7 Investment policy and regional development in decentralised Indonesia

This chapter examines investment trends and policies in Indonesia at the subnational level. It analyses how Indonesia's decentralisation reforms have been shaping the investment policymaking landscape. The chapter reviews regional development policies related to investment attractiveness and the responsibilities of subnational governments in improving the business climate, particularly the business licensing process, and in conducting investment promotion activities. It also provides an overview of zone-based policies in Indonesia, with a focus on the Special Economic Zone programme.

Summary and policy recommendations

Indonesia has embarked on ambitious decentralisation reforms since 1998, which have shaped regional development and the geography of investment across the country. Decentralisation was seen as a vital complement to the democratisation process and a reaction to the inherently centralised approach of the previous government in a country with over 17 000 islands and strong cultural and linguistic diversity, as well as stark regional inequalities. Local governments were handed large responsibilities for providing public services and shaping economic policy, including investment policy, along with extensive fiscal transfers.

Two decades later, decentralisation is still an unfinished policy agenda. After the massive transfer of authority in the 2000s, Indonesia has been struggling to find the right balance in the sharing of investment and regional development policies responsibilities across different tiers of government. To simplify an overly complex investment environment and reduce legal and regulatory uncertainties, the central government has enacted successive policy measures modifying the responsibilities devolved to subnational governments. In this quest, the central government has adjusted the legal framework for local governance several times, through back and forth movements of decentralisation and recentralisation.

Hastened devolution of responsibilities has led local governments to manage their regions without the required accompanying skills, technical capacities, resources and oversight (OECD, 2016a). As a result, decentralisation has not led to significant reductions in regional inequalities, which continue to be high across the country. Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia’s economy and, to some extent, more than in other emerging countries. Improvements in some policy areas have been made, but the capacity of subnational governments to produce public goods, generate inclusive growth and boost productivity has not always increased, even with rising transfers from the central to subnational governments. The COVID-19 outbreak, and the resulting crisis, may further exacerbate existing regional disparities.

Regional disparities in the levels of education, infrastructure, health and governance (e.g. less corruption) narrowed but they are still high and weigh on the ability of less developed regions to attract investment other than for commodity extraction. After decades of concentration on the island of Java, the observed catching-up in the level of investment by the other islands is partly driven by foreign exploitation of natural resources. Furthermore, the catching-up has not reached all regions, including urban areas with relatively high human capital and entrepreneurial activity. Resource-scarce and least developed regions, which are often at the periphery, have continued to attract little investment since being granted regional autonomy.

Regional governments have the authority to develop and implement their own investment-related regulations, in accordance with higher-level national regulations. The establishment of regional one stop integrated services centres, PTSPs, and, later on, the introduction of the online single submission (OSS) system were steps in the right direction to improve the business licensing process throughout the country. But regulatory, technical and governance challenges continue to hamper the efficacy of these initiatives, creating room for regulatory capture by local government. Not all local bodies in charge of delivering permits related to environmental standards or land use co-operate with the PTSP, arguing that the foreign investment projects are imposed by the central government. They may also lack the capacity to properly deliver such permits and can be more prone to corruption.

Overlapping regulations, if not contradictory investment policies, are another challenge behind the unclear division of authority between the central and subnational governments. For instance, some regions set their own regulations to restrict foreign investment in specific activities. Over the past two years, there has been a strong push for business climate improvements through a recentralisation of investment policymaking. The Omnibus Law on Job Creation, which was adopted in October 2020, seeks to harmonise central and regional regulations and ease the investment process. If the law is to reduce the level of legal uncertainty by withdrawing regulatory power from the regions – it allows the central administration to take

over environment-related licences from regional governments, the central government should ensure that implementation at the subnational level takes place, as the proposed reduction in powers may create ground for a constitutional challenge. To avoid that outcome, it is critical to have solid consultation mechanisms ex ante to ensure that subnational government views are taken on board.

The rationale for recentralising investment policymaking and business licensing is, in part, because less developed regions do not always have sufficient institutional and technical capacities. This recentralisation, however, should not come at the expense of much needed labour and environmental protection safeguarding a more inclusive and sustainable local development pathway (see Chapter 5 on responsible business conduct). Local bodies may be better placed to assess business opportunities and sustainability risks, and at the very least should have a clear role in this process, even if ultimately the decision-making process is re-centralised. Building gradually their capacity can be a more sustainable approach in the longer term, while also promoting shared responsibilities across tiers of government rather than top-down governance. At the same time, higher levels of government lack the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors and to avoid a possible race to the bottom in environmental or other sustainability standards across regions.

One priority for the central and regional government is to strengthen their efforts in order to create a predictable investment environment that supports a resilient, sustainable and inclusive economic recovery from the COVID-19 pandemic. These efforts are more than ever needed in less developed and poorer regions of the archipelago, where higher levels of uncertainty may delay much-needed investments in infrastructure and human capital development. The pandemic has revealed that after-care services can be crucial in times of high uncertainty and subnational investment agencies are well-placed to deliver specific and targeted support to established investors. On the regulatory front, uncertainty on the content of the negative investment list (DNI) and the related restrictions on foreign investment in sectors like maritime transport may delay or prevent new foreign projects in infrastructure.

Another priority for all levels of government is to boost regional development by attracting more diversified, sophisticated and sustainable investment. Regional investment agencies should upgrade their investment promotion tools, in co-ordination with the national investment promotion agency, BKPM, and its international investment promotion centre overseas offices (IIPC). Previous zone-based policies to attract productivity-enhancing foreign firms into lagging regions had no conclusive impact. The Special Economic Zone programme aspires to overcome previous shortcomings by involving subnational governments in the decision-making process and granting non-tax incentives. Fiscal incentives consist of both tax holidays and investment tax allowances. The latter are preferable to preserve fair competition between firms inside and outside of zones.

Main policy recommendations

- The central government could further clarify investment policy responsibilities assigned to different government levels to reduce duplication and overlaps. Responsibilities should be balanced across levels of government, sufficiently funded, explicit, mutually understood and clear for all actors. Clarifying responsibilities is particularly important when they are shared, such as in the case of investment policy. The implementation of the Omnibus Law on Job Creation could be an opportunity to clarify responsibilities. Higher levels of government should ensure that subnational government views are taken on board through inclusive consultation.
- Higher levels of government should continue building the capacity of investment and investment-related institutions, particularly of PTSPs and technical agencies delivering operational permits. They should assess capacity challenges in regions on a regular basis and prioritise those with the most pressing needs (e.g. poor and remote areas). The central government should ensure that PTSPs can operate effectively the OSS and that they can issue most, if not all, investment permits.

- The recent recentralisation should go hand in hand with building the capacity of local bodies and sharing responsibilities across levels of government. Ongoing recentralisation reforms should provide higher levels of government with legal levers to limit regulatory capture and asymmetries in information between local administrations and investors, and ensure that national environmental norms, labour standards and other sustainability aspects are well-respected across regions.
- Regional investment agencies could seek to upgrade their core investment functions, in close co-ordination with BKPM. Regional agencies could take a more pro-active role in promoting foreign investment and tailor their promotion tools to focus on relevant investments for their region, in co-operation with BKPM overseas offices. Collecting comparative information on foreign competitor regions can be useful in refining local investment promotion tools such as investment generation activities. To reduce uncertainty generated by COVID-19, regional agencies could also strengthen their after-care services to respond to requests of existing investors.
- Regional investment agencies could reinforce their co-operation with other local bodies such as business development services to better align the production of local suppliers with the needs of foreign firms. Central and regional government could also help to build local firms' absorptive capacity by raising awareness about business development services and easing procedures to get the adequate support.
- Incorporate the investment aims of zone-based policies into investment promotion and regional development strategies. Cost-based incentives such as tax allowances should be favoured over tax holidays. To streamline wider zone-based policy, phase-out zone types that have not achieved their goals. Otherwise, convert them to special economic zones (SEZs). Monitor impact of regulatory incentives in SEZs, and if effective and do not lead to lower norms or standards extend them to the rest of the country.
- Promote regional development policies that reduce disparities in education, infrastructure and the quality of local governance:
    - The impact of the recently introduced firm-level incentives on skills development should be monitored to assess impacts.
    - In light of the high relevance of maritime transport for the connectivity of the archipelago, the central government could explore whether easing restrictions in this sector could help to attract foreign projects which support inter-island connectivity.
    - Increase the presence of the Corruption Eradication Commission, KPK, in provinces, especially in those with business sectors at high risk of corruption.
- The central government could develop investment environment indicators to benchmark provinces, provide them with technical assistance where needed and monitor impacts of reforms. Performance-monitoring systems of decentralised investment environments need to be simple, with a reasonable number of standardised indicators. Higher-levels of government should be able to monitor subnational performance of governments below them.

Indonesia's decentralisation process: an unfinished reform agenda

Decentralisation in Indonesia began in 1998, a period during which the country went through a democratic transition, an era known as *Reformasi*. The initial goal behind decentralisation was to moderate political and social tensions over the use of natural resources. It was also to reduce the distance between elected officials and their voters with the goal of placing regions on track for better monitoring and governance. With regional autonomy, the objective of economic development was handed to subnational policymakers, the rationale being better accountability and service delivery through increased responsiveness to local needs (OECD, 2016). This path is not unique to Indonesia – the global trend has been towards more decentralisation. Besides the quest for democracy, greater efficiency and accountability, mega-trends like

digitalisation and globalisation also contribute to the stronger role played by subnational governments (OECD, 2019a).

Decentralisation has resulted in a significant rise in the number of subnational governments in Indonesia. The government consists of five levels of administration: central, provinces, regencies and cities, districts, and villages (Table 7.1). Villages are the only level with no dedicated investment policy responsibilities. Before 2000, there were 27 provinces and 297 regencies/cities. This number has increased to 34 provinces and 514 regencies/cities as of early 2020. To get an order of magnitude of the geographical size associated with each level, a province has a median land area of 41 000 square kilometres – approximately the size of Switzerland. A district has a median land area of 1886 square kilometres, which is slightly larger than a US county (Rothenberg et al., 2017).

Table 7.1. The levels of government and investment policymaking in Indonesia

Type	Number	Head of administration	Investment policy
Central	1	President (elected)	✓
Provincial	34	Governor (elected)	✓
Regency/City	514	Regent & mayor (elected)	✓
District	7160	Head of district (appointed by regency/city)	✓
Village	83184	Chief	x

Source: OECD (2017) and Statistics Indonesia.

This ambitious course of decentralisation has transformed the way the Indonesian government conducts investment policy and has shaped the archipelago's regional development objectives. Within an overarching strategy to improve the business climate, decentralisation can be a channel to improve investment promotion and facilitation. In decentralised countries, subnational levels of government are, to varying degrees, bound to legislative, operational and other constraints set at the national level. At the same time, decentralisation creates new opportunities for local innovation and progress by making the political process more efficient. Subnational governments can push reform to improve their investment regime to the greatest extent possible, while avoiding duplication of activities or conflicts with investment laws and policies of the central government (OECD, 2010).

The first wave of sweeping decentralisation reforms in 1999 devolved authority from the central government to subnational levels in all policy domains, except national security, defence, religious affairs, foreign affairs, monetary policy, and justice.[1] Local administrations became autonomous in managing economic development and providing public services. On investment, regional governments started issuing foreign and domestic investment and business licences while the central government continued to issue licences for foreign projects in high technology and high-risk sectors.[2] For instance, provinces established regional investment boards to advise the governor on local investment policy, issue licences and monitor implementation.

The abrupt and massive transfer of responsibilities to the subnational government, with no clear co-ordination mechanisms and little local capacities, led to a worsening of the business climate. In response, the government transferred two million civil servants to the provinces and adjusted the law on local governance twice, in 2004 and 2014.[3] With the second wave of reforms, the central government recentralised the authority to deliver investment licences for foreign projects and ran the licensing procedure through the Indonesian Coordinating Investment Board (BKPM).[4] The third wave in 2014 further delegated the issuing of permits to lower tiers of government, entitling them to grant operational permits like environmental and land use permits.[5] At the same time, the law gave back to provinces the authority that districts had in issuing licences for natural resource exploitation (e.g. mining and forest cultivation).

