6 Investment promotion and facilitation in Indonesia

This chapter examines investment promotion and facilitation policies in place in Indonesia. It analyses the institutional framework for investment promotion and facilitation, with a particular emphasis on the role and activities of BKPM, Indonesia's investment promotion focal point, which it benchmarks against other agencies in the world. It highlights key reforms and measures implemented by the government to improve the business environment and facilitate the process for incoming investors as well as to attract foreign investment. It also examines the tax regime and the role of tax incentives for investment in support of foreign investment promotion. The chapter identifies remaining challenges and proposes recommendations to address them.

Summary and main recommendations

Investment promotion and facilitation policies, including well-designed tax incentives for investment, can contribute to the competitiveness of a country by attracting quality and innovative investors and by making it easier for businesses to establish or expand their operations. Such initiatives are particularly important to respond to the crisis provoked by the COVID-19 pandemic, which poses significant challenges to public authorities. The economic contraction, drop of foreign direct investment (FDI), pressure on public budgets and the need to deliver on sustainable development goals are just some areas that will have an impact on institutions in charge of promoting and facilitating investment in Indonesia. Investment promotion and facilitation measures can not only support a sustainable recovery by creating an attractive economy, but also by helping ensure that foreign investments support national development objectives and generate positive spillovers through the development of less developed areas, linkages with local companies and skills transfer. It is important, however, that investment tax incentives are used cautiously due to increased pressure on public budgets. Investment promotion and facilitation efforts should also complement – and not replace – measures to ensure a sound investment policy framework.

Within Indonesia's institutional framework governing investment, the Indonesian Investment Coordinating Board or BKPM (for *Badan Koordinasi Penanaman Modal*,) is the government's implementing arm on investment promotion, facilitation and regulation. BKPM is a large organisation with a large number of official mandates, more than in many other investment promotion agencies (IPAs) around the world. Its regulatory and policy-oriented characteristics have been dominating the agency's mind-set and strategic orientations over the past decades, and have been instrumental in increasingly establishing a business-friendly environment in Indonesia, including for FDI.

BKPM aims to play a co-ordinating role within a multifaceted, if not fragmented, institutional landscape, where multiple public entities have a say on investment policies or on their implementation. These different roles and tasks across government actors can sometimes be complementary but can also overlap or be inconsistent with each other. This complexity at the central level is amplified by the important role played by local governments in investment promotion and facilitation.

Improving the business environment has been a top priority of the President since he took office in 2014 and which was then further emphasised at the beginning of his second term. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms aiming at improving transparency, streamlining licences and creating mechanisms to ease the business creation process. One of these recent flagship reforms is the Online Single Submission (OSS), an online business licensing system, which has allowed the business licensing process to become more efficient and more transparent.

In practice, however, investors have still been relying on too many procedures and requirements that cannot be processed by the OSS and that has hampered the efficiency of the system. Additionally, the OSS, by replacing a system that was put in place only a few years earlier and still well-established in certain cities and districts, is not without implementation problems and local resistance. The government is thus seeking to standardise further the licensing process by providing increased authority to BKPM. In parallel, it has prepared two Omnibus laws – one on job creation and one on taxation – which are seeking to modernise the regulatory framework.

The Omnibus Law on Job Creation, among various objectives, seeks to ease and harmonise the business licensing process by amending 76 laws related to a wide array of economic sectors. Its effective implementation remains nonetheless to be seen. In the future, the government may consider adopting the reverse sequencing of reforms: starting with assessing the regulatory stock and burden for businesses, then cutting unnecessary licences and administrative requirements, and finishing by implementing a top-notch online mechanism to start a business.

These reforms are taking place in an environment where stakeholder consultations are vital. While BKPM takes its role as an intermediary between the government and the private sector very seriously and organises business consultations on a regular basis, a key challenge lies precisely in reconciling sometimes conflicting views on investment-related matters across different market participants.

In terms of FDI attraction goals, the government has progressively taken a more proactive stance on investment promotion over the past years, but remains relatively less advanced than some of its peers. Led by BKPM, the government has collegially developed a strategy with priority sectors based on some well-defined criteria, but the focus remains too wide for BKPM's investment generation activities to be impactful and measurable. A large part of the agency's efforts are still dedicated to image building, while more specific targeting and attraction activities would be necessary, as is the case in more modern fully-fledged IPAs that are seeking to achieve similar goals. As the pipeline of new FDI projects is likely to drop due to the pandemic, an effective prioritisation strategy for investment promotion is an important success factor in the government's recovery efforts.

Tax reform is another pillar of Indonesia's strategy to enhance the investment climate and to promote the country as an attractive investment destination. In recent years, significant changes have been introduced through the gradual review and expansion of Indonesia's tax incentives. Broader tax reforms are also planned under the Omnibus Law on Taxation. The policy response to the COVID-19 economic crisis accelerated some reforms planned under the law to provide tax relief to affected businesses.

Indonesia's tax incentives are among the most generous in the region. Tax incentives' potential to attract investment, create jobs, acquire knowledge, skills and technology, and boost economic growth must be weighed against the resulting costs in terms of tax complexity, neutrality and revenue forgone. In Indonesia, tax incentives for investment continue to be at the core of the strategy to improve the business environment, but substantial changes have been introduced since 2018 in their design and in the targeted activities.

New cost-based incentives were introduced to promote labour-intensive sectors and activities with socio-economic spillovers, such as research and development (R&D) and vocational training, which has been a positive development. At the same time, previously existing incentives were also expanded to include new priority sectors under both the tax holiday and investment allowance schemes. The successive expansion of prioritised sectors (under the so-called *pioneer* and *certain* industries policies) make the intended policy objective less clear, however. For example, the 30% investment allowance was expanded to additional sectors and all new investment projects (rather than limited to newly registered firms), which creates unequal competition among firms that are granted incentives and those that are not.

The wider tax incentive scheme continues to be complex due to multiple – in some cases, overlapping – incentives and the density of the current legal framework. Tax incentives in Indonesia are introduced through multiple legal instruments, including laws and regulations. They can be modified by further regulations – for example, introducing additional requirements – that amend prior ones, which makes it difficult for investors to have a full overview of how incentives apply. While relevant regulations are available online, official English translations are not always available, which can create additional uncertainty. Significant efforts have nevertheless been made to increase transparency and communicate incentives more clearly. Investor guides provide a good overview but cannot capture some of the details and complexities of the regulations.

Main recommendations on investment promotion and facilitation

- Ensure BKPM's leadership role on investment promotion and facilitation is well recognised and that it has the means to co-ordinate the dialogue between all parties. While it has been a good development to integrate increased licensing responsibilities within the agency, its exact role within government remains sometimes unclear.

- To conclude ongoing discussions in the cabinet on the status of BKPM, decide whether to fully upgrade BKPM to ministerial level or to keep it as an operational agency. The first option would allow it to better fulfil its co-ordinating role and drive policy reform. If the second option is maintained, consider providing it with more autonomy, to reduce the number of mandates and to provide more responsibility to the Investment Committee. The committee could be upgraded to a board, to align it with good IPA international practices, and should include business representatives from all segments of the economy as well as representatives of academia and civil society.
- Given the rapid pace of ongoing reforms to facilitate investment, notably the establishment of the OSS and the Omnibus Law on Job Creation, ensure that officials in the national and regional administrations have sufficient and adequate resources, capacities and information to properly implement the new regulations and adapt to the new tools. This would help overcome the operational challenges of the OSS and make it more efficient. A review of the implementation and impact of reforms could be envisaged to understand whether these measures achieved their objectives.
- Provide clear rules and guidelines to investors on the use of the OSS and consider establishing information services. The implementing regulations of the Omnibus Law on Job Creation that relate to business licensing and forthcoming changes to the OSS also need to be well-discussed and communicated in advance. Ensure that increasing predictability and transparency in investment procedures – including to reduce corruption risks – continue driving ongoing and new investment facilitation reforms.
- Continue streamlining redundant and overly burdensome business licences and administrative procedures to provide a healthy business environment to both incoming and already-established investors. This, however, should not come at the expense of much needed labour and the environmental protection safeguarding a more inclusive and sustainable development pathway (see also Chapter 5 on responsible business conduct). In this light, while the preparation of the Omnibus Law on Job Creation seeks to ease the process of doing business, the reform should not be limited to amending sectoral laws, but focus on systematically identifying business regulations that could be eliminated and those that need to be preserved.
- Ensure that ongoing investment climate reform efforts, including implementing regulations of the Omnibus Law on Job Creation, are accompanied by wide-ranging and meaningful stakeholder consultations and communication campaigns. Involve all relevant stakeholders, including trade unions, civil society, affected stakeholders and academia in addition to the business community, more systematically and as early as possible in policy design, even if conflicting views sometimes occur, to maintain a constructive dialogue and reach an environment of trust. Diversify the number of interlocutors and ensure all the spectrum of stakeholders, including at the local levels, are involved and represented. Ensure that consultation remains transparent and that information on how stakeholder inputs were used is publicly available.
- In the context of its aftercare services, BKPM could strengthen its business matchmaking programme to foster the creation of linkages between foreign affiliates and domestic firms. In addition to matchmaking services, this programme could include the preparation of suppliers' databases, which, on the one hand, may reduce foreign firms' transaction costs and, on the other hand, can help providing opportunities for local firms. Greater co-ordination with similar initiatives across government would avoid overlaps and reinforce the implementation and monitoring of the linkage programme.
- In terms of investment promotion efforts, continue moving away from costly image building campaigns and adopt a more focused approach. BKPM could consider better prioritising its FDI attraction measures to complement the recent and ongoing improvements conducted to facilitate inward investments. Proactive FDI attraction should focus on targeted sectors and projects, which support the country's sustainable development goals and an inclusive and resilient recovery from

the pandemic. Focus should be given to industries where foreign investments' performance is proven to be higher than domestic ones in terms of productivity and innovation, wages and skills development, and environmental preservation.

