry, medicinal raw materials industry and toll road management, which in the prior regulations, such area is restricted or prohibited for foreign investors (MoF 2016).

Moreover, the Indonesian government released an economic policy package phase II and XII containing a number of measures to resolve obstacles in investment and licensing. The central government will instruct the local authorities to shorten the process of making a business license, through deregulation and de-bureaucratisation regulations to facilitate investment, including foreign investment. Economic policies of phase II provides a breakthrough policy to provide rapid service regarding licensing of investment in the industrial area, which was previously done for hundreds of days, shortened within three hours, to attract investors. With this license, the investor can directly conduct investment activities (Kominfo, 2016). While phase XII of economic policy focus on improving the ease of doing business rankings of Indonesia. The government targets to improve the ease of doing business in Indonesia rank from rank 109 to rank 40, based on 10 indicators of business level by the World Bank. The government cut the procedures to be performed to open a business from the previous 94 procedures to 49 procedures. The time required to complete the establishment of a business reduce from 1,566 days to 132 days (Bappenas 2016).

(2) Supplementary policies

Supplementary policies underpin the core of FDI policies to attain its goals. Trade policy is one of the supplementary policies which plays a paramount role in influencing locational choices of the investors (UN 1998, p. 92). There is an inter-correlation between FDI and trade, in which deep understanding regarding this inter-correlation can lead to mutually supportive policy design between FDI and trade concerning the policy purposes and efficiency in the application. Trade policies influence FDI flows in terms of the direction, composition and size (UNTAC 1996, p. 73). Foreign investors decide to invest in other countries on the consideration of the benefit of cost discrepancies and scale economies. Trade policies such as Tariffs and Non-Tariff Barriers can abolish the competitive benefits offered by the host country and bring the negative impact on investor considerations in selecting locations for investment. Restrictive trade policy will also reduce the positive impact of investments in the host country, since it will lead to a low operational efficiency, high consumer prices and the implementation of a lower quality of technology (OECD 2005, p. 6). Regional trade agreements (RTAs) are trade policy that would enlarge the markets. The combination between large market and economies of scale can generate a more profitable investment, therefore it will attract foreign investment to enter. The size of the market is not confined to state boundaries, but it also relies on a transboundary network of trade agreements, signed by the host country. RTAs are able to create both efficiency-seeking and market-seeking domestic and foreign investment (ibid, p. 9).

Tariff measures of Indonesia support trade liberalisation. Imported goods are subject to import duty based on treaty or international agreement which the procedure for the imposition of import duties and tariffs further stipulated by ministerial regulation (Law no. 17/2006). Since, Indonesia is a member of the Association of Southeast Asian Nations (ASEAN), Indonesia applies preferential tariffs to import goods from other member countries of ASEAN (Linklaters 2014, p. 53). The Government of Indonesia also intensively form the economic Partnership Agreement (EPA) with several potential countries for instance with South Korea, and with Japan that was signed in 2006. The aim of the EPA is to increase trade between the two countries, through liberalisation that remove or reduce import tariffs to both countries to encourage FDI to contribute their export-oriented development strategy (Tambunan, 2008, p. 4). In general, Indonesia's Most-Favored Nation (MFN) averages tariff experienced a significant reduction from 15.34 percent in 1995 to 7.23 per cent in 2013. Although there has been an insignificant rise in the simple average rate after 2010, and Jokowi's government has decided a further rise in rates to encourage and maximise the domestic industry (Patunru & Raharja 2015, pp. 5-6), according to the Minister of Finance of Indonesia, an average rate increase from 7.3 percent in 2014 to 8.3 percent in 2015 still makes the import tariffs in Indonesia one of the lowest tariff in the world. Therefore, the increase in tariffs does not mean a protectionist trade policy (Sambijantoro 2015). Tariff measures indicate a transformation of the protectionist paradigm to trade liberalisation to support FDI.

In contrast, non-tariff barrier measures applied by government convey a support for protectionism, for instance increasing local content requirements for telecommunication devices and for automobile parts, license and permit requirements, pre-shipment inspections, and new labelling requirements. Although the government has revised the negative list of investments, compared to China, Malaysia, India, and Thailand, Indonesia implements more trade restrictions (Patunru & Raharja 2015). As an example, there was a dramatic policy changing in the mineral sector in 2014 that could potentially affect the foreign capital inflows. Enacted in 2009, Law No. 4 of 2009 on Mineral and Coal Mining regulates that investors who hold Mining Permit (IUP) and Special Mining Permit (IUPK) are required to process and refine mineral ore domestically not later than 2014 (Article 103; Article 170). In the other words, exports of mineral ore were banned permanently starting 2014 and therefore, mining companies are encouraged to build smelter or refining facilities in Indonesia. On the one hand, this policy has brought a significant decrease in mineral export in which it has dropped by 15.02 percent or about US$ 3.7 billion in 2014 (Gumelar 2015). On the other hand, Indonesia was also benefited from the investment of smelters. According to Ministry of Energy and Mineral Resources' data, dominated by foreign investment, as much as 64 smelters facility amounted to US$ 18 billion will be built between 2014-2017 (Novie 2014). In the future, this policy could discourage mining sector investment because every company has to build smelter which means increasing their investment costs.