Box 7.1. Ten guidelines for effective decentralisation conducive to regional development

1. *Clarify the responsibilities assigned to different government levels*. Responsibilities should be balanced across levels of governments, explicit, mutually understood and clear for all actors. Equally important is clarity in the functions that are assigned within policy areas – financing, regulating, implementing or monitoring. Policy areas shared across different government levels need greater clarity to reduce duplication and overlaps.
2. *Ensure that all responsibilities are sufficiently funded.* Access to finance should be consistent with functional responsibilities. Division of financing responsibilities should ensure that there are no unfunded or underfunded assignments or mandates.
3. *Strengthen subnational fiscal autonomy to enhance accountability*. Subnational governments should have a certain degree of autonomy in the design and delivery of their public services within the limits set by regulations, such as minimum service standards. They need own-source revenues beyond grants and shared tax revenues.
4. *Support subnational capacity building.* Central government should assess capacity challenges in regions on a regular basis. Policies to strengthen capacities should be adapted to regions' specific needs. Governments should build capacity of institutions in a systemic approach, rather than adopting a narrow focus on technical assistance. Specialised agencies accessible to multiple jurisdictions should be encouraged.
5. *Build adequate co-ordination mechanisms across levels of government*. Tools for vertical co-ordination include dialogue platforms, fiscal councils, standing commissions and intergovernmental consultation boards, and contractual arrangements.
6. *Support cross-jurisdictional co-operation*. Carry out horizontal co-ordination using specific matching grants, and by promoting inter-municipal/interregional co-operation as well as metropolitan governance. Promote rural-urban partnerships as a form of cross-jurisdiction collaboration to enhance inclusive growth and address co-ordination failures.
7. *Strengthen innovative and experimental governance, and promote citizens' engagement*. Citizens should be empowered through access to information. Ensure that elected local councils have the ownership and control of citizen participation and engagement initiatives. Participatory budgeting can strengthen inclusive governance.
8. *Allow and make the most of asymmetric decentralisation arrangements.* Asymmetric decentralisation should be supported by effective co-ordination mechanisms and needs to go hand in hand with an effective equalisation system. Whenever possible, participation in such arrangements should be voluntary.
9. *Improve transparency, enhance data collection and strengthen monitoring*. Performance-monitoring systems of decentralisation and regional development policies need to be simple with a reasonable number of standardised indicators. Higher-level governments need to monitor subnational performance in critical service areas and inter-local performance in service delivery. Subnational governments need to be subject to higher-level fiscal rules to ensure fiscal discipline.
10. *Strengthen regional development policies and equalisation systems and reduce territorial disparities*. The equalisation programme must not be looked at in isolation from the broader fiscal system. Pro-active regional development policies should offset potential negative incentives of such equalisation systems.

Source: OECD (2019).

Decentralisation in Indonesia is an unfinished agenda and further adjustments to the reform process are happening both on the regulatory and operational fronts. Other countries are also conducting reforms to make the most out of decentralisation, particularly in the context of heightened regional inequalities within countries. Indonesia could rely on OECD's guidelines for implementing effective decentralisation conducive to regional development (Box 7.1). Despite progress, the division of responsibilities across levels of government continues to be imprecise and jurisdictional regulatory overlaps remain (OECD, 2016). The Omnibus Law on Job Creation aims at harmonising a still overly complex regulatory framework by, inter alia, recentralising some prerogatives that were devolved to regional governments in 2014. Meanwhile, regional governments still need very much to build their capacity to support regional development, including through effective and co-ordinated regional development policies.

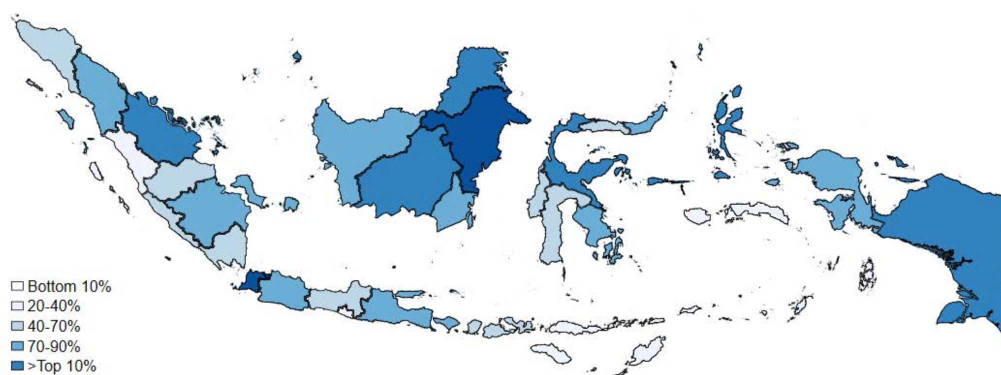
The geography of investment in decentralised Indonesia

Indonesia's noteworthy geographical and cultural diversity creates challenges but also formidable opportunities for attracting investment and enabling inclusive regional development. The country is the largest archipelago in the world, made up of over 17 000 islands, of which about 6000 are inhabited, spanning three different time zones. The population is unevenly distributed, with 62% on the island of Java with only 7% of the nation's land mass. Linguistic, cultural and religious diversity are remarkable, with over 300 distinct ethnic groups and, while Bahasa Indonesia is the national language, there are around 34 other languages spoken by at least half a million people. This section provides insights on the local context for investment policy following the process of decentralisation and examines regional variations in foreign and domestic investment.

The variety of policy settings created by regional autonomy, together with differences in economic performance across regions, have shaped the geography of investment in Indonesia. The sum of foreign and domestic investment per capita is highest in the Jakarta metropolitan area, which spreads over the provinces of Jakarta, Banten and West Java (Figure 7.1). The area is the most populous region in Indonesia and the second largest urban area in the world after Tokyo. Resource-rich regions like East Kalimantan (oil) and, to a lesser extent, Riau (oil, gas and palm oil) and Papua (copper and gold) are also home to large investment per capita. Provinces with lower investment per capita are often remote islands that lack natural resources like Maluku or East Nusa Tenggara but also areas in Java and Sumatra Islands like Yogyakarta and Aceh, the westernmost province of Indonesia.

Figure 7.1. Investment per capita across Indonesian provinces

Realised foreign and domestic investment per capita between 1990 and 2019, percentile distribution



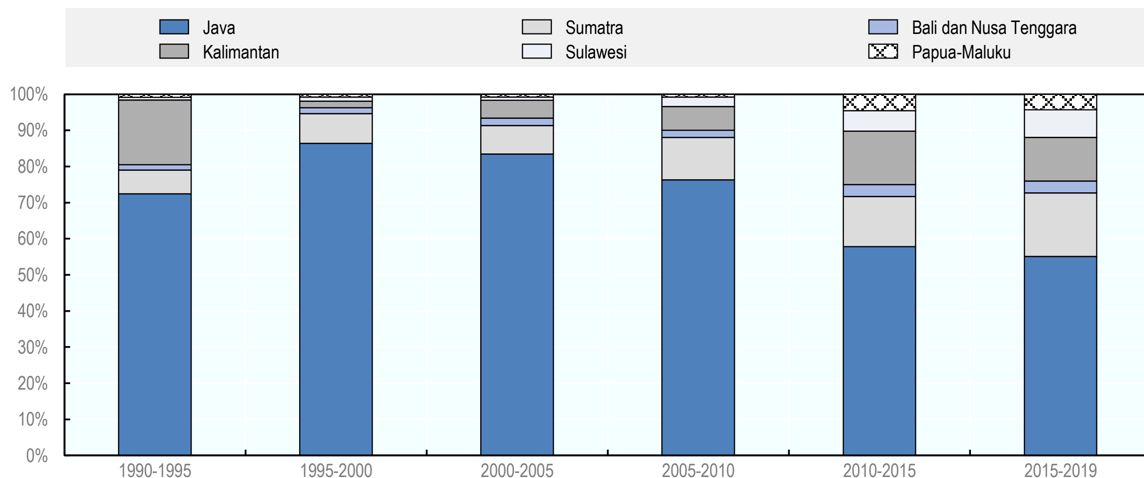
Source: OECD based on BKPM and Statistics Indonesia 2015 "Intercensal Population Census".

Decentralisation coincided with a decline in investment disparities across regions

Twenty years after decentralisation started, there are signs of convergence in the level of investment across Indonesian regions, although raw material exploitation is partly behind the catching-up. The adjustment in the geography of investment started to be visible from the early 2000s but mostly accelerated after 2010 (Figure 7.2). Industrial hubs in Jakarta, Banten, East and West Java continue to be the top investment recipients but they have gradually lost ground in favour of resource-rich and less densely populated regions outside of Java like Central Kalimantan, North Maluku, Papua, and Sulawesi. Convergence did not spread to all regions, however, including areas like Yogyakarta, an urban hub with high human capital and strong entrepreneurial activity (Box 7.2). Less wealthy provinces like Gorontalo and Maluku continued receiving little investment after regional autonomy.

Figure 7.2. Investment across Indonesia's main Islands before and after decentralisation

Share of realised investment by island



Source: OECD based on BKPM.

Box 7.2. SME and entrepreneurship activity across Indonesia's provinces

Investment is one indicator of regional economic performance among many others. Measures of small and medium-sized enterprise (SME) and entrepreneurship activity corroborate the regional patterns for investment only to some extent. For instance, small businesses density in Aceh, Maluku, Yogyakarta, and West Nusa Tenggara is high relative to other provinces while investment per capita in these areas is the lowest. Resource-rich regions such as Riau and East Kalimantan have the opposite patterns. Local factors like natural resources (large investments dominate the exploitation of natural resources) and urbanisation can explain differences between SME and investment activity across Indonesia's regions.

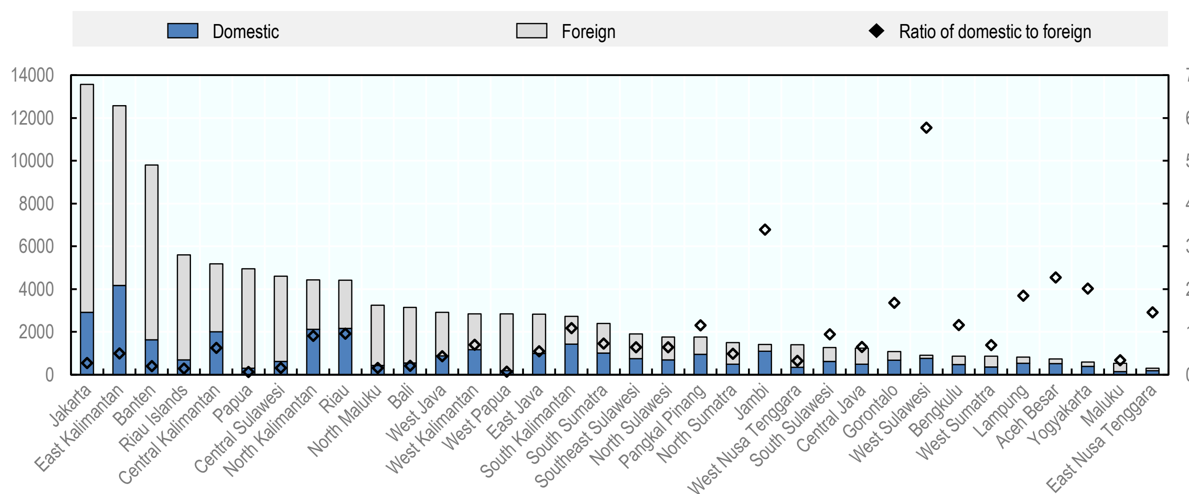
Source: OECD (2018a)

Foreign investment is geographically more concentrated than domestic investment

The activity of foreign firms has largely shaped the geography of investment in Indonesia. Between 1990 and 2019, two-thirds of investment going through BKPM was foreign but its prevalence relative to domestic investment varies strongly across the 34 provinces (Figure 7.3). Regions with larger markets, better infrastructure and more natural resources have attracted more foreign investors (Sodik et al, 2019). This is the case of industrial and tourism hubs in Java and Bali and of the region of Papua, which hosts the world's largest gold mine. National restrictions on foreign ownership in some sectors or specific regional policies could be further affecting the geographic differences between the two groups of investors. For instance, regions endowed with gas and oil such as Kalimantan and Riau have a more balanced share of foreign and domestic investors. Domestic projects prevail in regions with low foreign investment such as in Aceh Besar, Jambi and West Sulawesi.