Main recommendations on tax incentives for investment

- Monitor effects of tax reform on Indonesia's tax base. Lower tax revenues can constrain government spending on infrastructure and social services, which in turn can hamper progress toward improving the business environment in the long-run.
- Continue to shift towards cost-based tax incentives. New tax incentives introduced since 2018 have all been cost-based, but profit-based incentives (tax holidays) remained in place or were expanded to additional industries. Authorities could consider limiting profit-based incentives to high priority investments. In the medium-term, once recovery from the COVID-19 crisis strengthens, consider reducing the number of promoted *pioneer industries*.
- More clearly define the policy objective for the 30% investment allowance to *certain industries*. Authorities could consider more clearly communicating the policy's intention and how it differs from other sector-based incentives (i.e. *pioneer industries* incentives). The latest restructuring of the incentive has significantly expanded the qualifying industries under this tax incentive, which risks creating an uneven playing field relative to non-promoted ones.
- Consolidate tax incentive regulations in the relevant tax law. In Indonesia, tax incentives are introduced and regulated through multiple legal instruments: laws, government, Ministry of Finance and BKPM regulations. Consolidating tax incentive regulations can increase transparency and reduce policy overlaps.
- Facilitate foreign investors' access to implementing regulations. BKPM could consider producing additional in-depth guides on how incentives apply, explaining differences between incentive regimes. Official translations of all relevant regulations and business segment lists (that include industry codes of eligible industries under each incentive) can also enhance transparency.
- Introduce sunset clauses on tax incentives to promote regular policy reviews. These can help identify new sector priorities as well as incentives that are no longer needed.
- Continue to conduct and publish annual tax expenditure reports and expand their analysis to include new tax incentives and forgone tax revenues within special economic zones.
- Continue to engage in regional and international dialogue on taxation. Regional forums provide a space for discussion on potentially harmful tax competition, as well as sharing information on good practice examples from other regions. Regional dialogue and tax co-operation will be even more important in the COVID-19 context, as a way to avoid tax disputes that could harm economic recovery.

Overview of the institutional framework for investment promotion and facilitation in Indonesia

Recognising the importance of private investment for economic and social development, most countries in the world have established IPAs dedicated to promoting and facilitating investment, often with a particular emphasis on attracting multinational enterprises (MNEs) and capturing the benefits of FDI. IPAs are never the sole actors and other public entities often also play complementary – sometimes overlapping – roles to promote and facilitate investment.

The way governments around the world organise their institutional framework for investment promotion and facilitation responds to their policy objectives and the priority they give to investment. These choices can greatly influence their success in attracting investment in the most efficient and effective manner.

In Indonesia, the investment promotion and facilitation landscape is dominated by BKPM, the Indonesian Investment Coordinating Board, which is the main government agency in charge of implementing investment-related policies at national level. BKPM is a large organisation that has had various responsibilities over the past decades. It was initially established in 1967, as the Technical Committee on Investment and then replaced by BKPM in 1973. It is only in 2001 that it began to focus its role on investment promotion and facilitation tasks, when it was reshaped as an independent agency and when a Presidential Decree created the first National Single Window for investment. Since 2014, its three main tasks are as follows: *i)* licensing simplification; *ii)* assisting and facilitating investment projects; and *iii)* improving investment attraction results.

BKPM's tasks are supplemented by a number of other public entities that play a central role on investment promotion and facilitation:

- The Coordinating Ministry for Maritime Affairs and Investments is, since the new Cabinet is in place, overseeing the work of BKPM and given special authority to facilitate inter-ministerial co-ordination and ensure policy enforcement;
- The Coordinating Ministry for Economic Affairs (Menko) has traditionally always been a key player on many areas affecting investment. It has notably been playing an important role in liberalisation efforts by driving and co-ordinating the revision of the Negative Investment List (DNI). It has also been at the forefront of the recently established Online Single Submission system and has been driving the preparation of the Omnibus Law on Job Creation. It is also in charge of the new regime for special economic zones;
- The Ministry of Foreign Affairs is leading the country's economic diplomacy agenda and is often involved in investment promotion missions abroad. In the new Cabinet, it has been given the task to improve Indonesia's trade and investment relations with other countries;
- The Executive Office of the President provides guidance on national priority programmes and strategic issues. It has a dedicated Deputy Chief of Staff in charge of the management of strategic economy issues, which include investment;
- The Ministry of Finance is in charge of designing the investment tax incentives scheme while BKPM is in charge of preparing the operational regulations that apply to the eligible sectors accordingly. They co-operates with each other and line ministries to ensure and monitor the fiscal incentives regime's effective implementation;
- The Ministry of Industry is responsible for the country's industrial policies and notably in charge of the management of the 'real estates', which are specific zones where a high number of firms, especially in the manufacturing sector, decide to locate;
- The Ministry of National Development Planning (Bappenas) is designing long- and short-term development plans across all public policy areas, among which investment is increasingly becoming a key component;
- Local governments – at the provincial, district and municipal levels – have acquired a high level of decision-making power since the initiation of decentralisation programmes in the 2000s. They are essential players to make the local investment climates healthy and can play an important role to promote and facilitate investments.

Although investment promotion and facilitation often involves a network of various ministries and public agencies, the case of Indonesia is particularly multifaceted and co-ordination needs to be optimal to respond to investors' needs while also serving the government's short- and long-term national development objectives. BKPM needs to play a key role in this regard.

BKPM as the main national IPA: benchmarking and analysing its characteristics

Large differences exist across IPAs in terms of institutional settings, governance policy, strategic priorities, and investment promotion tools and activities. To better understand the characteristics of investment promotion and facilitation dynamics in Indonesia and to compare its main national IPA with international peers, Indonesia recently participated in a survey of IPAs conducted by the OECD (Box 6.1). The results serve as the basis of the comparative analysis conducted in this chapter and allows benchmarking BKPM against its peers from the OECD and from other regions.

Box 6.1. The OECD-IDB survey of investment promotion agencies

The OECD and the Inter-American Development Bank (IDB) have partnered to design a comprehensive survey of IPAs. The questionnaire provides detailed data that reflect rich and comparable information on the work of national agencies in different countries. The survey was displayed in the form of an online questionnaire and divided into nine parts:

- Basic profile;
- Budget; Personnel;
- Offices (home and abroad);
- Activities;
- Prioritisation;
- Monitoring and evaluation;
- Institutional interactions; and
- IPA perceptions on FDI.

In 2017-2018, the survey was shared with IPA representatives from 32 OECD and 19 Latin America and Caribbean (LAC) countries. In 2018, 10 national agencies from the Middle East and North Africa (MENA) participated in the same survey and 10 additional countries from Eastern Europe, Southern Caucasus and Central Asia (Eurasia) joined the same exercise the following year.

The results of the survey are presented in comprehensive IPA mapping reports, which provide a full and comparative picture of IPAs in selected regions (http://www.oecd.org/investment/investment-promotion-and-facilitation.htm). The reports are benchmarking agencies against each other as well as the average IPA in a region against other regions.

Indonesia's main national IPA – BKPM – participated in the survey in 2019 in the context of this second Investment Policy Review. The results are used to provide an in-depth analysis of the agency and compare it with other agencies in the world.

Key organisational features

Scope and diversity of BKPM's mandates

IPAs can be either fully dedicated to the attraction and facilitation of inward foreign investment or be part of a broader agency that includes additional mandates, such as the promotion of exports, innovation, regional development, outward investment and domestic investment, among others. In practice, for reasons of efficiency and synergies, most IPAs around the world have multiple mandates and conduct activities that go beyond inward foreign investment promotion.

