Executive summary

Indonesia has made remarkable economic, political and social progress over the past two decades through ambitious reforms. Steady economic growth, sound macroeconomic policies and progress in social protection have raised living standards and reduced poverty in both rural and urban areas. The COVID-19 pandemic has halted this progress and plunged Indonesia into a severe recession with dire economic and social consequences.

Private investment, both foreign and domestic, can contribute strongly to Indonesia's recovery from the pandemic. Foreign direct investment (FDI) has dropped significantly during the crisis and will be needed to achieve the country's sustainable development objectives. Foreign firms in Indonesia are more productive, have higher employment ratios and pay higher wages than domestic firms. They also export a higher share of their production and generate important multiplier effects on the domestic economy. While the government has put business environment reforms high on its agenda, it has the opportunity to build a sound, transparent and responsible investment environment to support the economic recovery from the pandemic and ensure investment benefits are widely shared and environmentally sustainable.

Policymakers have yet to demonstrate their intention to establish a clear role for FDI in Indonesia's development ambitions. Already before the outbreak, Indonesia was failing to live up to its potential as a host to FDI, despite its numerous attributes. On the one hand, there is a desire to protect the local economy from foreign investment, on the other a willingness to undertake deep reforms to further benefit from FDI. Government efforts on transparency, the rule of law and the quality of institutions have been notable but insufficiently consistent to improve investor confidence and ensure responsible business practices by foreign and domestic companies. Roles and responsibilities across ministries are sometimes unclear and uncoordinated. And while decentralisation came with new opportunities, it also makes it challenging to conduct consistent investment policymaking. The Omnibus Law on Job Creation enacted in October 2020 is a major reform package seeking to address many of these challenges. While it is premature to analyse its full impact, the law presents opportunities to improve the investment climate but may also pose some risks to society.

Despite past liberalisation efforts, Indonesia's approach towards FDI remains restrictive, with many primary and services sectors still partly off limits to foreign investors. A range of discriminatory policies apply across the board, such as higher minimum capital requirements for foreign-invested companies and stringent conditions on employing foreigners in key management positions. Local content requirements are also widespread, adding to the hurdles of carrying out foreign investments. A bold and comprehensive reform package to significantly reduce FDI barriers could increase the stock of FDI by up to 85%. Indonesia should consider prioritising liberalisation of FDI in services sectors due to their economy-wide productivity implications, eliminating discriminatory requirements against FDI in horizontal regulations and preserving the current 'negative list' approach to ensure transparency.

Indonesian law provides core protections to investors relating to non-discrimination, expropriation and free transfer of funds. These protections generally provide clear rights that should instil investor confidence to the extent that enforcement mechanisms are robust. An overarching regulatory framework for cybersecurity and data protection would better help Indonesia meet its objective of developing the digital

economy. In terms of dispute resolution, the Indonesian court system lacks transparency and impartiality, with many firms preferring to use alternative dispute resolution. Fighting corruption in all levels of society has also been a top priority for many years but efforts to build a culture of integrity in the public sector could be reinforced. A comprehensive review of investment treaties was conducted in 2014-16, but priorities with respect to investment treaty policy could continue being reassessed, clarified and updated.

Indonesia was one of the first countries to integrate corporate social responsibility within the legal framework and has recently promoted responsible business conduct (RBC), notably in sustainable finance and business and human rights. Indonesia's ambition to introduce transparency of beneficial ownership information is also notable. A more strategic approach to promoting RBC across sectors by the government may be warranted, particularly in light of the social impact COVID-19 has had on Indonesia's manufacturing sector and the high environmental costs that growth so far has brought. Embracing RBC would help the government ensure ongoing industrial strategies are fit-for-purpose for today's global economy and help re-orient the financial sector toward sustainable finance. Greater focus could be given to existing business operations in sectors where risks are high, and incorporating RBC in state-owned enterprises would give a signal to the market.

Recent business environment reforms include the establishment of an online single submission system to harmonise the business licensing process, which still suffers from inefficiencies and implementation issues. The Omnibus Law on Job Creation seeks to address the ease of doing business in a structural manner, but wide-ranging consultations are needed to ensure its implementation is both successful and beneficial. The pandemic has also revealed that reinforced aftercare services supporting established investors are crucial in times of uncertainty. In parallel, as the pipeline of new FDI projects is likely to drop, a more focused investment promotion strategy would be well-advised in recovery efforts. Indonesia's tax incentives are among the most generous in the region and could be used more judiciously in investment promotion. The gradual shift to cost-based incentives is a positive development. Efforts have also been made to increase transparency and communicate incentives more clearly, but the wider tax incentive scheme remains complex.

Ambitious decentralisation reforms since 1998 have shaped regional development and the geography of investment across the country. Regional governments have the authority to develop and implement their own investment-related regulations, in accordance with higher-level national regulations. Despite the establishment of regional one-stop integrated services centres, the lack of co-ordination between the central and subnational governments, the unclear division of authority and overlapping regulations remain important challenges. Investment policymaking has been increasingly recentralised to improve the business climate, but subnational governments should be involved in the decision-making process and gradually build their capacity to ensure a sustainable approach in the longer-term.

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