Figure 7.3. Foreign and domestic investment per capita across Indonesian provinces

Realised foreign and domestic investment per capita between 1990 and 2019, in USD

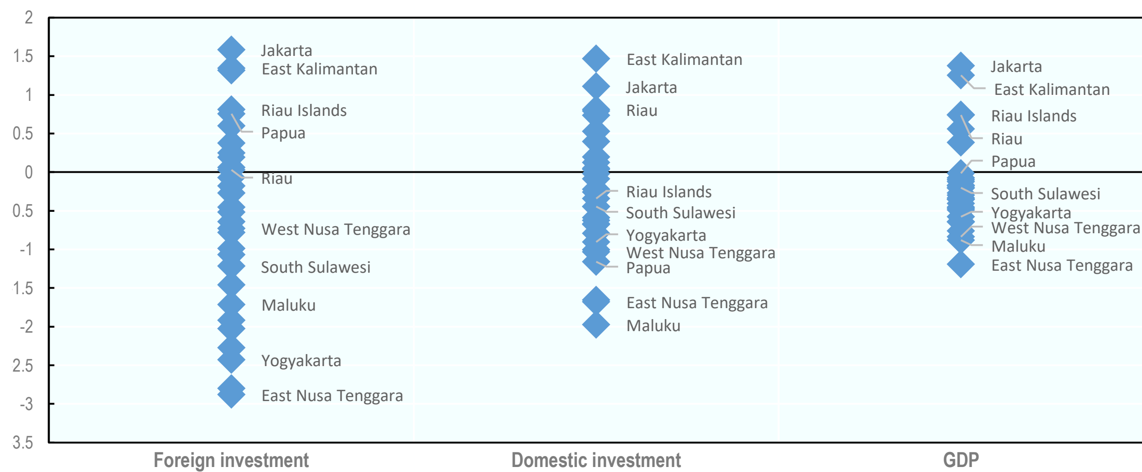


Note: Provinces' population is based on 2015 figures.
Source: OECD based on BKPM and Statistics Indonesia 2015 "Inter-censal Population Census".

Foreign businesses' unequal distribution and impacts across regions may hinder the wider process of regional convergence and, if excessive, such inequalities can feed a geography of discontent. Foreign investment in Indonesia is more concentrated in the most dynamic regions of the archipelago than are regional domestic investment and gross domestic product (GDP) (Figure 7.4). For instance, Jakarta's foreign investment is four times higher than the national average while only three times higher for domestic investment. Less developed provinces have much lower foreign investment per capita than the national average, which drives the geographical disparities in foreign investment.

Figure 7.4. Distribution of investment and GDP per capita across Indonesian provinces

Log of ratio of per capita regional foreign and domestic investment and GDP to national averages



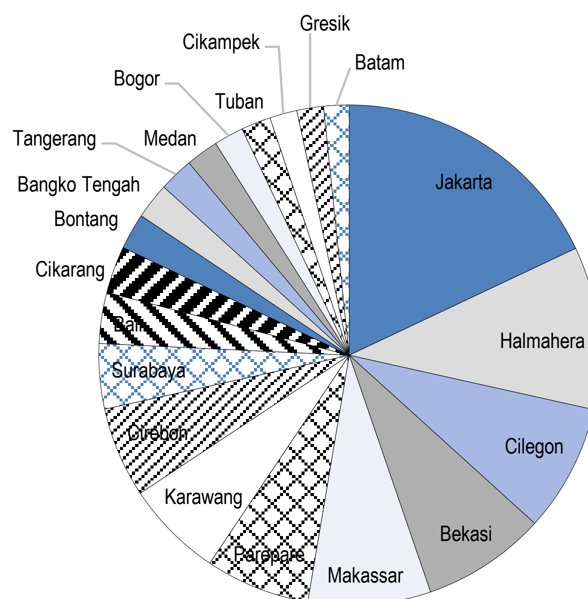
Note: Investment: realised investment between 1990 and 2019; Regional GDP: 2015. Values above (below) zero indicate that the province regional outcome is higher (lower) than the national average.
Source: OECD based on BKPM and Statistics Indonesia BPS Gross Regional Domestic Products Series.

The concentration of foreign investment in specific regions is not unique to Indonesia and is observable in other countries as well. Although there are no cross-country comparable data on foreign direct investment (FDI) geographical concentration, available statistics on GDP per capita reveal that regional disparities are larger within Indonesia than in other emerging countries (OECD, 2016). Foreign multinational activity tends to be less widespread than domestic activity, either concentrated in the industrial sector or economic hubs within the tertiary sector of host countries (Lejaragga and Ragoussis, 2019). This is partly driven by the behaviour of larger firms, whether foreign or domestic. More specific to Indonesia is the concentration of large-scale foreign projects in remote regions with natural resources such as Papua.

Along with natural resources, the presence of urban hubs also shapes the variations in FDI flows across Indonesia. Some provinces are home to nine cities (e.g. East Java) while others host two (e.g. Jambi). Among 90 cities with greenfield FDI projects between 2003 and 2019, the 20 cities with the largest amount of FDI accounted nearly for 40% of the total (Figure 7.5). The metropolis of Jakarta, the largest recipient, ranks 29th in the world as a recipient of FDI, ahead of Manila but behind Shanghai and Ho Chi Minh City (Wall, 2019). Major cities like Surabaya and Bekasi in Java and Makassar in South Suwalesi are also top recipients. Despite their smaller population, Halmahera and Cilegon account for large shares of greenfield investment. Halmahera in the province of North Maluku had a boom in mining activity in the 2000s – the provincial government issued at least 34 mining licences at that time. Cilegon is a major coastal industrial city in the province of Banten and one of the largest steel production centres in Southeast Asia. The city hosts industrial estates that are home to factories of large multinational companies.

Figure 7.5. Greenfield foreign investment across top 20 Indonesian cities, 2003 to 2019

Announced greenfield foreign investment by city, in percent



Source: OECD based Financial Times fDi Markets.

The economic crisis generated by the COVID-19 pandemic can affect the geography of FDI in Indonesia and may even slow down the observed convergence in the distribution of investment across regions. Although Jakarta is hit hardest, the shock is likely to be more transitory than in other regions of the archipelago. Provinces relying on investment in tourism (e.g. Bali) and oil production (e.g. Riau) will be temporarily affected too. More problematic for regional convergence is the rising level of uncertainty that may push investors to cancel projects in riskier sectors and regions such as infrastructure investments in remote areas with poor institutional and socio-economic conditions.

Regional disparities affect the geography of FDI and its development impact

Regional specificities, and related policies, shape the location choice of foreign investors in Indonesia and their motives, which in turn can amplify or reduce spatial development inequalities (Box 7.3). Regional disparities in the concentration of economic activity have been a long-standing feature of Indonesia's economy. In the 1980s, the per capita gross regional GDP of Central Jakarta, the richest district, was over 23 times that of South Bengkulu in Southeast Sumatra, the poorest district (Rothenberg et al., 2017). Decentralisation to promote regional development and reduce disparities has had mixed outcomes (OECD, 2016). The difference in per capita GDP across Indonesian provinces continues to be high relative to other emerging countries like Brazil, China and Mexico.

This section reviews regional development challenges and policies that are most relevant for attracting investment. Aside from market size, investors in Indonesia are attracted to provinces with both hard (transport, electricity, etc.) and soft (ICT) quality infrastructure, a skilled labour force, competitive wages, and a larger pool of exporters (Sodik et al., 2019). Indonesia has made progress in some areas but the capacity of local governments to produce public goods and boost productivity has not always increased, despite an increase in transfers from the central to subnational governments (OECD, 2016a). Despite the advances, regional disparities in education, infrastructure, governance, continue to be large.

Box 7.3. Reconciling global investment with regional development policies

Globalisation has led to a stronger role of subnational governments (OECD, 2019a). Free movement of capital means that subnational governments can compete for global investment, a task once monopolised by central governments. On the other hand, globalisation has exacerbated within-country inequalities. The disparity, which has fuelled a geography of discontent, questions the achievements of traditional liberalisation policies and the view that location advantages reflect only national policies and not regional features (Iammarino, 2018). In this context of a backlash against globalisation, the role of subnational governments became a way to better echo citizens' demands and needs.

Regions' specificities shape the location choice of FDI. Regional development policy includes business climate policies related to education and infrastructure, support to local firms, and skills development. By improving human capital and modernising infrastructure, a region not only becomes more attractive but can also benefit more from FDI through higher spillover mechanisms and absorptive capacities. A well-informed subnational strategy for improving the investment climate must target specific reform areas where local governments' room for manoeuvre is greatest, and where other challenges could be addressed at central level through effective policy advocacy.

Other policies influence directly the location choice of firms. These include fiscal incentives, the creation of special economic zones and the establishment of local bodies in charge of investment policy. Non-fiscal policies striving at informing investors about the investment potential of regions and improving the local business climate, for example by removing burdensome regulations, can be effective. For instance, FDI responds particularly well to the activity of subnational investment promotion agencies, especially in regions with malfunctioning institutions and inadequate information diffusion mechanisms (Crescenzi et al., 2019).

Regional variations in the ease of doing business persist despite improvements

Contrary to expectations, the investment climate in Indonesia did not significantly improve following regional autonomy (OECD, 2010). The cost of starting a business in Indonesia continues to be high and varies widely across regions, and procedures for obtaining a business permit can remain lengthy and complex despite recent improvements (see Chapter 6 for an analysis of the investment environment at the national level). A number of surveys identify variations in the ease of doing business across Indonesian provinces or cities, although the surveys are often outdated, except for an annual comparison of Jakarta and Surabaya in the World Bank Doing Business indicators. [6] Available surveys also examine few aspects of the business climate, or cover only a small number of provinces or cities.[7]

Since 2017, UKM Indonesia, a web portal developed by UKM University, tracks all licensing regulations at the subnational level. In a pilot project covering eight cities, the initiative has collected, analysed and published in a user-friendly format more than 130 national regulations and 371 regional regulations so that users can access information that is relevant to their business context. The project identifies whether a one stop integrated services office (PTSP) or a specific technical agency (SKPD) issues the licences. The results have shown that the number of licences is broadly similar across cities – between 100 and 130 licences, but the capacity of the PTSP to be the authority responsible of issuing them can strongly differ (Table 7.2). In most of the surveyed cities, PTSPs issue up to two thirds of the licences. In the city of Pajakumbuh, the PTSP issues 107 out of the 115 licences while Bandung's office issues less than 30 out the 130 licences inventoried by the project.

The initiative by UKM Indonesia is useful in providing an online inventory of all existing licensing regulations at the subnational level. But there continues to be a dearth of complete, comparable and up-to-date information on the quality of the business climate in Indonesian regions. The central and regional governments could work with UKM Indonesia to further extend the inventory of regulations to cover other

cities, particularly in the eastern islands of Indonesia, where information about the business climate is less available. Policymakers could leverage this inventory as an evidence-based tool to streamline the business registration process and monitoring progress.

Table 7.2. Number of licensing regulations at the city level, 2017

City	All Licences	One Stop Integrated Service Office (PTSP)	Specific technical Agency (SKPD)
Bandung (West Java)	130	28	102
Bekasi (West Java)	107	47	60
Bogor (West Java)	131	72	59
Denpasar (Bali)	130	80	50
Depok (West Java)	112	59	53
Payakumbuh (West Sumatra)	115	108	7
Sukabumi (West Java)	58	41	17
Surabaya (East Java)	137	76	61

Source: UKM Indonesia and World Bank, see http://www.ukmindonesia.id.

As a complement to the initiative by UKM Indonesia, which only lists permits, the central government, together with regional actors like KPPOD, could develop and publish online regional indicators on de facto barriers to private sector development. This would help to benchmark provinces, identify those most in need of support and monitor progress over time. Transparency could push regional governments to undertake reforms that improve the business climate. For instance, the provincial competitiveness index in Viet Nam, released every year, has been used by Vietnamese provincial authorities to learn from one another and conduct reforms (OECD, 2018c). As in Indonesia, provinces in Viet Nam have the authority to issue investment certificates and business registration certificates (Box 7.4)

Box 7.4. Tracking improvements in provinces' business climates: The example of Viet Nam

In Viet Nam, the Investment Law of 2005 (since superseded by the Investment Law of 2014) transferred the authority to issue investment certificates and business registration certificates, among other things, to the provinces. Following these reforms, provincial authorities were formally empowered to improve their own investment climate. Teams were charged with facilitating FDI in each province and many provinces were able make significant changes in the rules and regulations governing business activities.