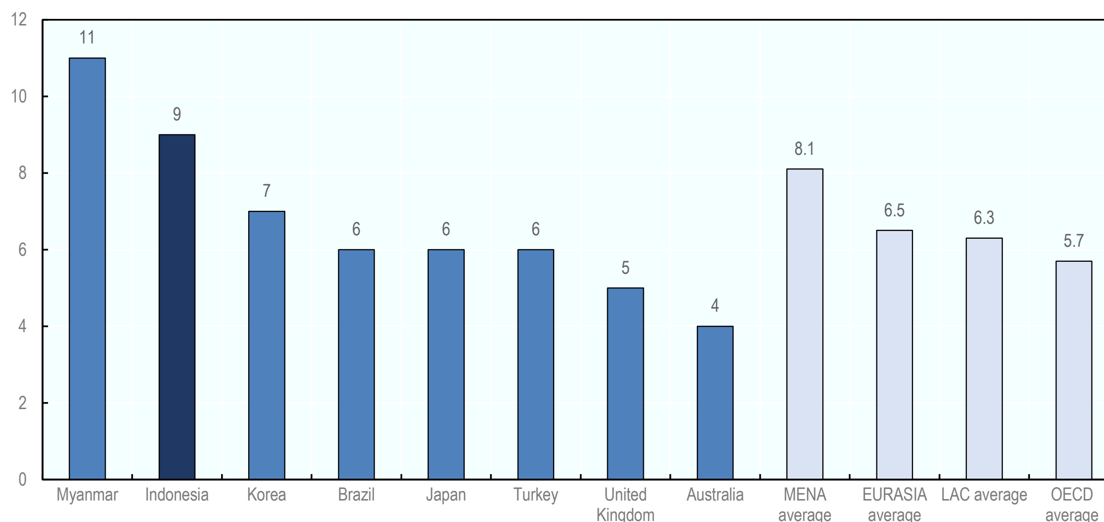
BKPM reported in its responses to the IPA survey to have nine official mandates (out of 18 possible mandates):

1. Inward foreign investment promotion
2. Outward investment promotion
3. Domestic investment promotion
4. Operation of one-stop shop
5. Screening and prior approval of investment projects with foreign participation or investor registration
6. Issuing of relevant business permits
7. Negotiation of international trade, investment or other agreements
8. Granting fiscal incentives
9. Promotion of regional development

Although large differences exist across agencies, including within the same regions of the world, IPAs in OECD, LAC and Eurasia countries have generally fewer mandates, with an average of 5.7, 6.3 and 6.5 different mandates respectively under the agency's responsibility (Figure 6.1). As reflected on the figure, the size of the economy does not necessarily have an implication on the number of mandates.

Figure 6.1. Number of mandates of BKPM and selected other national IPAs

(Out of 18 possible mandates)

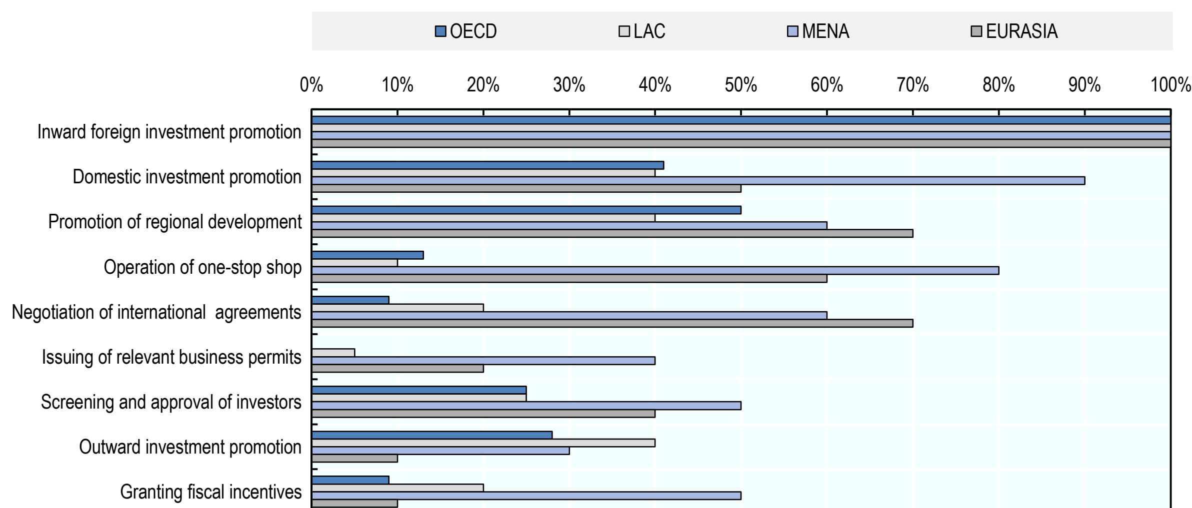


Note: 32 countries are included in the OECD group, 19 in LAC, 8 in MENA and 10 in Eurasia.
Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

BKPM's relatively large number of mandates reflects its wide scope of responsibilities and activities, which are strongly articulated around investment, as no other policy area (such as export promotion, for example, which is often combined with investment promotion) is included in its official mandates. This reflects the importance of investment in the government's overall development policy and demonstrates a coherent approach to making investment work for growth and prosperity – notably by including foreign investment promotion, domestic investment promotion, regional development and the operation of a one-stop shop under the same umbrella.

Many of BKPM's official mandates are more frequently executed by agencies in the MENA and Eurasia regions than in OECD countries (Figure 6.2). This is the case for the vast majority of its mandates, but particularly striking for domestic investment promotion, operation of one-stop shop, negotiation of international agreements and issuing of relevant business permits.

Figure 6.2. BKPM's mandates and their frequency across IPAs in other regions



Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

One-stop shops, for example, are often established within IPAs in MENA and Eurasia to facilitate business transactions and reduce the cost of doing business by avoiding excessive bureaucracy and red tape, as in the case of Indonesia. It is a key difference with OECD IPAs, where only 13% of which operate one-stop shops (OECD, 2018a). This difference is likely due to generally more complex institutional bureaucracies in large emerging markets.

On the contrary, in OECD economies, the most frequent combination of mandates in IPAs are with export promotion (56% of agencies) and with innovation promotion (same percentage) (ibid.). In the LAC region, two agencies out of three have decided to merge investment and export promotion. In these two regions, IPAs are often the operational arms of ministries and are in charge of implementing – not designing – the policies. This is one of the reasons why several disciplines can be found under the same roof, while those touching upon regulation or policymaking (e.g. operation of one-stop shop, issuing or relevant licences, negotiation of international treaties, screening and prior approval, etc.) are taken care by ministries.

In many emerging countries, such as Indonesia, IPAs are fully fledged investment agencies with a high number of promotional and regulatory mandates. While it gives a strong leadership on investment to a single government entity, it can also lead to potential risks of mixing regulatory or policy-related functions and promotional activities. Some studies show that those IPAs focusing exclusively on investment promotion achieve significantly higher results in attracting investors than those which carry out both regulatory/policy and promotional tasks (World Bank, 2011). The reason behind this finding is that attracting FDI and ensuring that investors comply with legal requirements are two different functions with different objectives and that require different skillsets. Investors contacted by the IPA may wonder whether it is intended to solve their problems or to create new ones. The IPA is often expected to represent private investors' interests within government and it will be less credible to do so and to influence policymaking if it is the same agency that regulates them. This is why countries like Malaysia, Singapore and a vast majority of OECD members have separated their investment ministry – in charge of policymaking, treaty

negotiation and regulatory tasks – from their IPA – in charge of investment promotion and facilitation (also often slightly more autonomous from the government).

In Indonesia, BKPM is doing what, in other countries, both the ministry and the IPA would be doing distinctly. BKPM is a large organisation in charge of a high number of different mandates. It thus requires both a wide scope of skillsets and a clear strategic orientation that all divisions and units can hang on to. In this context, it could be envisaged to upgrade BKPM to fully-fledged ministerial level to help the agency fulfil its co-ordinating role, drive policy reform and conduct all its mandates effectively. A distinct unit would be fully dedicated to the agency's promotional activities and could, in the future, take gradually more autonomy – like in many other more advanced IPAs.

Another challenge is that the multiplicity of mandates may lead to a duplication of tasks with other government entities, particularly if institutional co-ordination mechanisms are poorly designed. According to the IPA survey, a number of BKPM's mandates are also carried out by other national agencies or ministries as well as by sub-national authorities (Table 6.1). The prominent role of sub-national authorities in investment promotion and facilitation testifies of their commitment to making investment work for regional development but can also raise questions about potential co-ordination challenges (as further examined in Chapter 7 on the local dimension of investment policy in Indonesia). Since 2019, however, the ease of doing business reform was granted to BKPM (by virtue of Presidential Instruction No.7 of 2019), which was meant to strengthen its convening power and position to co-ordinate inter-ministerial dialogue on investment and licensing, including on investment promotion and facilitation.