Furthermore, the government also restricts the import of certain goods. There are three levels of import restrictions to preserve the stability of economic and political and / or to protect the domestic manufacturing. Prohibited - such as electric light bulbs, specific types of textiles, iron sheets, radio and television sets, explosives and narcotics. Restricted to State Owned Enterprises- for example fuel for vehicles, aircraft and ships. Restricted to single agencies who must get the approval from the GOI, for instance CBU (Completely Built-Up) motor vehicles of a type not assembled in Indonesia (KPMG 2015, pp. 48-49). Protectionist policies tend to be counterproductive, increasing consumer prices in Indonesia and diminishing the competitiveness level of Indonesian companies (Patunru & Raharja 2015).

(3) Outer-ring policies

Outer-ring policies are macroeconomic and macro-organisational policies which are indirectly used to influence FDI (UN 1998, p. 97). Indonesia's stable macroeconomic condition and prudent fiscal policy have been successful in attracting FDI inflows in recent years, especially for the period after the Asian Financial Crisis 1998. During the period of 2000 to 2015, Indonesia's economy grew at an average of 5.3 percent per year (World Bank 2016). Inflation has also been maintained at a low and stable level during the same period by an average of 7 percent per year (ibid). This points to a stable macroeconomic condition and implicitly suggesting that domestic demand should be able to absorb the accumulated investment. On the monetary side, the quarterly central bank rate, which reflects a signal of monetary policy response towards inflation forecast, has been in decreasing trend from 12.75 percent in January 2006 to 6.50 in September 2016 (Bank Indonesia 2016). This was an indication of a better domestic economy that attract most global investor.

On the fiscal side, prudent fiscal management has been shown by the government's ability to maintain fiscal deficit below the fiscal rules set by Law 17/2003 on State Finance at maximum three percent of GDP and debt to GDP ratio below 60 percent of GDP. According to the Ministry of Finance's (2011, p. 8, p. 28; 2016, p. 9, p. 33) data, Indonesia's budget deficit was relatively low at an average of 1.47 percent during the period of 2006 to 2015, while the debt ratio has been in decreasing trend from 39 percent in 2006 to 27.4 in 2015. According to Gondor and Nistor (2012), prudent fiscal policy would attract FDI as foreign investors possess a high confidence about the future of host country's stability, sustainability and development (p. 633).

On the other hand, under Indonesia's taxation system, every company, including FDI company, which was established and was operated in Indonesia will be treated equally and have the same tax obligations before the government. Yet, the government has also offered several tax incentives which are specifically aimed to attract FDI. According to BKPM (2016), there are tax holidays, tax allowances, import and export duty exemption as well as Value Added Tax (VAT) exemption that will be granted for foreign investors who meet certain requirements. Although many countries offer tax incentives to attract new investment and encourage growth, there is a long list of concerns with tax incentives. Nakayama et al. (2011) argues that tax incentives are inequitable and inefficient because different treatment among taxpayers leads to a distortion in resource allocations as investors' investment choices are distorted by the incentives (pp. 12-13). In support, OECD (2007) argues that tax incentives create a discrimination between old and new investment which could lead to a pressure towards decreasing compliance and higher tax avoidance (p. 7). In light of these concerns, Indonesia should not choose the road of further expanding its business tax incentives. Instead, creating a stable, fair and predictable tax system will be more effective and more efficient way to improve the country's investment climate.

Table 1 **Main tax rates for selected ASEAN countries**

Country	CIT rate (%)	PIT rate (%)	VAT rate (%)
	Standard	**Top rate**	**Standard**
Indonesia	25	30	10
ASEAN			
Cambodia	20	20	10
Laos	24	24	10
Malaysia	25	26	n.a
Philippines	30	32	12
Singapore	17	20	7
Thailand	20	35	7
Vietnam	22	35	10
Unweighted average (excluding Indonesia)	**22.6**	**27.4**	**9.3**

Source: KPMG 2013, pp. 10-11.

Furthermore, in terms of its main taxes rates, namely Corporate Income Tax (CIT), Personal Income Tax (PIT) and Value Added Tax (VAT), Indonesia is considered less competitive compared to the neighbouring ASEAN countries as shown in Table 1. Both the standard CIT and VAT rates as well as the top PIT rate are higher yet close to the average of other ASEAN countries. Among these taxes, the standard CIT rate matters for the investment climate and for the incentives of multinational firms to allocate their taxable income offshore (Bellak et al. 2009, pp. 286-287). Yet, while the CIT rate does matter for foreign investors, non-tax considerations such as macroeconomic stability, the size of the market, labour costs, and infrastructure are generally seen as more important factors. A cross countries study by the World Bank (2002) reveals a fact that a country's tax burden is not the main factor in business investment decisions, in which national taxes rank number 11 among the top 20 important factors in determining investment location decisions (p. 19). In that sense, Indonesia has a lot to offer for investors and might thus be able to sustain a slightly higher tax rates than its neighbours, while still being competitive.

Conclusion

In conclusion, Indonesia's FDI policy framework is effective to attract FDI. Indonesia offers a high level of openness and liberalisation towards a lot of FDI sectors, by implementing the Law No. 25 Year 2007 on Investment and the government's economic policy packages that ensures standards of treatment and improvement of the investment climate. Moreover, Indonesia applies a relatively low import tariff to attract FDI. However, non-tariff barrier measures by government which tend to underpin protectionism might discourage foreign investors. Lastly, stable macroeconomic condition and prudent fiscal policy have been able to attract FDI by enhancing the investors' confidence towards the stability and sustainability of Indonesia in the future. Yet, the government should reconsider the provision of tax incentives to attract FDI as these incentives are inequitable and inefficient. To enhance the investment climate, a stable, fair and predictable tax system is more preferable because it ensures certainty and creates a fair playing field for investors.

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