Following the 2005 reforms, peer learning and benchmarking among Vietnamese provinces helped boosting regulatory reform at local level. This is illustrated by the Provincial Competitiveness Index, which assesses and ranks the economic governance quality of provincial authorities. The index is based on annual business surveys of the local business environment and data from official sources regarding local conditions. The business survey data can be disaggregated by firm age, legal type and sector.

The Provincial Competitiveness Index is divided into ten sub-indices: (i) entry costs for business start-up; (ii) access to land and security of business premises; (iii) transparency of the business environment and equitable business information; (iv) existence of informal charges; (v) time required for bureaucratic procedures and inspections; (vi) crowding out of private activity from policy biases toward state, foreign, or connected firms; (vii) proactivity and creativity of provincial leadership in solving problems for businesses; (viii) existence and quality of business support services; (ix) existence and quality of training policies; and (x) fairness and effectiveness of legal procedures for dispute resolution.

Source: OECD (2018c).

Spatial inequalities in infrastructure continue to be a challenge for connectivity

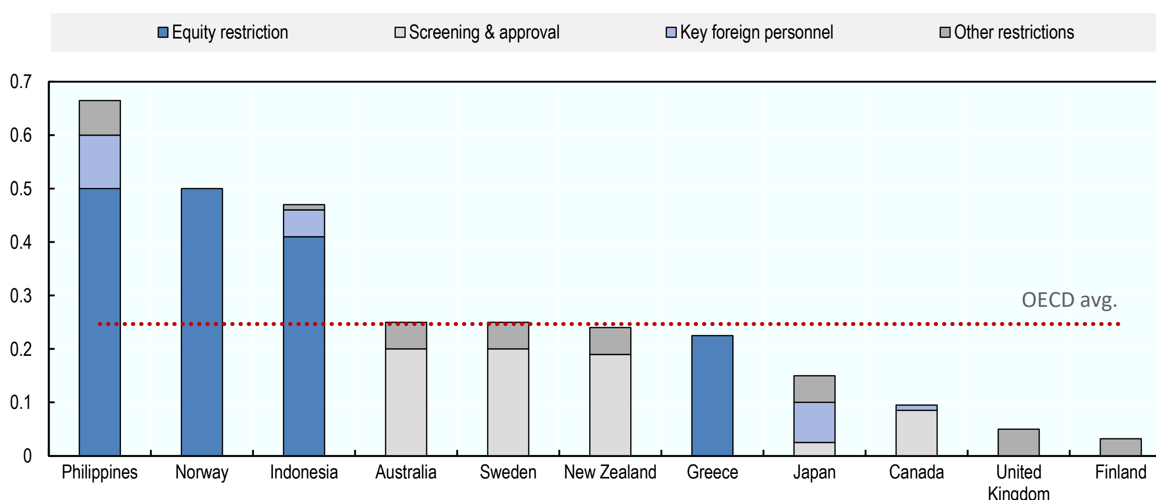
Improvements in infrastructure have occurred in the last few years, and private investment has been on the rise in the sector, but regional disparities remain a big challenge (OECD, 2018b). The decentralisation process transferred both decision-making and financial resources for the provision of transport infrastructure to local governments. The process was slowed down by the lack of co- ordination among key stakeholders and still needs to be improved (OECD, 2013).

Despite being an activity that needs involvement of different jurisdictions, in practice, shared responsibilities across levels of government in developing physical infrastructure is limited in comparison with other countries, including other unitary states like Indonesia – more than one government level is involved in only 30% of the decisions related to transport policy (OECD, 2019a). Local administrations do not necessarily have the capacity to design and implement their assigned infrastructure projects effectively. Central government needs to intervene to build local capacity, by increasing resources, training local government staff, and improving e-government tools.

Insufficient in quantity and inadequate in quality, transport infrastructure is a serious bottleneck in developing regions of Indonesia (Vujanovic, 2017). The disparities across regions, and between urban and rural infrastructure, pose further challenges (OECD, 2013). The expansion of air transport infrastructure to new regions of the country has been visible over the past years and, among other things, has facilitated the rapid growth of tourism. Investment is still needed to improve existing airports and build new ones, however. Environmental infrastructure such as waste, water, sanitation and sewerage facilities is also spread unequally across regions. Soft infrastructure is equally essential for connecting islands with each other and beyond national borders. Better reach and reliability of 4G technology and broader internet availability would help local firm creation and growth and reduce the gap between urban and rural Internet users (OECD, 2018b).

Figure 7.6. Maritime transport: restrictions on FDI in top countries with islands

OECD FDI Regulatory Restrictiveness Index (open=0; closed=1), 2018



Note: The OECD FDI Regulatory Restrictiveness Index covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other important aspects of an investment climate (e.g. the implementation of regulations and state monopolies, preferential treatment for export-oriented investors and SEZ regimes among other) are not considered. Data reflect regulatory restrictions as of end-December. Please refer to Kalinova et al. (2010) for further information on the methodology.
Source: OECD FDI Regulatory Restrictiveness Index, www.oecd.org/investment/fdiindex.htm.

Given the government's revenue constraints, public and private investment in infrastructure, particularly in transport, should be encouraged. In order to increase regional access to infrastructure financing sources, the government has made several efforts such as relaxing the rules related to regional loans in 2018.[8] This included an expansion of the types of projects that can financed by regional bonds but also a clarification of the division of tasks between the Ministry of Finance and the Ministry of Home Affairs in the loan approval process.

Foreign investors can also help plug the investment gaps that hamper infrastructure development, particularly outside of Java. Easing restrictions in the transport and tourism sectors, notably by reducing foreign equity limitations and restrictions on foreign personnel, could facilitate foreign investment (see Chapter 3 on the FDI regime).[9] If restrictions in maritime transport are common across countries, they are often low in those with many islands, particularly foreign equity limitations, reflecting their larger investment needs in this sector (Figure 7.6). Outside of special economic zones, foreign land ownership restrictions also limit the development of hotels and restaurants although a right to build can be issued to foreign companies for 30 years.

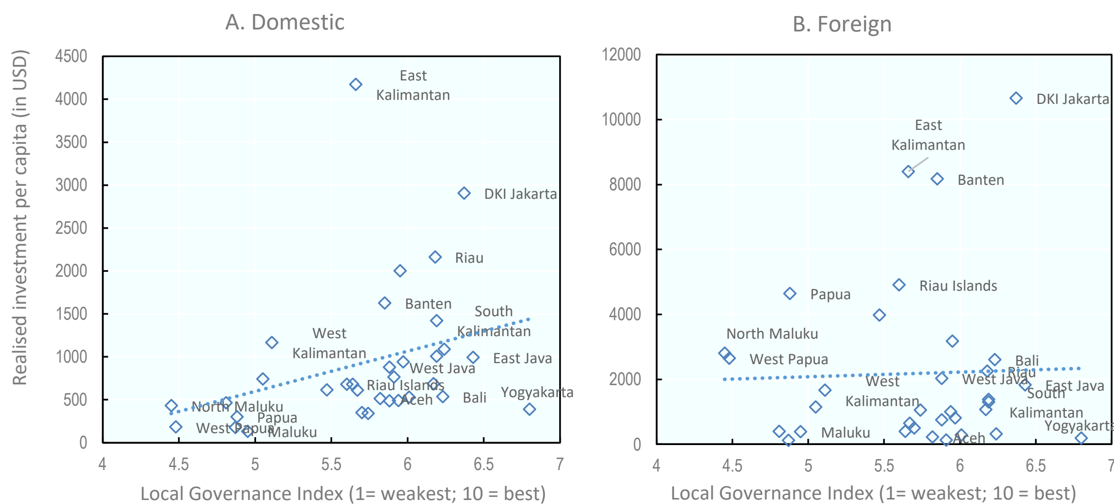
Better local governance can unlock investment in non-resource activities

The quality of local governance is a strong factor of foreign investment attractiveness. In China and Russia, for instance, regions with higher levels of government efficiency and active anti-corruption campaigns attract more FDI (Cole et al., 2009; Zakharov, 2019). In Indonesia, anti-corruption reforms have enjoyed some success. But decentralisation has, in effect, shifted corruption to the local level (Transparency International, 2018). Strong variations exist in the quality of local governance across Indonesian provinces. The Indonesia Governance Index shows that the quality of local government is best in Yogyakarta and Jakarta and worst in North Maluku and West Papua, suggesting that it is linked, among other things, to local levels of income (OECD, 2016a).

Agencies such as the Corruption Eradication Commission (KPK) play crucial roles in improving local governance, notably in reducing losses due to bribery and corruption and in providing capacity building to local bodies. KPK's resources and institutional capacities are largely concentrated at the national level, however, leaving the fight against local corruption primarily in the hands of local governments (Tomsa, 2015). Reforms must further target corruption in local government, notably by increasing KPK's local presence in provinces, especially in those with business sectors at high risk of corruption or conducting infrastructure procurements (OECD, 2016b). Recent reforms in local governments to increase e-procurement and strengthen internal budgeting and controls go in the right direction (OECD, 2018b).

Better local governance would help resource-rich regions diversify away from FDI in commodity extraction, where large-scale investors may be offered specific guarantees by the government, and strengthen investment impacts on the local economy. Figure 7.7, panel a, shows that the quality of local governance relates positively to domestic investment per capita – provinces with better governance attract more investment. The poor performance of Yogyakarta is puzzling in light of the province's better governance and higher skilled workforce. The relationship between local governance and foreign investment is altered by resource-rich areas, like Papua and North Maluka, which attract relatively high amounts of foreign investment, despite weaker governance (Figure 7.7, panel b).[10]

Figure 7.7. The quality of governance and investment per capita across Indonesia's provinces



Note: Realised investment per capita corresponds to foreign and domestic investment between 1990 and 2019.
Source: OECD based on Indonesia Governance Index (2012) and BKPM.

The impact of foreign investment on jobs and other development outcomes in resource-rich regions is probably limited, as companies are capital-intensive. Fiscal revenues from large mining companies, to the extent they are retained locally, could contribute to improving development outcomes indirectly as they could be used to develop infrastructure and improve the level of skills of the workforce. Taxation is relatively centralised, however, and funding for public services continues to be through central government transfers and, to a lesser extent, equalisation funds that share revenues from natural resources across governments (OECD, 2018b). At the same time, fiscal decentralisation with limited local capacity and low accountability may favour corruption cases in local governments.

Upgrading SME capabilities in less developed regions will improve FDI impacts

Foreign investment in Indonesia can create significant business linkages with domestic companies (see Chapter 2). Nonetheless, investment outside of Java has not necessarily generated the expected spillovers on the local economy as it has often been confined to resource-rich projects that forge few business linkages in an environment with weak rule of law. Furthermore, the performance gap between foreign and domestic firms in Indonesia also points to gaps in domestic SME capabilities, which may reduce chances for linkages with foreign firms and limit spillovers, especially in less developed regions with a larger knowledge gap between foreign and domestic firms.

Strengthening domestic firms' capabilities requires policy efforts in different areas, including improving human capital, boosting innovation, and promoting responsible business conduct (see Chapter 5 on responsible business conduct). Indonesia, as other countries, provides recourse to business development services (BDS) to enhance the productivity and competitiveness of SMEs through the upgrading of managerial and technical skills, access to markets, new or improved technologies, and appropriate financing mechanisms. The use of BDS varies strongly across Indonesian provinces, ranging from 1.5% in the eastern province of Maluku to 14% in the Special Region of Papua in 2015. Lack of awareness about BDS has been the main reason across all provinces for small businesses not using them, followed by procedural difficulties. Indonesia could seek to remedy this through awareness-raising campaigns on existing BDS programmes and through ensuring that these services are available in all provinces (OECD, 2018a).