Table 6.1. Other government entities in Indonesia with the same mandates

	Other national entity with this mandate	Other sub-national entity with this mandate
Inward foreign investment promotion	NO	YES
Outward investment promotion	YES (Ministry of State Owned Enterprises)	YES
Domestic investment promotion	YES (Ministry of SMEs, Indonesia Agency for the Creative Economy)	YES
Operation of one-stop shop	NO	YES
Screening and prior approval of investment projects	YES (Line ministries)	YES
Issuing of relevant business permits	YES (Line ministries)	YES
Negotiation of international agreements	YES (Ministry of Trade)	NO

Source: OECD-IDB Survey of Investment Promotion Agencies: Indonesia, 2019.

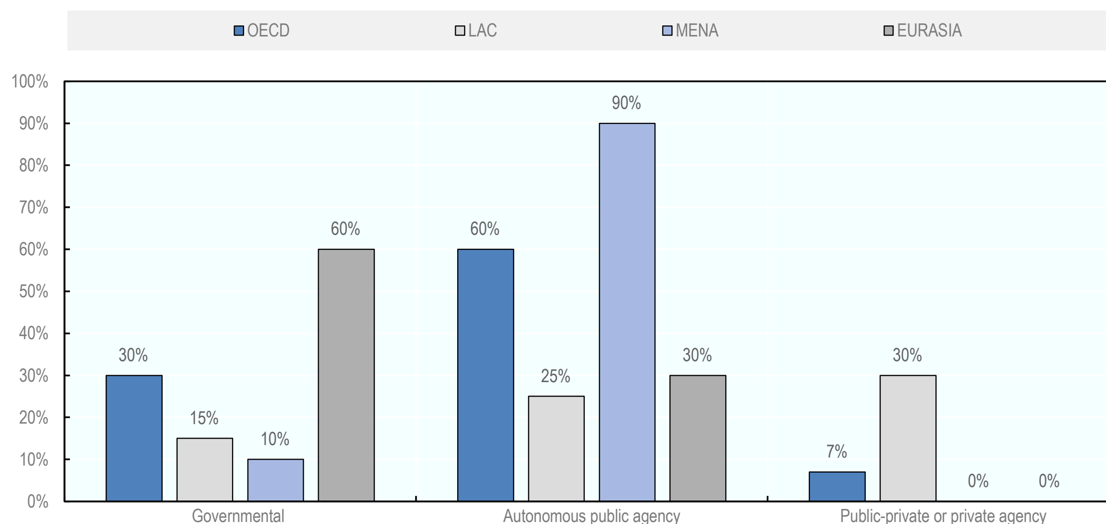
BKPM's governance policy

The governance of an IPA relates to the way it is supervised, guided, controlled and managed. An IPAs' governance policies are often dictated by their institutional context and broader political choices. The governance policy of an IPA is important because it affects its legal status, reporting lines and managerial structure. It can thus have an impact on the degree of autonomy the IPA has from the government, particularly in terms of financial and human resources management.

The legal status of IPAs can vary. They are usually created either as: *i)* a governmental body (e.g. ministry or a unit within a ministry); *ii)* an autonomous public agency; *iii)* a joint public-private body; or *iv)* a fully privately-owned organisation. BKPM belongs to the first category, as it is a non-ministerial government

agency, which has been reporting directly to the President of the Republic until 2019. It is now under the authority of the Coordinating Ministry for Maritime Affairs and Investments. IPAs with this legal status, due to their governmental nature, are the least autonomous types of agencies. In other regions of the world, IPAs with similar legal status are in the minority, with the exception of the Eurasia region (Figure 6.3). In Southeast Asia, national IPAs from Cambodia, Lao PDR, Myanmar and Viet Nam are governmental agencies, while those from Malaysia, the Philippines, Thailand and Singapore have more autonomous settings.

Figure 6.3. IPAs' legal status across other regions



Note: Some regions do not add up to 100% because some IPAs are categorised as "others".
Source*: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).*

Another component of an IPA's governance policy is the existence and role of a board. When a board exists, it is meant to supervise or advise the work of the agency, or both, with a somehow independent perspective. Boards vary greatly from one IPA to another; they can be of an advisory nature or with a high degree of decision-making power. A vast majority of IPAs around the world have a board in place – 69% in OECD countries, 86% in LAC and all agencies surveyed in MENA.

Being a co-ordinating board itself, BKPM's role is to co-ordinate with other ministries and agencies and to consult and collaborate with external public entities on a regular basis. As such, BKPM did not have a board for a long period of time, but it established in 2019 an Investment Committee composed of external private sector representatives and professionals advising the Chairman of BKPM and its technical staff on investment policy and promotion related issues. BKPM was well advised to establish an Investment Committee of external advisers to provide guidance and advice on its promotion and facilitation activities. Having stakeholder representatives on the board can help ensure that the views and interests of different market players, including businesses, are taken into consideration in BKPM's overall strategic directions. In OECD IPAs, boards are composed of approximately 10 people on average and are dominated by representatives from the private sector (41% on average) and the public sector (38% on average), the remaining being representatives of research and academia, civil society or other areas.

One last important element is that it is not only private and autonomous agencies that have boards. As in the case of BKPM, governmental IPAs also have boards even if they are less autonomous from the government. For example, half of governmental IPAs in OECD countries have a board whereas, by

definition, they are less autonomous – their boards tend to be of an advisory nature rather than a supervising board of directors to which IPAs have to report.

Breakdown of BKPM's activity mix

Within their main investment promotion and facilitation mandate, IPAs are usually major players in the implementation of four core functions:

- *image building* consists of fostering the positive image of the host country and branding it as a profitable investment destination;
- *investment generation* deals with direct marketing techniques targeting specific sectors, markets, projects, activities and investors, in line with national priorities;
- *investment facilitation and aftercare* is about providing support to investors to facilitate their establishment phase as well as retaining existing ones and encouraging reinvestments by responding to their needs and challenges; and
- *policy advocacy* includes identifying bottlenecks in the investment climate and providing recommendations to government in order to address them.

While the first two functions relate to investment promotion (i.e. attracting new investment to support national development objectives), the latter two rather deal with investment facilitation (i.e. making it easy for investors to establish, operate and expand). Investment promotion is meant to attract potential investors that have not yet selected a destination, whereas facilitation starts at the pre-establishment phase, when an investor shows interest in a location. As such, investment promotion and attraction is primarily the business of IPAs while facilitation often involves a whole-of-government approach (Novik and de Crombrugghe, 2018).

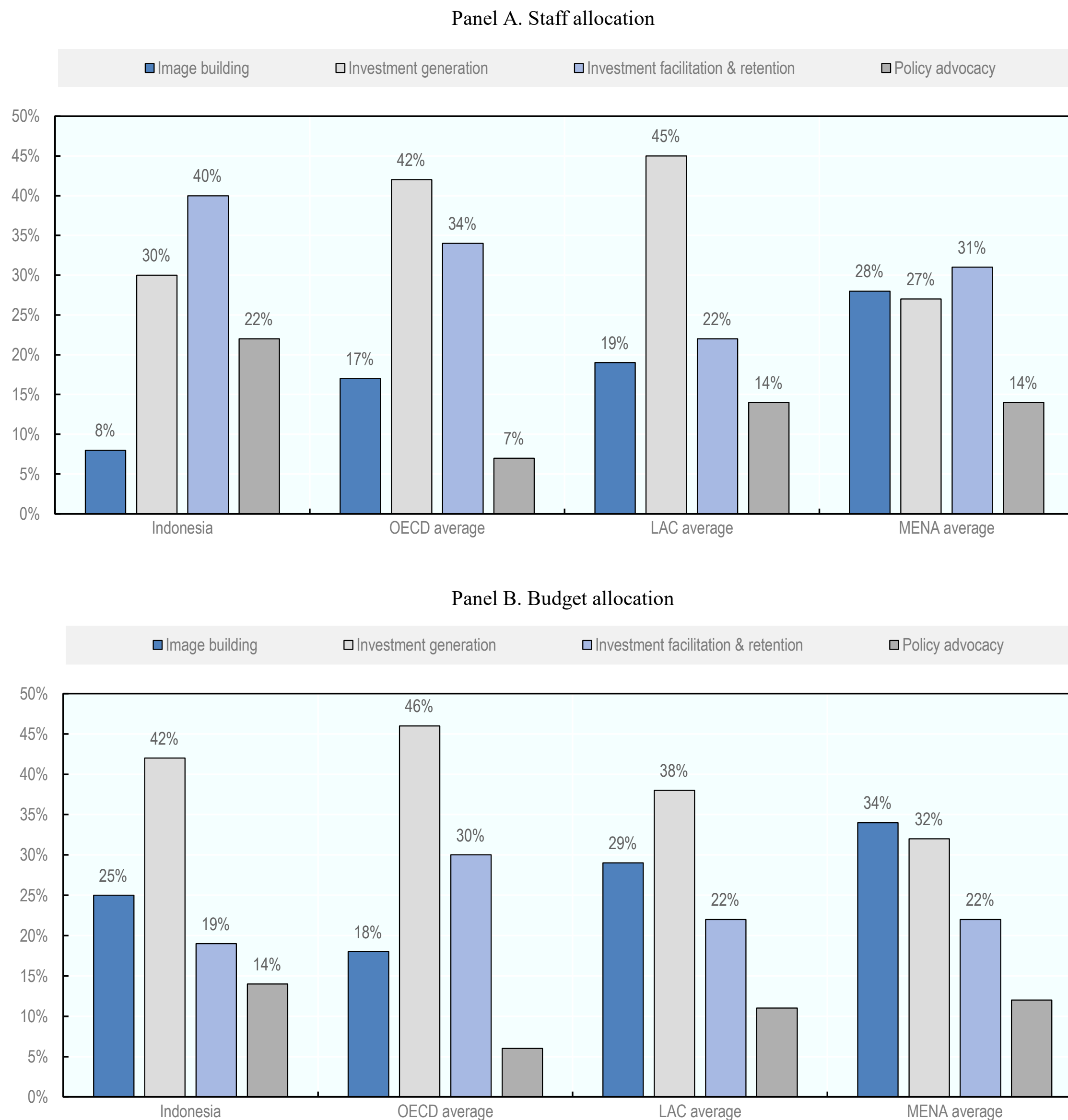
According to the OECD survey of IPAs, BKPM allocates a higher share of its employees to investment facilitation and retention (40% of staff) than to investment generation (30%), which is the opposite trend to that observed in OECD and LAC agencies (Figure 6.4 – Panel A). As discussed in the above section on mandates, this reflects the importance given by BKPM to supporting licensing and requirements to start a business, including with the successive one-stop shops that it has been hosting (see section below). The budgetary allocation of the four core functions provides a very different picture by suggesting that investment facilitation is a function that, in the case of Indonesia, seems to use far more human than financial resources (Figure 6.4 – Panel B). Investment generation produces the opposite effect, which could potentially be due to the fact that these activities are more cost-intensive (e.g. market intelligence, overseas missions and fairs).