Beyond strengthening SME capabilities, Indonesia's subnational governments have an incentive to maximise their own FDI attraction efforts, building on the competitive advantages of their local economies

to attract investments that have the potential to amplify productivity diffusion. Indonesia's restrictive regulations on foreign businesses such as local content requirements, performance standard requirements and divestment requirements can be barriers to attract foreign investment with productivity spillover potential in non-resources activities (see Chapter 3 for more details). Proactive measures incentivising foreign firms to forge business linkages with local SMEs may prove to be more effective. But there are only a few tools at the disposal of local governments to forge linkages between foreign and domestic firms, to facilitate technology spillover, or to reduce the gap of technical capacity between domestic and foreign firms (Kuswanto, 2019).

Investing in skills is a priority to reduce development gaps across regions

Indonesia has achieved substantial progress in improving education and skills outcomes across regions but considerable challenges remain to ensure that regions have relevant and high levels of skills. Rural and remote provinces, especially those located in the east of the country, are characterised by poorer skills outcomes as seen by the difference in the OECD PISA scores between villages and large cities. For example, more than one in four people in Papua are illiterate, making it the province with the lowest literacy in the country. Disparities in educational attainment among the different provinces show that Jakarta has the best qualified human resources with 13% of the population reaching higher education. The picture contrasts with the mostly rural provinces of Papua, West and East Nusa Tenggara, West and South Sulawesi, and West Kalimantan, where between 13% and 38% of the population have never attended school (OECD, 2020 forthcoming).

Providing the right incentives to invest in skills is essential to help regions reduce skill mismatch with investors' needs. Most Indonesian workers do not have access to training and substantial differences exist between rural and urban workers. Out of the 13% of the working population who receives training, less than one third works in rural areas (OECD, 2020 forthcoming). Differences are also high across provinces, mostly reflecting the presence of large firms, which often have more capacity to train their workers. According to the 2015 World Bank Enterprise Survey of Indonesia, 21% of businesses in Jakarta Special Capital Region (DKI) provided training to their workers while the national average was 8%. The recent tax deductions granted to firms that invest in human resources development activities could help smaller businesses build the skills of their workers but also improve the wider quality of apprenticeships and vocational training (see also Chapter 6 on investment promotion).

Regional policy has shaped Indonesia's investment climate but policy coherence is limited

Decentralisation granted regional governments in Indonesia the responsibility to develop and implement their own investment policies and investment-related regulations. These must be aligned with national investment policies as presidential regulations supersede regional regulations.[11] Rather than a clear-cut separation of responsibilities, most duties are shared among levels of government – the trend toward shared responsibilities has increased over the past decades in other countries too. The need to share responsibilities may arise for practical reasons – as is common between different tiers of government around issues of transport and infrastructure, environment and economic development (OECD, 2019a).

Table 7.3 shows the respective responsibilities of the central and regional government in investment policy, based on Law No. 23 of 2014 on Regional Governance. Both national and regional governments run public institutions with the mandate to regulate the business climate, including foreign investors' entry and operations, and to develop and implement investment promotion strategies, including the provision of incentives. Duties across different levels of government are not identical, however, and higher tiers hold more responsibilities, including the supervision of the lower tiers. The division of tasks will likely evolve with the implementation of the Omnibus Law on Job Creation.

Table 7.3. Investment policymaking across different levels of government

Function		Central government	Subnational government
Business climate regulations	Investment effects on society and environment	National regulations to protect domestic firms National land use planning policies National environment policies	Regulations on local wages Local land use planning policies Local environment policies
	Investment facilitation	Stipulate investment licence Stipulate business licence (operational)	Stipulate permits as part of business licence: location permit, environment permit and land use permit
Investment promotion	Strategic planning to attract FDI/investment promotion	Develop general investment plan at national level International investment promotion	Develop general investment plan at local level International and national investment promotion
	Investment incentives	Provide national financial and non-financial incentives	Provide local financial and non-financial incentives

Note: Provinces and districts have similar mandates except that districts only provide non-financial incentives.
Source: OECD based on Law No. 23 of 2014 on Regional Governance and Kuswanto (2019).

Subnational institutions in charge of investment policymaking have similar mandates to the national investment promotion agency (IPA), BKPM, although they are not subsidiaries of BKPM and their exact institutional configuration within regional administrations can vary between and within different tiers of government (provinces, regencies/cities, and districts). All provinces have established regional co-ordinating investment agencies (DPMPTSP), with both investment promotion and facilitation responsibilities. Governments in regencies or cities and districts often have an investment unit located within the administration. The next sub-sections describe subnational investment-related regulations and examine how these are co-ordinated with national policies.

Investment facilitation through the lens of subnational governments

Indonesia has enacted successive measures to facilitate the establishment of new companies, thereby regularly modifying the responsibilities devolved to subnational governments in that area. After the rushed and massive transfer of authority to subnational governments in the 2000s, the country has been struggling to find the right balance in the level of responsibilities devolved to different tiers of government. In this quest, the central government has adjusted the legal framework for investment facilitation, through back and forth movements of decentralisation and recentralisation. Since 2019, there was a push for investment climate improvements, with a steep trend towards recentralising business licensing responsibilities.

With regional autonomy, subnational governments that proactively sought to attract investment obtained the policymaking space to do so, in particular as concerns business facilitation measures. Those that have been successful in improving their area’s business climate have focused on investment facilitation measures, in particular on simplifying procedures to obtain a business permit (OECD, 2010). Subnational governments have also contributed to wider investment facilitation efforts by the central government and more specifically to improving the licensing process – even if they also are criticised for hindering the process. Following decentralisation, several districts unilaterally established one-stop integrated services offices, or PTSP, with the objectives of auto-regulating themselves and simplifying procedures (Kuswanto, 2019). The innovation spread to other districts and became a benchmark. It ultimately led to the creation of an informal PTSP forum to share good practices and build capacity of local officials (Priyono et al., 2015). During that period, the central government helped set standards and provided guidance.

With the growing number of locally-established PTSPs, the central government made it mandatory to run such agencies for all tiers of government in 2009, along with the operation of an electronic information and licensing service system (SPIPISE). This collaborative, bottom-up, approach to generalise the creation of

PTSPs to the whole country was praised for its success (Kuswanto et al., 2015). Districts granted the authority to issue the licences to their PTSP. Three institutions were involved: BKPM (assistance in investment procedures), the Ministry of Bureaucratic Reform (assistance in human resources) and the Ministry of Home Affairs (monitoring the operations of the PTSPs).

Despite the success in establishing PTSPs in most regions of Indonesia, there are challenges in implementation, particularly in the less developed and remote regions of the country. Limited human and operational capacity strongly affected the quality of operations of PTSPs. Some district-level offices are not equipped with electronic systems and thus are not connected to the provincial and national governments. One reason behind this implementation failure in services delivery is the uniform treatment of heterogeneous subnational units in policy design and implementation and the inadequate financial resourcing of provinces and districts (World Bank, 2014). Even if there is a well-functioning PTSP, the lack of co-ordination between and within tiers of government obstructs the licensing process. There is no guarantee that the technical local agencies (SKPD) are willing to delegate their licensing authority to the regional PTSP (Kuswanto, 2019). For instance, in eight cities, PTSP offices could only issue up to two thirds of the licences (Table 6.2). Firms still have to go to the SKPDs to obtain the remaining permits.

Reforms to harmonise the licensing process across tiers of government procedures have accelerated in the past years. The Online Single Submission (OSS), launched in 2018, connects the centralised licensing service system (central PTSP) in BKPM with regional PTSPs. Investors can access online regional licensing data without going to the concerned offices. The Ministry of Home Affairs pushed regional governments to accelerate the implementation of OSS by simplifying the types of licensing and non-licensing services and setting up the adequate facilities. To accelerate the process, the central government has set strict rules with financial sanctions for local governments that do not implement the new system. It also created district/city level task forces to ensure transparency in the licensing process and that it does not harm the state or investors.

Despite the technological improvement, the OSS system could not solve the issues of the large number of licences and the multiplicity of local agencies (and related line ministries) providing these licences. Investors still have to obtain some licences from ministries, government institutions or regional administrations (e.g. OPD *or Organisasi Perangkat Daerah*). Co-ordination and harmonisation of regulations between line ministries and regional governments is challenging because of the variety of regional governments, both across and within administrative levels (provinces, regencies/cities and districts). Implementation of the OSS tool will take time due to different capacities and resources across provinces and districts.

The transfer of greater business licensing authority to BKPM in 2019 marked a new step in the centralisation of the licensing process around the national IPA (see Chapter 6 on investment promotion and facilitation policies).[12] It is not clear, however, whether the Presidential instruction is addressed to central government ministries only or also to subnational governments. Notwithstanding the vagueness of the instruction, there is more than ever a need for more effective co-ordination across tiers of government. Regional investment agencies complain that licensing requests sent through the OSS system to other regional agencies, with each possibly reporting to specific line ministries at the central level, often stall (Kuswanto, 2019). Strong buy-in from all regional players is crucial to integrate the countrywide OSS system into PTSPs' electronic system (SPIPISE). The use of hierarchical governance should be limited to cases where co-operation and sharing responsibilities across different levels of government is not effective or not possible.

Besides licensing services, Indonesian subnational investment agencies also have a mandate to provide non-licensing services. Local agencies should strengthen this component of their mandate, as they are well-placed to deliver specific and targeted after-care support to investors. The crisis generated by the COVID-19 pandemic has revealed that after-care services can be crucial in times of high uncertainty. During the crisis, IPAs worldwide temporarily shifted their activities towards after-care and retention

services (OECD, 2020a). Regional IPAs in Indonesia should be ready to provide support in such circumstances and help with unexpected requests.

Regional policies relating investment to societal and environmental outcomes

Subnational governments set minimum wages, develop land use planning and define environmental policy, as per Law No. 23 of 2014 on Regional Governance. The law also delegated the issuing of permits to lower tiers of governments, entitling them to grant location permits, environmental permits, land use permits, and building permits. This is part of the government's wider objective of better mitigating adverse effects of foreign businesses on society (e.g. rising income inequality) and the environment, although evidence suggests that FDI impacts on these outcomes can also be positive. Chapter 2 has shown that while foreign investment goes to more polluting sectors of the Indonesian economy, foreign firms are more energy-efficient that domestic firms. They also hire more people, pay higher salaries and are more gender-inclusive than domestic firms. The Omnibus Law on Job Creation – enacted in October 2020 despite strong opposition by labour unions and civil society – amends the law on regional governance and weakens the regional government role in policymaking, particularly with respect to environmental protection.

Statutory minimum wages should continue reflecting the cost of living in regions

Despite the preconceived idea that regions with lower minimum wages attract more foreign investments, there is no strong evidence that this is the case for either Indonesia or other emerging countries (Sodik et al., 2019; Haepp and Lin, 2017). Overall, the minimum wage in Indonesia is higher than in other emerging countries such as Brazil, Mexico and China (OECD, forthcoming). DKI Jakarta had the highest provincial minimum wage (USD 298), a rate that is more than twice higher the rate in East Java (USD 125), owing to cost of living variations. Differences within provinces are substantial too. For instance, the regency of Karawang sets a rate that is as high as in DKI Jakarta, although the regency is located in East Java.[13]

The statutory minimum wage, regulated by Government Regulation 78 of 2015, consists of a fixed basic wage set by the governor or head of the province or regency/district as a safety net. The minimum wage in a regency/district cannot be lower than the minimum wage set at the province. The Omnibus Law on Job Creation includes new stipulations about minimum wage setting. While minimum wages are still set at a provincial and regency level, the minimum wage will now depend on a formula to be set out in a later government regulation, which will take into account the level of economic growth, inflation and productivity in provinces. Furthermore, the law abolishes sectoral minimum wages, but only when these were lower than the minimum wage fixed by the regency. More problematic, the law removes specific protections afforded to workers when employers underpay the minimum wage.

The One Map project should improve land use planning in less developed regions

Local land use planning (RDTR) is one prerogative of subnational governments that has a considerable impact both on the investment environment and on sustainable development. Local agencies deliver land use permits based on subnational government land use planning. Subnational bodies define which parcels of land are for development and which business activities are permitted. As such, they can use the plan to protect the environment from potentially harmful activities. Land use planning is predominantly a local task in other countries too, even though several countries use land use plans prepared at the inter-municipal or regional levels (OECD, 2019a). National and regional governments both focus primarily on strategic planning and the provision of policy guidelines – they often prepare land use plans only for areas of particular importance.