BKPM noticeably dedicates a higher share of its resources (both staff and budget) to policy advocacy than its peers in other regions, which could be linked to its regulatory, co-ordinating and policy advisory functions. The agency's Deregulation Directorate, for example, is in charge of advising and consulting line ministries on policies and regulations that could affect FDI (e.g. business licences, restrictions to FDI, etc.).

Image building seems a marginal function in terms of staff allocation, but a very important one in terms of budget. Activities under this function often involve costly communication campaigns that are not necessarily personnel-intensive. For example, in the past years, BKPM had embarked in a large image building campaign called "Remarkable Indonesia". It involved communication activities aiming at reinforcing Indonesia's strengths in terms of market size and growth, and at promoting the country as a friendly destination to do business (Adam Smith International, 2014). BKPM's focus has since then increasingly shifted to more practical services designed to provide information to support actual investment decisions (i.e. investment generation) and support companies establish and operate (i.e. investment facilitation).

Moving away from large and costly communication campaigns for a country like Indonesia – which already enjoys a positive image as a large, stable, democratic and influential ASEAN and G20 member – is a reasonable idea. This becomes even more important in the context of the COVID-19 crisis, where sound and targeted investment facilitation and promotion measures are more efficient and relevant to support Indonesia's recovery, and should hence remain BKPM's core priority functions.

Figure 6.4. Estimated use of resources across the four core functions in BKPM and in the average IPAs of selected regions



Source*:* Based on OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

Facilitating investments – from both incoming and existing firms

Investment facilitation starts when an investor shows interest in a location. It includes the way enquiries are handled by the relevant authorities, notably the IPA, and measures to reduce potential obstacles faced by investors once they have decided to invest. But investment facilitation does not stop there: encouraging the expansion of existing investors and helping them overcome the challenges they face in operating their business is at least as important as facilitating new investments. Aftercare measures can be influential in companies' decisions to stay in the country and reinvest, and policy advocacy is a powerful instrument to bolster reforms and enhance the business environment by leveraging the private sector's feedback.

The government of Indonesia has placed the need to improve the business environment high on its agenda, recognising its contribution to sustainable and inclusive economic growth. Successive measures to facilitate the establishment of new companies have been implemented over the past years. After President Joko Widodo's re-election in 2019, there was an even bigger push for investment climate improvements, as the simplification of regulations and de-bureaucratisation have been placed among the top five priorities of the newly formed Cabinet.[1] Reforms to improve the business environment and measures to ensure that business regulations are transparent and predictable are particularly important in the context of the economic recovery from the pandemic.

The business licensing reform: ongoing efforts to facilitate new investments

The Online Single Submission: an attempt to improve the business environment

Making it easier for companies to establish has been a top priority for over a decade in Indonesia. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated a long-term licensing reform to facilitate investments. Efforts have been aiming at improving transparency and creating mechanisms to simplify and harmonise the business licensing process.

A multi-layer system of one-stop-shops was established in 2009 with the One-Stop Integrated Services Centre, or PTSP (standing for *Pelayanan Terpadu Satu Pintu*). A central office was created in BKPM's headquarters and dedicated decentralised offices in provinces and districts. Gradually equipped with an electronic information and licensing service system (SPIPISE), regional PTSP offices were tasked to receive and treat investors' applications. The role of the national government was to provide guidance and monitor performance of regional PTSPs while BKPM was providing them with technical and managerial assistance and training (Holzacker et al., 2015). As President Widodo placed the business environment among its top priority since the beginning of its first term in 2014, his government accelerated the licensing reform at all levels of government. In addition to reinforcing PTSP offices, it launched a 3-hour investment service at BKPM for large investments. The establishment of PTSPs was perceived as an investment climate improvement, which also allowed national, provincial and district governments to work together on their creation, functioning and monitoring (Kuswanto, 2019). The local dimension of investment facilitation measures and the implications of decentralisation on investment policy is further analysed in Chapter 7 of this *Review*.

By mid-2018, a new system to facilitate investments – the Online Single Submission (OSS) – was created to improve efficiency, transparency and further centralise business procedures and requirements. The new OSS has been an important step in the government's efforts to improve the country's business environment, although it has been suffering from implementation challenges. The system was launched jointly by the Coordinating Ministry for Economic Affairs and BKPM and is now fully managed by the latter. The Indonesian Corruption Eradication Commission, KPK, was also involved since the inception of the system to improve the transparency of the business licensing process. According to KPK, the number and

complexity of licences in Indonesia had often been an avenue for corruption and the OSS, by standardising – if not centralising – business procedures in an online system, now helps in mitigating this problem.

The OSS issues three types of licences electronically: 1) the company identification number (NIB); 2) the business licence; and 3) the commercial/operating licence (if necessary). Until December 2019, other required licences and permits (e.g. land, construction, environmental permits, etc.) had to be obtained from other ministries or local authorities after the successive business licences had been received from the OSS.

Although the former system was recognised as an improvement in many respects, the new OSS brings an innovative approach to investment facilitation in Indonesia on different fronts:

- First, it consists in a fully integrated online system adopting modern technology for the registration of businesses. Although it is still at the first stage of operation, it aims to allow for data sharing on an electronic platform bringing together 22 relevant ministries and institutions as well as regional governments.
- Second, all licences issued by the OSS are centralised and thus supersede all other licensing authorities.[2] Ministries and local governments are thus no longer allowed to issues business licences within the sectors covered by the OSS (i.e. all sectors except mining, oil and gas, and finance).
- Third, the OSS now integrates the principle of "self-declaration" for investors applying for a licence, which is innovative in the way that the OSS issues the business licence upfront, before the investor fulfils the necessary related requirements. It is only after having obtained a licence that the investor must comply with obligations, without which his licence proves to be null and void.

The system is monitored by taskforces that are operating at the national, provincial and district (or city) levels. The main responsibilities of these taskforces are to monitor whether: 1) investors that have been granted the licences are fulfilling their commitments and complying with required standards, certification and other necessary registrations; and 2) other government bodies and local authorities are providing investors with their required licences once they obtained those delivered by the OSS. KPK is also involved in the monitoring process and provides advisory services to the taskforces. Monitoring and evaluation of licensing systems, through qualitative and quantitative indicators, can not only improve the registration programme itself but also assist in overall burden reduction policy and planning through enhanced data collection. For example, BizPaL, a Canadian one-stop shop, collected data that was used to create a 'burden index' to identify heavily burdened business sectors, both nationally and regionally (Box 6.2).

Box 6.2. Regulatory transformation opportunities as a result of BizPaL

When the Canadian one-stop shop BizPaL was launched, one aspect was to support Smart Regulations and Paper Burden Reduction initiatives by analysing opportunities for regulatory transformation. The purpose was to identify areas where regulatory burden could be reduced. The Strategic Policy Sector of Industry Canada used the data in the BizPaL database for the federal, provincial, and territorial Committee on Internal Trade. It researched the extent to which business licencing arrangements act as a barrier to inter-provincial trade in Canada.