Getting a land use permit can be a challenge for foreign firms in Indonesia, and their conflicts with the local community are often over land issues. Ambiguity in the national legislation together with the decentralised property registers widens the scope for corruption in allocating property rights (OECD, 2018b). This

increases businesses' operating costs, with compensation sometimes needed to be paid to local communities or NGOs, due to unresolved conflicts, that are not always based on transparent and predetermined criteria (Kuswanto, 2019). The Indonesian government launched in 2018 a unified map of land use, One Map, in an effort to resolve overlapping claims that have led to conflict, human rights abuses and environmental damage. One Map establishes a single database for all government maps to eliminate disparities between the various maps in use by different agencies. Finalising the remaining elements of the One Map will help to improve the land use permitting system (OECD, 2019b).

Some regional governments may divert environmental regulation from its initial objective

Subnational governments have the authority to manage their natural resources. The ministry of environment and forestry oversees compliance monitoring and enforcement activities of subnational administrations. Provincial and district governments set up bodies to conduct environmental audits of companies, as per the environment law. They also implement environmental impact assessments (AMDAL) and, if projects do not require an AMDAL, the firm must submit an Environmental Management and Monitoring Program (EMMP) document. AMDAL or EMMP approval results in the issuance of an environmental permit. The quality of the assessments conducted by local bodies has improved due to stricter regulations and better guidance from the central government, although capacity building continues to be necessary. Better guidance on the content of environmental permits is another pressing priority. Permits rarely fix limits on polluting activities, are valid indefinitely and are not subject to periodic review (OECD, 2019b).

Subnational administrations use sometimes the issuance of land use or environmental permits as de facto regulatory tools to screen foreign projects, as the business licensing procedure is centralised at BKPM. This has led foreign investors to report cases of arbitrary treatment on the part of local governments in terms of getting operational permits (USAID, 2013). This is particularly the case of district governments with little or no involvement in the negotiations between central (or provincial) governments and investors. Foreign businesses usually have obtained their investment licences from BKPM and have determined with the help of the national IPA the location for their establishment (Kuswanto, 2019). They enter in contact with the subnational administration only to apply for the operational permits needed for the business licence. By rejecting or delaying investors' requests, local governments exercise their influence but can obstruct the registration process. They are also open to capture by local elites and by foreign investors, which can multiply the opportunities for corruption and raise the possibility that environmental and social standards are not properly enforced.

The recently enacted Omnibus Law on Job Creation weakens regional government role in environmental policy. The law amends Law 32/2009 on environmental protection and management to allow the central government to take over environment-related licences from regional governments, including AMDAL. The objective is to simplify administrative procedures for investors by adopting a risk-based approach to licensing – the Omnibus law on Job Creation stipulates that only "high-risk" projects will require a licence. This, however, should not come at the expense of much needed environmental protection safeguarding a more inclusive and sustainable local development pathway (see Chapter 5 on responsible business conduct).

Overlapping and conflicting central and regional investment policies persist

The country's decentralisation "big-bang" has complicated policy and regulatory certainty for investors (OECD, 2010). The variable capacity of regional governments to formulate, implement and enforce policies has led to a multiplication of overlapping and conflicting central and local government regulations. The inability to raise taxes at the local level partly led to a proliferation of regulations on local levies on business activities, which has generated challenges with regard to the investment environment. In some cases, local

authorities request foreign investors to pay levies without a clear legal basis, in addition to paying taxes to the central government (USAID, 2013).

Some local governments have enacted laws discriminating, sometimes indirectly, against foreign investment projects, in conflict with the principle of equal treatment between foreign and domestic investors as per the 2007 Investment Law. This undermines the ability of the DNI to provide clarity to investors as the single legal resource of investment restrictions (World Bank, 2017). For instance, Malang regency recently stopped the licensing process for a foreign investment in the business of modern shopping centres, stipulating that the investment goes against a regional regulation on the zoning allocation for shopping centres and the protection of traditional markets.[14]

The emergence of overlapping regulations, if not contradictory policies, is one of the main challenges behind the unclear division of authority between the central and local governments, including those related to investment. The central government tries to use hierarchical governance in order to harmonise regulations across different levels of government (Kuswanto, 2019). Firstly, the national government creates guidance for local governments in enacting local regulations, and the draft of local regulation must get approval from the central government. A second mechanism is that the central government revokes local regulations that contradict national law, public interest and moral norms. Law No. 23 of 2014 on local governance gives the Ministry of Home Affairs the power to revoke such regulations through the Ministry of Home Affairs Regulation No. 80 of 2015 on the enactment of local regulation.

Through hierarchical governance, the central government has revoked some local regulations conflicting with higher-level laws, but the approach has not been successful enough and the ease of obtaining business licences from local authorities still varies greatly across the country. According to the Ministry of Home Affairs, there were 3143 local regulations in 2016 that contradicted national laws and the public interest. In 2017, a review of 1084 local regulations related to business licensing revealed that 61% of the subnational regulations contradict central government regulations (Pangestu, 2020). During the first mandate of President Jokowi (2014-19), the government attempted, through a ministerial decree based on regulation No. 80 of 2015 on the enactment of local regulation, to cut 3000 regional regulations considered to be in conflict with central government rules, but the nation’s highest court ruled that the move was unconstitutional.

Ongoing reforms aspire to harmonise regulations but recentralise policymaking

The Omnibus Law on Job Creation seeks to harmonise government regulations and regional bylaws to ease the investment process and reduce corruption risk. The law amends Article 25 of the Investment Law to place all relevant licensing authority in the hands of BKPM, including operational licences such as environmental permits. Furthermore, the law amends the regional governance law of 2014 to give the central government the power, through presidential decree, to revoke regional regulations in contravention of “higher statutory provisions”, including as regards investment licensing. To bypass the possibility that the constitution rejects central government requests for revoking regional laws, as in 2016, the Omnibus law plans to scrap provisions allowing regional governments to appeal against revocations.

From a legal perspective, the implementation of the Omnibus law may prove challenging. The constitution expressly states that the division of authority between central and regional government is to be determined by national law but it also provides that the division of authority in the field of public services must be "just and appropriate". According to consultations with stakeholders, this may create enough ground for a constitutional challenge to the proposed reduction in the powers of regional government licensing authority. If the Omnibus law intends to reduce the current level of legal uncertainty, the government should ensure that implementation at the subnational level takes place. The reform may be counterproductive without solid consultation mechanisms on the implementing regulations to ensure that subnational government views are taken on board.

The Omnibus Law on Job Creation transfers regulatory power to the central government, represented by BKPM, rather than individual line ministries. This may be a step in the right direction for regional investment agencies, as it could address the longstanding problems of silos across ministries, and across their respective reporting regional agencies. The law also establishes that regions must set up a one-stop integrated service unit providing licensing services in compliance with regulatory requirements. Business licensing services must use the electronic system managed by the central government, in that case BKPM. District/city governments who do not provide services business licensing through the electronically integrated system are subject to sanctions, including the possibility that the governor, as a representative of the central authority, grants the licence.

The implementation plan of the Omnibus Law on Job Creation should be realistic in light of the major changes it intends to bring to the regulatory framework. Remote and less developed districts do not necessarily have the institutional capacities for effective implementation of the law. For instance, the law transfers the authority over land use (RDTR) and environmental impact assessments (AMDAL) from local bodies to the central government in case the latter does not have the necessary tools and resources. According to the regional autonomy implementation monitoring committee, KPPOD, fewer than 100 regencies and cities (out of 514) have a RDTR, which means that the central government will handle the approval for the more than 400 remaining entities.

Under the right conditions, local bodies may be better placed to assess land use and environmental risks. Building gradually their capacity and equipping them with, inter alia, a RDTR is a more sustainable option in the longer-term, an option that would promote co-operation across tiers of government. At the same time, higher levels of government should have the necessary levers to limit regulatory capture and asymmetries in information between local administrations and investors, and a possible race to the bottom in environmental or other sustainability standards. Moving forward, the authority of provinces may have to be strengthened to streamline governance across the archipelago. Recently, governors emerged as effective intermediaries in the COVID-19 crisis by synchronising district responses and forcing the central government hand when necessary (Jaffrey, 2020).

Regional investment promotion: place-based strategies and attraction tools

The Indonesian government has been relentlessly trying to attract FDI to specific regions to support regional development objectives. These attempts have entailed mostly national investment policies disregarding that each city or province is unique in the way it competes in national, regional and global trade and investment networks. Decentralisation gave subnational governments the autonomy to promote investment, along with promotion activities by the central government. Provinces, cities and districts could exploit further this opportunity, which in other countries is often limited or non-existent because of centralised investment policy.

Decentralised investment promotion

Besides operating a PTSP, each subnational IPA in Indonesia, sometimes called DPMPTSP (or BKPMD), is in charge of elaborating an investment strategy at the subnational level (e.g. selecting priority sectors for investment attraction), in line with the region's wider economic development plan. They operate independently from, but in co-operation with, the national IPA, BKPM, which is in charge of developing the overall strategy of the country with respect to investment promotion (see Chapter 6). Subnational IPAs develop investment promotion strategies with objectives, target indicators and corresponding policies and strategies to achieve them. For instance, the Aceh Investment and One Stop Integrated Services Agency (DPMPTSP Aceh) has based investment priorities on the Midterm Development Plan of Aceh, which focuses on agro-industry, infrastructure and energy and tourism.

Both the national and subnational IPAs undertake investment promotion activities to attract foreign and domestic investment. BKPM co-ordinates the wider investment promotion activities and co-operates with subnational IPAs. It focuses on promoting foreign investment, through the Investment Promotion Centre (IIPC) overseas offices, and domestic investment projects with scope covering multiple provinces. Subnational IPAs promote both foreign and domestic investment. With respect to domestic investment, for many decentralised entities, attracting companies from the same country can be as important an objective as attracting foreign investors – local companies from the same country may not have access to full information on investment opportunities in other regions of the country (MCI and VCC, 2009; OECD, 2018c).

Indonesia's central and regional governments promote regional investment through different mechanisms. At the subnational level (provinces, regencies and cities and districts), IPAs conduct their own investment promotion activities. Each IPA performs various functions pertaining to investment attraction, such as marketing their location as an investment destination, conducting promotional missions and organising meetings with businesses and embassies of potential investing countries, organising site visits for prospective investors, and arranging matchmaking between domestic businesses and foreign affiliates.

Subnational IPAs can also provide tax incentives, financial grants, and facilities for investment that are tailored to the development priorities of their regions. The provision of incentives is regulated by a central government regulation but regional governments must issue a specific regional regulation to elaborate further on the criteria and on the procedure for obtaining them.[15] The mechanism is voluntary instead of mandatory, which means subnational governments have the option to develop those policies. For instance, the district of Banyuwangi provides incentives for multinational enterprises (MNEs) that purchase products from local SMEs (Box 7.5). To incentivise regional governments to use this policy, the central government commits to give "awards" to regional governments that have been outstanding in providing incentives or facilities to investors in accordance with the provisions of the regulation.

Box 7.5. Investment promotion at the local level: Learning from the district of Banyuwangi

Banyuwangi is the administrative capital of Banyuwangi Regency at the far eastern end of the island of Java. The capital is the largest district both in the Eastern Java Province and on Java itself with 5 800 square kilometres in total. Socio-economic conditions are better than the national average: The district enjoys economic growth of 7% per annum, unemployment of 4.7% and a poverty rate of less than 10%.

The district of Banyuwangi provides financial and non-financial incentives for MNEs if they purchase goods and services from domestic enterprises, especially SMEs. The district also starts the matchmaking process from the investment promotion phase. During this phase, the district government facilitates meetings between potential foreign investors and local enterprises. After the business is established, the MNE is required to train domestic managers and employees, so they learn the technology used by the MNE.

Source*:* Kuswanto, K. (2019).

At the central government level, BKPM, notably through the IIPC, seeks potential (foreign) investors by organising promotional events in Indonesia and abroad and inviting subnational IPAs to participate. It also organises networking sessions between the IIPC overseas offices and representatives from the subnational IPAs. Thirdly, BKPM co-ordinates with subnational IPAs the provision of information on potential investment projects in the regions. BKPM disseminates the online material on business opportunities and regions' business potential.