Industry Canada concluded that the BizPaL database was the only viable source of reliable and comparable information across a wide range of industry sectors. The data was used to create a 'burden index' by sector, by jurisdiction. When the data was combined with business statistics, the report identified businesses sectors, both nationally and regionally, that were heavily burdened by licencing requirements.

Source: (Government of Canada, 2011).

An unfinished agenda

The licensing reform and the different, sometimes successive, measures to facilitate investment may take time to materialise and to bear fruit. The environment for starting and operating a business in Indonesia has often times been reported as challenging by the private sector and efforts must be consistent and persistent.

The authorities realised that the business environment needed more regulatory reforms and investment facilitation measures. Centralising only three types of licences through the OSS (as mentioned above) appeared not to be sufficient. In practice, many investors continued to have difficulties obtaining the remaining licences and permits from the line ministries and regional administrations, and investors were therefore unable to run their business. Consequently, by issuing Presidential Instruction 07/2019 on the Acceleration of Ease of Doing Business at the end of 2019, the government decided to standardise the licensing system one step further by providing BKPM with the authority to issue all additional business-related licences and permits. This new measure is marking an important step in the reform process, by seeking to make the OSS more autonomous and hence more functional. As mentioned below, the success of this measure will very much depend on the implementation of the Omnibus Law on Job Creation, which is meant to lay the legal background for such a recentralisation process.

It remains to be seen if this will always be smoothly implemented in practice. The pace of reforms has been rapid and the transfer from the PTSP system to the new OSS, particularly in many remote or less developed districts, has not always been well-understood or well-implemented. The implementation of the OSS has generated operational problems and is sometimes facing local resistance.

According to stakeholders, some local governments have invested significant resources in the implementation of well-functioning PTSPs and do not seem ready to abandon their efforts after such a short period of time. The same goes for the additional business-related licences recently transferred to BKPM (Presidential Instruction 07/2019): it is not clear to what extent local authorities will accept to yield their licensing authority on a voluntary basis. The decentralisation process initiated in 1998 have provided local governments with a high level of responsibility and the central government needs to work very closely with them to ensure that they do not challenge these reforms, keeping in mind that the ultimate goal is to make the process of starting a business more efficient (see Chapter 7 for a more complete picture of investment policy at subnational level).

The government needs to ensure that, while reforms are ongoing or in transition, the overlap of systems does not make things more costly and time-consuming for investors and officials. Capacity building should be delivered to local authorities for a smooth integration of the new OSS and more guidelines must be provided to investors on how to use the OSS. What businesses are seeking as a priority is transparency and predictability. As new regulations and licensing systems have been established over short periods of time in Indonesia, clear rules and guidelines need to be made available to investors as well as information services, so that firms can easily navigate into the new system and adapt to it. Forthcoming changes also need to be well-communicated in advance.

The OECD has prepared a set of best practice principles of citizen and business one-stop shops to offer general guidance on the establishment and maintenance of such tools based on the experience of different countries. Some of these principles are reflected in the Indonesian approach: including plans to develop an OSS within a broader administration strategy and showing high-level political commitment to the programme. The OSS also has a monitoring and evaluation system as well as a tailored governance to co-ordinate and facilitate co-operation between multiple sectors and regional levels of government. Greater review and clarification of considerations of human capital development of staff and management as well as public consultation with users in the creation and improvement of the OSS should however be considered (see Box 6.3 for more details).

Box 6.3. The OECD Best Practice Principles of citizen and business one-stop shops

Business and citizen interactions with governments are becoming increasingly complex – as interactions with government becomes more interconnected, both domestically and internationally. Governments can unnecessarily hamper growth opportunities where the interface with businesses and citizens is delinked or cumbersome. To address this issue, one-stop shops – a centralised platform for cross-government services – are introduced as a means of reducing transaction costs.

The OECD has prepared this list of principles to offer general guidance on the establishment and maintenance of one-stop shops based on the experience of different governments – utilising a series of country-specific case studies as well as previous general research and OECD work.

One-stop shops should be part of a broader administrative simplification strategy, as a means to improve service delivery, reduce transaction costs and improve societal welfare. Fundamentally, they should be user-centred and based on life events for citizens and businesses – thus deconstructing government silos and presenting information in formats that are of greater benefit to users. The following specific principles should also be considered:

- Political commitment, which has been unanimously highlighted in OECD country research as critical to the success of reforms such as one-stop shops. Continuous communication is important between the political and administrative levels.
- A legal framework that lays a foundation for effective co-operation and co-ordination across different sections and regional levels of government – fostering strong relationships and permanent communication channels.
- Governance of the one-stop shop can vary, but should still allow operative decisions to be taken by a single organism and ensure all agencies participate at an executive level.
- Leadership that carries out realistic planning that is flexible to changing circumstances. Sufficient resources need to be allocated to human capital in terms of appropriate, technical and interpersonal, skills and tailored training.
- Public consultation to ascertain, and pilot, whether one-stop shops are the best solution for the user and meet their needs. A phased approach can be taken to ensure lessons from previous phases are taken into the following.
- Communication and technological approaches, with a clear idea of one-stop shop's purpose, that are fit-for-purpose using a mix of approaches, be that a physical shop front or central website – taking into account the accessibility issues for certain users.
- Monitoring and evaluation to ensure that the programme continues to meet the expectations and needs of users as well as governments. Quantitative and qualitative indicators should be established to improve the programme and ensure that any changes are subject to public consultation and impact assessment.

Source: OECD (2020a).

An ever more ambitious reform to improve the business environment

The authorities realised that the OSS should not overshadow more ambitious policy and regulatory reforms aiming at improving the business environment, and that its success relies on these wider reforms. The modest results in the World Bank Ease of Doing Business indicators, although improving, reflect the fact that Indonesia has not yet reached the level of some of its peers in the region or elsewhere (Table 6.2).

Although it ranked at a slowly improving 73rd place out of 190 economies in 2020 on the overall indicator, its score in the Starting a Business category was significantly worse in 140th place. President Widodo has set as a target to improve Indonesia's ranking to 40th position. While the Doing Business indicators do not portray a comprehensive image of the business environment in Indonesia, they can illustrate both the efforts undertaken in the recent past and the necessity to address certain remaining shortcomings to ease the establishment of companies.

Table 6.2. Doing Business' scores in Indonesia and selected other countries, 2019-2020

		Indonesia	Brazil	Malaysia	Mexico	Philippines	Thailand	Turkey	Viet Nam
Ease of Doing Business (overall)	2019	**68.2**	58.6	81.3	72.3	60.9	79.5	75.3	68.6
	2020	**69.6**	59.1	81.5	72.4	62.8	80.1	76.8	69.8
Starting a Business	2019	**79.4**	80.3	82.8	85.9	69.3	92.3	88.2	84.8
	2020	**81.2**	81.3	83.3	86.1	71.3	92.4	88.8	85.1

Note: An economy's ease of doing business score is reflected on a scale from 0 to 100, where 0 represents the lowest and 100 represents the best performance
Source: World Bank.

In this context, the authorities realised that identifying and cutting redundant regulations and streamlining overly burdensome procedures and requirements for investors should remain the top priority. While BKPM was already tasked to identify cumbersome regulations and procedures to start and operate a business in Indonesia over the past years, it had little convening power to influence line ministries to amend or remove them. As mentioned previously, with the issuance of Presidential Instruction 07/2019, one of the new government's first decisions was to provide more power to BKPM in the streamlining process of existing business licences. Line ministries are requested to actively identify and assess regulations regarded as disruptive toward the ease of doing business and to report them to BKPM, which in turn has to provide recommendations for their revisions. The Presidential Instruction also provides that a secretariat is created by the ministries and government institutions to implement BKPM's recommendations.

More importantly, the new Cabinet embarked upon an ambitious reform process with the preparation of two new Omnibus laws, one on job creation, and the other on taxation. The Omnibus Law on Job Creation is a wide regulatory reform process, for which the government identified 76 laws and over 1000 articles that are either overlapping or need to be revised. It addresses 11 clusters:

1. Simplification of licensing endeavours
2. investment terms and requirements
3. labour reform
4. protection and empowerment of micro, small and medium enterprises
5. ease of doing business
6. research and innovation support
7. government administration
8. penalty (sanctions)
9. land acquisition
10. ease for government projects; and
11. special economic zones.

The law aims to establish a friendlier investment environment, notably by significantly reducing the existing restrictions on foreign investments (see Chapter 3 on Indonesia's FDI regime). It also seeks to harmonise and simplify the business licensing process by amending and superseding individual laws related to almost all economic sectors and by limiting the role of local governments' licensing authority. By further centralising the licensing authority within BKPM, the Omnibus Law on Job Creation is seeking to make the OSS fully functional.

The law, enacted in October 2020, has been facing resistance, notably on its labour and environment components. Indonesia has strong and well-established trade unions, which are concerned about adding more flexibility to the labour regime. By relaxing environmental standards, the law is also raising concerns on its potential impact on environmental protection (see also Chapter 5 on responsible business conduct). In order to implement successfully such a high-profile reform, the government needs to go through a wide-ranging and meaningful consultation and communication process to avoid fierce confrontation with part of the population and promote an environment of trust (see below).

While this reform bodes well in some aspects, the rapid pace of successive measures is putting pressure on government officials, not only at national level but also at provincial and district (or city) level. New regulations come with new rules, tighter deadlines, new technology, while local administrations have to adapt, often with the same resources. Remote and less developed districts do not necessarily have institutional capacities to properly implement national policies and regulations. At the same time, these attempts to re-centralise the business licensing processes from local authorities may not be well accepted nor allow investors to fully bypass local officials in practice. And while the Omnibus Law on Job Creation is an ambitious reform, its success will depend on its application throughout the national administration and in the regions. Continuous efforts should hence be put on strengthening the capacities of officials dealing with businesses, enhancing the transparency in decision-making and maintaining a constructive dialogue with all stakeholders involved.

Maintaining a constructive dialogue with stakeholders for an ever improving business climate

Consulting stakeholders and advocating for better policies

In their continuous efforts to provide a friendlier investment climate, governments should maintain a regular dialogue with the private sector as well as other stakeholders – including labour unions, civil society and academia – to ensure an environment of trust, encourage investment retentions or expansions, and involve stakeholders in policy design. Consultation mechanisms and aftercare services are also key to collect feedback on recurrent issues affecting business operations and conduct effective policy advocacy.

The private sector is often consulted on an ad hoc basis in Indonesia, particularly when new policies and regulations are in preparation, including through KADIN – the Indonesian Chamber of Commerce and Industry. KADIN is the umbrella organisation of the Indonesian business chambers and association, covering all sectors of the economy throughout the nation. Thanks to this large network, it is the government's privileged private sector counterpart.

The government, especially BKPM, also consults foreign chambers of commerce and embassies but less systematically. In order to properly monitor the investment climate, it is important that all segments of the business community are taken into consideration equally, no matter the size, nationality or sectors of the companies. The voice of civil society and that of workers and consumers should also be taken into consideration in the government's investment climate related decisions.

BKPM performs well its interface role between government and businesses, but there is no formal public-private dialogue platform in place allowing for systematic, comprehensive and open discussions on investment climate challenges and priorities. BKPM collects business' feedback through ad hoc meetings

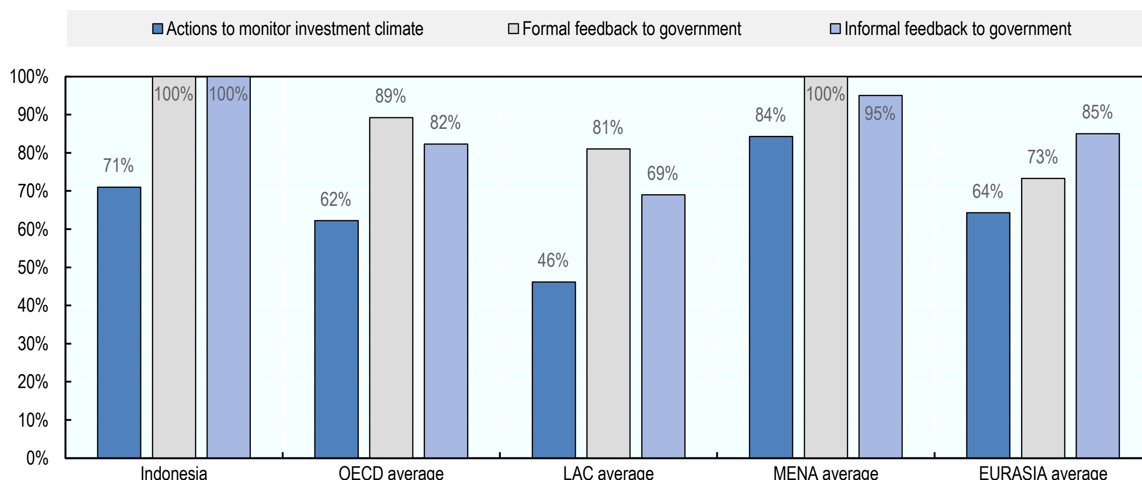
and workshops, as well as surveys of foreign investors, but the latter are mostly used to collect and disseminate data rather than to provide recommendations to policy designers.

BKPM uses the feedback collected from the private sector to formulate recommendations to other parts of the government in co-ordination meetings and position papers, and often advocates for friendlier investment policies and regulations. Policy advocacy is a natural function for a co-ordinating body involved in regulatory and facilitation activities like BKPM. IPAs involved in policy advocacy can decide to focus on specific activities over others, which are often grouped into three main categories: 1) performing actions to monitor the investment climate (e.g. tracking of rankings, meetings with the private sector, business surveys, consultation with embassies); 2) providing formal feedback to the government on how to improve the investment climate (e.g. meetings with government officials, production of position papers); and 3) providing informal feedback to the government on how to improve the investment climate (e.g. participation in periodic meetings, events, press articles).

Policy advocacy is conducted by a majority of IPAs around the world, but BKPM performs a wider range of related activities than its peers from the OECD, LAC and Eurasia areas (Figure 6.5). IPAs in OECD countries, for example, are often more focused on the implementing aspects of investment promotion and facilitation than on their policy and regulatory features, whereas their counterparts in the Middle-East and Southeast Asia tend to have broader policy mandates (see above). In the future, as the spread of the COVID-19 is prompting global uncertainty and declining FDI flows, IPAs will have an ever greater policy advocacy role to play to support sound business environments (OECD, 2020b). Working at the intersection of business and public service, IPAs are particularly well-placed to advocate for open, transparent and well-regulated markets. IPAs from OECD countries, such as Germany, Spain and the United Kingdom, are already planning to reinforce their policy advocacy roles to limit trade and investment barriers, improve the investment climate and ensure that policy instruments are non-discriminatory.

Figure 6.5. Comparative overview of BKPM's policy advocacy activities

As a percentage of all possible activities under this category



Source: *OECD-IDB Survey of Investment Promotion Agencies (most recent years available).*

Effective co-ordination within government to channel pertinent policy and regulatory recommendations – and ensure their implementation – is as important as collecting relevant feedback from investors, but it can also be as challenging if not more (de Crombrugghe, 2019). The case of the Australian Trade and Investment Commission (Austrade) illustrates how building a strategic network of key relationships is

critical to make policy advocacy effective and successful (Box 6.4). It shows that both getting relevant feedback from investors and nurturing constructive relationships with relevant public bodies are equally important.

Box 6.4. Austrade's Policy Influence Strategy: building on a strategic network of partners

Austrade works across government to advocate for investors in policy debates and decision-making processes. Its policy advocacy relies on its practitioners' knowledge of government policy agendas and decision-making processes. The agency often faces an asymmetric playing field, however, as other parts of government have more resources and direct policy responsibility. It thus needs to carefully pick its policy battles and thus developed a Policy Influence Strategy to maximise its policy resources.

Against this background, Austrade recognises the need to develop and nurture the relationships in its policy ecosystem – both with government agencies and other stakeholders. Using those relationships to prosecute policy arguments at the highest levels within government and the policy ecosystem can help maximising the number of successful cases. The Australian IPA also seeks to use the right tools, including data to ground their policy arguments and commercial insights from the agency's client-facing teams and their policy networks. Austrade is the only Federal government agency that can provide commercial-level input into policy debates.

The agency is working on the best ways to routinely get insights from its client-facing teams, who are busy servicing clients. Building external relationships, particularly with large policy agencies, is also critical to be successful. Partnering with other like-minded agencies in policy processes helps amplify the voice and arguments of Austrade in their quest for investment climate improvements.