Decentralisation of investment promotion can provide an incentive for subnational authorities to become more efficient in their efforts to promote investment. Even if the priority of these IPAs is with the licensing process, developing more sophisticated and innovative investment promotion tools is equally relevant.

Subnational IPAs can convey critical information about the attractiveness of their regions to potential investors. Evidence from the European Union's regions shows that FDI responds better to the activity of subnational IPAs operating in closer proximity to investors' operations (Crescenzi et al., 2019). Stronger and better co-ordination between BKPM's IIPC and subnational IPAs can help to channel more effectively information about investment prospects in regions.

Mechanisms for tailoring national investment promotion to local conditions

Two elements characterise the governance of investment promotion at the subnational level. On the one hand, the central government alone cannot foster economic attractiveness, suggesting the importance of a multilevel arrangement. On the other hand, the ideas of flexibility and a single point of entry for foreign companies and investors have gained awareness and interest. Subnational IPAs are encouraged to think beyond their administrative borders (Pasquinelli and Vuignier, 2020). Thus, investment promotion should strike a balance between a reasonably centralised strategic decision-making and enough room for manoeuvre for subnational governments.

The multiplicity of investment promotion activities at the subnational level does not necessarily have to generate a race to the bottom. While the risk of exacerbated competition between Indonesian regions (or cities) is real, competitors can often be regions outside the national borders. Foreign competitors can be very different from one region to another and depend, inter alia, on regions' distinct positions in global supply chains (Box 7.6). Some regions compete with each other while others, like Batam, have rivals in ASEAN, and a minority, including perhaps the metropolis of Jakarta, compete worldwide. This underlines the importance for IPAs involved in investment promotion, either BKPM or local agencies, to know whom their rivals are and for which economic activity they are competing.

Box 7.6. Identifying cities' rivalry over FDI: Casablanca versus Cairo

FDI geographical networks provide unique insights on competing destinations by decrypting greenfield foreign investment project flows from source to destination city. The analysis of these networks shows that some cities compete with peers within the same country, while others compete more regionally (e.g. ASEAN, Europe, Latin America, MENA, etc.), and only a few cities, most often metropolises, have rivals at the global scale. Network analysis also reveals that neighbouring cities, including within the same national borders, are not necessarily rivals as they may attract FDI in distinct economic activities or in different segments of the global supply chain.

The OECD applied such network analysis to shed light on the geography of FDI in MENA cities. For instance, Casablanca and Cairo do not compete over foreign investment, despite their countries' geographic and cultural proximity. Casablanca's rivals are port-cities spread over different continents and include Panama City, Danang and Valencia. Cairo's competitors are mostly neighbouring cities like Algiers, Riyadh and Tunis. One reason Casablanca has global rivals is likely because the city is well anchored in global value chains and has access to maritime networks through Casablanca port. Casablanca and its rivals compete over efficiency-seeking investment automotive, business services and transport. In Cairo, the world's 16th largest metropolis, foreign investors are more interested in serving domestic consumers and in using the capital as an entry gate to markets in Africa or in the Middle East. This is visible in the city geography of FDI networks as Cairo, and its city rivals, compete over FDI in services like real estate, energy and financial services.

This comparative information can help IPAs, with their subnational branches, or subnational agencies craft investment promotion strategies tailored to the competitive strengths and potentials of each territory. It can also help developing policy tools that connect foreign investors with local suppliers. For instance, smaller cities may deploy massive efforts to attract large, top-end, companies (e.g. by offering

generous tax incentives) instead of focussing their promotion strategies on smaller investors that they can realistically attract. Investment promotion policies to attract such second-tier firms might prove useful as these may forge stronger linkages with local companies than large top-firms because of lower absorptive capacity gaps and higher labour mobility.

Source: Wall (2019).

Co-operation between BKPM and subnational agencies brings a number of challenges, as interests are not necessarily aligned. Subnational agencies often attempt to steer foreign investors to their respective regions by seeking the attention of BKPM, rather than by their own means. Because of such inter-region competition, a national IPA can become an arbitrator (i.e. which province should they direct a foreign investor to) and face difficult decisions or, on the contrary, can be deliberately excluded from locally identified opportunities (OECD, 2018d). Some regions may also resist the establishment of a foreign investor that was directed to the region by the central or provincial agency.

Co-ordination tools help partly to overcome these challenges. In Sweden, a code of conduct agreement among the national IPA and the regions was established to better communicate opportunities and encourage exchange of information. The IPA also uses software that allows information sharing with external partners. The French IPA has a formal information-sharing process to increase the efficiency of the collaboration with France's subnational IPAs (Box 7.7). The agency created a "marketplace" of investment projects and shares information weekly with its regional partners (OECD, 2018d).

Box 7.7. Business France's co-operation agreement with regional agencies

Business France has a formal agreement with the 13 regional agencies of the country that provides a clear framework for co-operation. The co-operation agreement entails prospection and promotion activities, as well as support for project implementation. Shared trainings are organised in its framework. An annual performance survey monitors the results of the co-operation. This framework also guarantees the impartiality and neutrality of Business France vis-à-vis all the regions (not favouring one over the other when bringing new projects). This is essential to establish trusted partnerships.

As part of the co-operation, Business France has also developed a dedicated information-sharing process for investment projects. It consist of a "market platform" where Business France and its regional partners can enter information about new foreign investment projects identified, and requests made at the regional level. Thanks to this platform, partners can co-ordinate their responses and identify areas for joint action. In 2016, this system allowed to provide to investors 650 regional setting offers, and organise 220 business visits.

Source: OECD (2020b) based on Business France, presentation at the OECD seminar in Paris in October 2017, http://www.oecd.org/mena/competitiveness/REPORT-Regional-EU-OECD-IPA-Workshop-Paris-201710.pdf

Zone-based policies to attract foreign firms with high productivity gains

Indonesia has attempted to use zone-based policy to attract FDI, increase exports, create jobs, and support the country's development but, so far, these policies have not had a strong record of demonstrated success. The government established the first zones in 1970 and the country has since seen a proliferation of these areas (Table 7.4). Most zones are governed by specific laws, overseen by different levels of government, operate under distinct regulatory and institutional frameworks, provide different incentives to investors and often have overlapping goals, most often to boost exports. Zones in Indonesia can fall into five types: free trade zones

(FTZ), bonded or export processing zones (kawasan berikat), industrial estates (kawasan industri), integrated economic development zones (KAPET), and special economic zones (KEK). The multiplicity of zones and related types can create institutional bottlenecks and generate confusion for private investors.

Table 7.4. Overview of zone-based policies in Indonesia

Zone	Year	Number	Main objectives	Main incentives
Free trade Zone	1970	1	Develop tradeable sector and improve exports	- Import income tax exemption - Import duty exemption
Bonded Zone	1986	1350	Encourage high-value exports with focus on manufacturing	- Import income tax exemption - Import duty temporary exemption
Industrial Estate	1989	87	Improve growth and industrial competitiveness aimed at export and domestic demand	- Depends on the location of the industrial estate.
Integrated economic development zone (KAPET)	1996	13	Create new centres of economic development and promote inclusive growth	- Investment allowance on CIT - Import income tax exemption - import duty temporary exemption
Special Economic Zone (KEK)	2009	15	Combine objectives of all previous zones	- Tax holidays on CIT - Import income tax exemption - Import duty exemption - Foreign ownership of property

Note: Among the 15 KEK, 11 are operational as of February 2020. OECD (1999) counts seven bonded zones but this number strongly varied in 2000 and beyond. Batam is both an SEZ and a FTZ.
Source: OECD based on Wicaksono et al. (2019); Rothenberg and Temenggung (2019); OECD (1999); the National Council for Special Economic Zones.

Zone objectives have changed over time with the evolving place-based policy

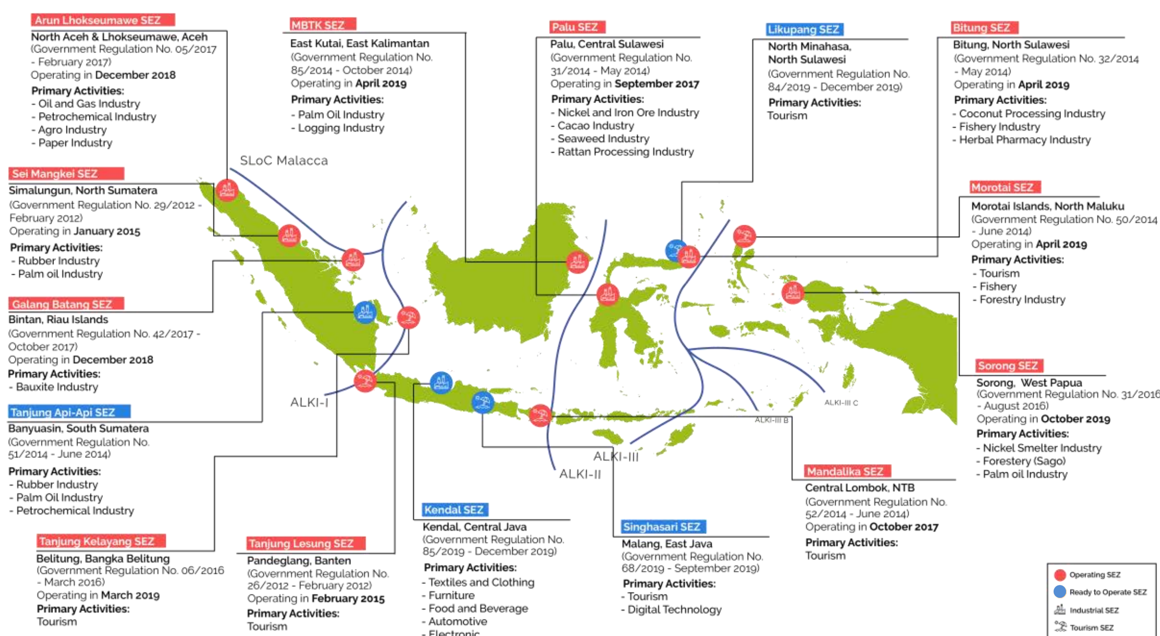
Indonesia established the five zone types at distinct time intervals and in different regions and districts. The legal status of some zones changed over time to adapt to the evolving place-based policy of the government. FTZs and bonded zones, established in the 1970s and 1980s, proliferated until the early 2000s, before stagnating or receiving the status of a newer type of zone. They promote imports and exports by granting import duty and value-added tax exemptions. There are around 1500 foreign and domestic firms with licences to operate in bonded zones but the majority are located on Java. In the late 1980s, the government introduced industrial estates, which grant non-fiscal incentives. For instance, in Batam, a FTZ (and since 2020 also a SEZ), foreign ownership restrictions were relaxed in industrial estates to attract nearby firms from Singapore, notably in the electronics sector (OECD, 1999). The private sector developed the majority of industrial estates, which it also operates. Most of the successful estates are located in West Java (ASEAN, 2017).

The success of liberalisation reforms in the 1980s created export-oriented industrial hubs in Java and Sumatra while the eastern islands continued lagging behind (Wicaksono et al., 2019). As in other developing countries, liberalisation led the government to move away from confined free trade and manufacturing bonded zones, cut off from the local economy, to large-scale hubs with regional development goals. Accordingly, the government's place-based policy expanded from granting trade-related exemptions to wider incentives, including corporate income tax (CIT) holidays. It introduced the KAPET programme in 1996, a few years before the decentralisation "big bang", to create growth centres in the Eastern districts of the country. On top of various tax breaks, KAPET grants specific incentives to foreign firms. The policy shift culminated with the launch of the SEZ programme (KEK) in 2009, although it started operating in 2015. SEZs combine export-oriented goals of bonded zones with regional development objectives of KAPET.

SEZs are the government's new policy to attract investment outside of Java

The SEZ programme is one of the latest place-based tools to develop regions outside Java. It spreads over all of the Indonesian territory, unlike KAPET zones, and SEZs often cover the entire locality where they are situated, and each could contain several industrial estates. As of early 2020, they were 11 operating SEZs, and four were in the development phase (Figure 7.8) - the government plan is to have 25 under the Mid-term National Development Plan. SEZs cover a broad range of activities, as per Law No. 39 of 2009 on SEZs, ranging from the mineral industry to food processing (e.g. fishing industry). Five SEZs are touristic destinations that are part of the government's wider tourism development strategy, which prioritised 10 destinations for tourism infrastructure development.[16]

Figure 7.8. Indonesia's SEZ distribution map as of February 2020



Source: National Council for Special Economic Zones.

One difference between the SEZ programme and other zone-based policies, all launched before decentralisation, is the active role played by regional governments in the institutional framework surrounding SEZs' establishment and supervision. The central government, through a National SEZ Council, takes the decision to establish a zone, but proposals to establish zones come from local governments. The council reports directly to the president and is chaired by the Coordinating Minister for Economic Affairs. BKPM is a member of the council, along with several other government bodies.

The bottom-up approach in SEZ establishment should ensure buy-in from regional governments in developing and managing zones. This inclusive approach is missing in KAPET zones, where the lack of co-ordination between the central and local government is one the main reasons for their limited success (Rothenberg and Temenggung, 2019). Despite a stronger role by local governments, they are not sufficiently involved, for instance in the planning of SEZs that are part of the national tourism strategy. Greater co-ordination would ensure that tourism serves regional development needs (OECD, 2018b).

SEZs grant CIT holidays and many other tax and non-tax incentives, including softer regulations on foreign ownership of property, simplified foreign worker arrangements and simplified licensing procedures. Regulation 12/2020 on Facilities and Ease in Special Economic Zones, which revoked a previous regulation issued in 2015, clarified the provisions with regard to the incentives granted by SEZs and extended further these incentives.[17] According to an evaluation by the government, the performance of SEZs has not been optimal in terms of realised investment, especially foreign investment, because the 2015 regulation was not clear, generating uncertainty for investors, and incentives granted, including facilitation measures, were not as attractive as in other countries' zones like in Chinese SEZs.

SEZ policy should gradually shift from relying on tax incentives to facilitating a more conducive business environment

SEZ policy should focus on promoting a friendlier business regulatory environment. This could also help improve the wider business environment. The government could experiment with different non-tax incentives in SEZs to extend proven good practices to the whole economy (OECD, 2018b). Given the recent creation of SEZs, no studies have evaluated their impact on regional development goals. Previous zone-based policy has helped to attract FDI and create jobs in regions with attractive geographical locations and good endowments in terms of infrastructure and skills (e.g. West Java). But they have had little impact on attracting FDI to other, less attractive, regions as well as in generating sufficient productivity spillovers to improve national welfare (Rothenberg et al. 2017; Rothenberg and Temenggung, 2019; Wicaksono et al., 2019).

Previous zones were not entirely successful in attracting significant investment or generating significant employment, due to their remote locations, a shortage of infrastructure and lack of jurisdictional clarity (OECD, 2016). Bonded zones did not lead to a significant increase, either in existing firms' exports or in the number of new firms exporting, although there is some evidence that they created jobs (Wicaksono et al., 2019). Similarly, KAPET zones reduced production costs, thanks to the incentives, but had little impact on productivity, investment and employment (OECD, 2016; Rothenberg et al. 2017). Evaluations of these programmes call for caution from policymakers in spending resources to subsidise development in lagging regions. There is a potential for such policies to be tax giveaways to firms that would have located in the targeted regions in the absence of such incentives.

The FTZ of Batam is another example of the partial success of zone-based policy in Indonesia. The island is an important manufacturing hub in the region and has attracted more than USD 20 billion in investments, of which half are foreign. Most foreign investors established their subsidiaries primarily because of the island's proximity with Singapore where labour costs are much higher (a setting that is it difficult to replicate in other regions with less favourable locations). Since decentralisation, the performance of the FTZ stagnated because of, inter alia, rampant legal uncertainty over zone management between the central government-appointed FTZ authority and the regional government (OECD, 2016). Investment in the FTZ also did not led to growth extending beyond the immediate vicinity of the zone (Rothenberg and Temenggung, 2019). This prompted a presidential decision in 2019 to change the status of Batam from a FTZ to a SEZ, although the government already announced a similar plan in 2015. As of today, this has not yet been completed. Instead, the government launched in 2020 two SEZs in Batam but outside of the borders of the FTZ.

Zone-based policies impose a certain cost on government revenues, as the incentives granted to firms can reduce the fiscal base. More problematic, zones in Indonesia may be impeding fair competition between firms inside and outside of zones. This can be particularly the case for the SEZ programme, as it provides CIT holidays, a type of incentive that raises two concerns. The first is the limited efficiency of CIT holidays in attracting investors, in comparison with other incentives such as investment tax allowances (see Chapter 6 for more details). A second concern, which directly relates to zones' impacts on regional development, is the possibility for SEZ firms to sell into the domestic market while they enjoy a competitive advantage over peers outside of zones, owing to tax relief.

To foster business linkages between SEZ firms and suppliers nearby, goods exiting from the SEZs to the domestic market are not subject to customs duty if they fulfil a minimum local content requirement of 40%. This policy, which also exists in other countries like Brazil, intends to generate local economic development in areas nearby SEZs. The possibility for SEZ-based firms to sell their goods on the domestic market may have adverse impacts on countrywide productivity, however, as firms can avoid export markets and related competitiveness pressures to be profitable at international prices. When poorly designed, zone-based policy could have adverse impacts on the wider economy (Box 7.8).

Box 7.8. Zone-based firms' sales on the domestic market: international evidence

Governments have opted for various policies regarding zone-based investors' sales on the domestic market. In Thailand, as in most other countries, sales on the domestic market are treated as any imported good and thus zone-based firms pay the related customs duties. Countries like Bangladesh and Egypt have a similar practice but impose a ceiling on domestic market sales, the rest of the production being for export only. Other countries permit a fixed percentage of production to be sold on the domestic market without facing customs duties, using duty-free domestic access as an incentive to attract FDI to the zones. This is the case of Mauritius, where firms are allowed to sell up to 20% of their production duty free on the domestic market, thus offering them preferential, albeit limited, access. In Brazil, the FTZ of Manaus grants tariff incentives conditional on the local value-added created in total production, a similar policy to Indonesia's SEZs.

Notwithstanding the policy choice, all countries, in one way or in another, let zone-based companies sell their products on the domestic market, even if the primary objective of such areas is to boost exports (some zones face important trade deficits). Sales to the domestic market can adversely affect firms outside zones by exposing them to unfair competition. Preferential treatment given to firms in zones, in particular corporate income tax holidays, along with import facilitation measures, may offset the cost of customs duties they may have pay to sell on the domestic market. This preferential treatment gives market-seeking businesses in zones a comparative advantage over firms outside zones. Countrywide productivity growth may be adversely affected by zone-based firms' sales on the domestic market, as they can avoid export markets and related competitiveness pressures to be profitable at international prices while benefiting from tax incentives.

The design of zone-based policy should consider the potential adverse impacts of zones on the wider economy. It should shift from relying on fiscal incentives to facilitating a more effective business environment that promotes competition, integrates targeted sectors with the rest of the economy, and adequately protects the environment. Governments should opt for policy reforms that align the country's import tariffs, import procedures and corporate income tax incentives with those in zones to cut the detrimental comparative advantage gap between firms inside and outside of zones. Levelling the playing field between zones and the rest of the country is an even more pressing priority in light of many governments' strategy, including Indonesia, to expand the number of zones.

Some countries have successfully managed to address challenges inherited from their zone-based policies. Poland established zones in the 1980s for a temporary period of 20 years (setting a temporary lifespan for zones is in itself a good practice). Zones in Poland contributed to productivity growth but were not without some adverse consequences. The criteria discriminated against SMEs based outside zones. Furthermore, neighbouring countries started offering tax incentives regardless of investors' location. As a remedy, Poland introduced in 2018 a law to expand zones incentives to the entire territory and shifted criteria from geographical and investment scale to sustainability and innovation.

Source*:* OECD (2020c), OECD Investment Policy Reviews: Egypt 2020, OECD Publishing, Paris.

The phenomenon of zone-based firms selling on the domestic market is observable in bonded zones. In these areas, the gap between output and exported output is substantial, suggesting that not all firms export their products.[18] This is a concern amongst policymakers, some of whom call for removing bonded-zones, as some firms enjoy incentives without exporting (Wicaksono et al., 2019). More problematic, the proportion of exported output amongst bonded-zone businesses is lower than amongst non-bonded exporting firms, particularly in the food and textile industries. Thus, not only do bonded-zones not contribute to raise exports of firms, they also host businesses that take advantage of the zone incentive and use it as a platform to produce and sell to the domestic market.

There is little evidence of zone-based productivity spillovers to nearby Indonesian regions. In other countries, too, the results are often mixed, illustrating both the benefits and limitations of zone-based policies. In Brazil, Manaus FTZ was successful in reducing local poverty through higher incomes in the zone but spillovers to neighbouring areas were limited (Castilho et al., 2019). In India, place-based policy attracted large and productive firms but there were no tangible spillovers (Chaurey, 2017). The Chinese SEZ programme, which inspired the latest SEZ regulation in Indonesia, has had a positive effect on investment, employment, productivity and wages, mostly driven by the entry of new firms rather than incumbents. Because of the CIT incentives, capital-intensive industries benefit more than labour-intensive ones from the programme (Lu et al., 2019).

Zone-based policy in Indonesia should gradually shift from relying on fiscal incentives to facilitating a more effective business environment that promotes competition, integrates targeted sectors with the rest of the economy, and adequately protects the environment. The government could opt for reforms that align the country's import tariffs, import procedures and corporate income tax incentives with those in zones to cut the detrimental comparative advantage gap between firms inside and outside of zones. Levelling the playing field between zones and the rest of the country is an even more pressing priority in light of the government's strategy to expand the number of SEZs.

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Notes

[1] Law No. 22 of 1999 on Local Governance.

[2] Presidential Decree No. 117 of 1999; Government Regulation No. 25 of 2000.

[3] About half of the civil servants were already in the regions but paid by the central government.

[4] Law 32 of 2004 on Local Governance; Head of BKPM Decree No 57&58/SK/2004.

[5] Law No. 23 of 2014 on Local Governance; Head of BKPM Decree No. 14 the Year of 2015.

[6] The World Bank Doing Business surveys in 2010 and 2012 benchmarked 14 Indonesian cities and found large differences in the ease of doing business. For example, the cost of dealing with construction permits ranged from 132% of per capita income in Makassar to 32% in Jambi, while the cost of opening a business in relation to income per capita was nearly twice as high in Manado as in Pontianak.

[7] In 2014 and 2017 the ADB and KPPOD conducted a joint survey on the ease of doing business in five Indonesian cities: Jakarta, Surabaya, Medan, Balikpapan, and Dan Makassar. The results of the surveys could not be retrieved online. The translation of online press articles in Bahasa indicates that the top three impediments to doing business across the five cities were the ease of starting a business, the ease of getting construction permits, and registration of land and building rights.

[8] Government regulation No. 30 of 2011 on regional loans became regulation No. 56 of 2018.

[9] Foreign investment in passenger and cargo sea transport is limited to 49% of equity interest and in some sea transport auxiliary services to 67% (OECD FDI Regulatory Restrictiveness Database).

[10] The Indonesia Governance Index measures the quality of local governance in four areas: government, bureaucracy, civil society and economic society.

[11] Law No. 12 of 2011 on the hierarchy of laws and legislations in Indonesia.

[12] Presidential Instruction No. 7 of 2019 on the acceleration of ease of doing business.

[13] Unlike most provinces, East Java has not established a provincial level minimum wage, and instead sets wages at the district and regency level.

[14] Malang Regency Regulation No. 3 of 2012 on Protection and Empowerment of Traditional Markets and Structuring and Control of Shopping Centres and Modern Stores, article 10 paragraph (2) letter (a). See also: https://nusadaily.com/en/headlines/breaking-through-complex-permits-jokowi-issues-presidential-instruction-7-of-2019.html.

[15] Government Regulation No. 24, 2019.

[16] The four SEZs are in Mandalika, Tanjung Lesung, Tanjung Kelayan and Morotai.

[17] The provisions of the tax holiday for SEZs are listed in Regulation Number 104/PMK010/2016, where investors could get a reduction in corporate income tax by 20% to 100%.

[18] A bonded zone is required to export at least 25% of total zone output. Thus, a firm in a bonded zone does not need to export if total exports in the zone account for more than 25% of total output.

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