Source: Australian Trade and Investment Commission, July 2019 (based on de Crombrugghe, 2019)

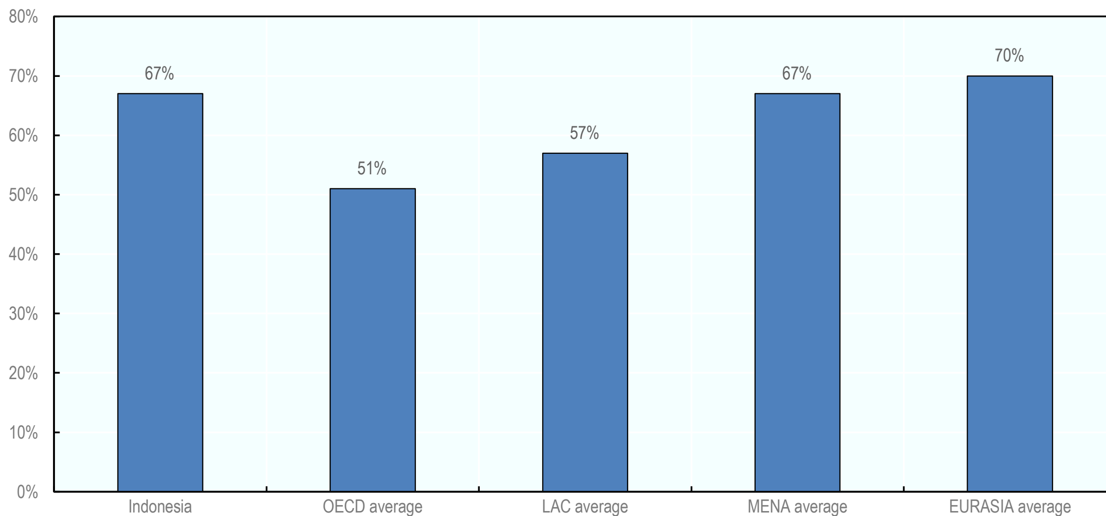
Aftercare as a channel to avoid disputes and promote business linkages

In addition to involving the private sector in policy design, working more closely with the private sector through aftercare can also help retain existing investors and encourage expansions. As the crisis is affecting businesses worldwide, IPAs have considerably scaled up their aftercare activities to help existing investors cope with the crisis and support their ongoing investments or operations (OECD, 2020b). Two areas where IPAs can make a difference are in avoiding potential disputes, on the one hand, and building business partnerships, on the other. While BKPM is using its leverage to prevent disputes involving investors, it is not yet involved in supporting business linkages between foreign affiliates and local companies.

IPAs can play an important role in preventing potential disputes involving investors, notably through structured trouble-shooting with individual investors, mitigation of conflicts (e.g. between investors and authorities, between investors and communities, etc.) and ombudsman intervention. BKPM provides the first two, which are also the most frequent dispute prevention mechanisms used by other IPAs, and compares relatively well vis-à-vis its international peers (Figure 6.6).

Figure 6.6. Comparative overview of BKPM's dispute prevention activities

As a percentage of all possible activities under the category



Source: OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

Structured trouble-shooting with individual investors, for example, is provided by at least 80% of IPAs in OECD, MENA, LAC and Eurasia countries. Ombudsman intervention is the least frequently available activity of the three across IPAs and is not performed by BKPM either. Korea was a forerunner in setting up a foreign investment ombudsman in its IPA in 1999. Its role is to solve complaints reported by foreign investors both by sending relevant experts to business sites and by taking pre-emptive measures to prevent future grievances by encouraging systemic improvements and legal amendments.

Aftercare can also support creating linkages between foreign investors and domestic firms, especially small and medium-sized enterprises (SMEs). MNEs do not necessarily engage in linkages with domestic suppliers automatically – even when local firms are competitive enough and technology-ready. Many MNEs are bound by international contracting arrangements that tie them to international suppliers, offsetting the effectiveness of public policies to promote linkages. In some other cases, MNEs rely on their usual overseas business partners for convenience or because of lack of information, and do not make the effort to look for local firms that can act as suppliers. In this case, the government can bridge information gaps with targeted measures to facilitate exchange of information. By interacting with MNEs on a daily basis, IPAs are often well placed to do so, especially through their aftercare activities.

As such, many IPAs around the world are involved in linkages programmes, most often through matchmaking services between foreign and domestic firms. BKPM, like many other IPAs, currently runs a business matchmaking programme between foreign investors and domestic firms (as mandated by the Presidential Regulation Number 44 of 2016). It could, however, benefit from further strengthening and better co-ordination with other existing MNE-SME linkage programmes across ministries and agencies, which would not only avoid that such initiatives are implemented in silos and overlap, but also help monitor the linkage programme. BKPM could also consider compiling a database of domestic firms and make it available to MNEs that are looking for suppliers in Indonesia. Co-ordination with similar initiatives across government is also important to establish a single database, which could help MNEs reduce their transaction costs while providing opportunities for local businesses. Suppliers' databases are often industry-specific and sometimes focus on priority sectors for FDI attraction. Some IPAs, often those that also integrate the mandate to promote domestic investment, have more sophisticated business support programmes (e.g. cluster programmes and capacity building) that can help domestic firms become suppliers of foreign affiliates.

Evidence shows also that long-lasting foreign investors, by knowing the local context better, are more inclined to use domestic suppliers instead of sourcing internationally (Farole and Winkler, 2014). Aftercare can thus support the double purpose of better anchoring foreign investors in the local economy and enhancing their positive spill-overs.

Through its aftercare activities, BKPM may also consider working with existing investors to promote responsible business conduct and encourage them to more systematically comply with laws, such as those on the respect for human rights, environmental protection, labour relations and financial accountability, as well as to embrace responsible and sustainable practices in their business operations (see Chapter 5 on policies to promote and enable responsible business conduct).

Investment promotion efforts

Prioritising FDI and designing a well-crafted investment promotion strategy

To attract FDI and fully benefit from it, measures to facilitate incoming investments and retain existing ones are not sufficient. A government needs to design a clear and well-defined investment promotion strategy to provide an overall direction to the IPA, with specific targets and means to achieve the set targets.

Investment promotion strategies are prepared to ensure that attraction efforts are well-targeted and contribute to the government's broader national development objectives. They need to draw on the country's economic development strategies but focus on what FDI can bring in addition to domestic investment and how MNEs can support national development objectives. These strategies revolve around the question of what to promote (i.e. sectors, countries, projects, investors) and how to implement this promotion in practice. Prioritising sectors, countries and projects should be conducted according to a set of well-defined criteria in line with the country's economic, social and environmental goals.

FDI prioritisation is a dominant practice across IPAs in the world, as virtually all IPAs target some investments over others. In OECD countries for example, 84% prioritise sectors, 59% prioritise countries and 78% prioritise projects (OECD, 2018a). Across MENA and Eurasia agencies, the majority prioritise sectors (80% and 70% respectively) and projects (70% each), while in LAC IPAs the majority prioritise countries (84%).

According to the IPA survey filled in by BKPM, Indonesia prioritises sectors, countries and projects. Its national investment promotion strategy is jointly designed by BKPM, the Coordinating Ministry for Economic Affairs, the Ministry of Foreign Affairs, the Executive Office of the President, the Ministry of Industry and the Ministry of National Development Planning. The collegial preparation of such a document is a good initiative given the horizontal nature of investment. The strategy draws on two main current strategic documents guiding the country's overall development objectives:

- The *Medium-Term National Development Plans 2015-2019 and 2020-2024*, prepared by the Ministry of National Development Planning, which are the third and fourth phases of implementation of the *Long-Term National Development Plan 2005-2025* that lays out the long-term vision. The five-year plans provide guidance to the entire cabinet, including on economic policy. They identified the following economic priorities: *i)* food sovereignty; *ii)* energy sovereignty; *iii)* maritime affairs; *iv)* tourism and manufacturing industry; and *v)* water security, infrastructure and connectivity.
- *Indonesia 4.0*, the country's latest industrial strategy, which is a roadmap designed to move from a traditional manufacturing-based economy to a high-tech mode of production with a stronger focus on R&D activities. It is led by the Ministry of Industry and has identified five sectors: *i)* food and beverage; *ii)* textile and apparel; *iii)* automotive; *iv)* chemicals; and *v)* electronics.

According to the information provided by BKPM, the sectors targeted for FDI attraction broadly reflect a combination of those included in both strategies, notably: *i)* infrastructure (electricity and transport); *ii)* tourism; *iii)* manufacturing (labour-intensive and export-oriented); *iv)* lifestyle industry & digital economy; *v)* maritime & fisheries; and *vi)* agriculture. The level of sector prioritisation is thus relatively low, as the wide range of industries for FDI promotion reflects the government's willingness to attract FDI to almost all sectors of the economy. The only sectors, for which BKPM does not conduct proactive promotion are financial services and upstream oil and gas.

Although the economic literature warns against a counter-productive "picking winner" approach by governments (Rodrik, 2004), empirical research also finds that countries obtain higher FDI levels in sectors targeted by their IPAs (Harding and Javorcik, 2011). BKPM should thus consider further focusing its promotional efforts on industries where a locational advantage can be developed rather than dispersing its attraction activities across a large scope of sectors. Working on a focused prioritisation strategy with more targeted objectives will make the work of BKPM more impactful and aligned with the country's sustainable development goals. It will also be easier for its staff to establish concrete targets, monitor progress and measure results.

BKPM also prioritises certain FDI projects, those they define as high quality investments, which is a way to be further focus its attraction efforts within each sector. The way Indonesia selects its criteria for prioritising investment projects reflects its willingness to maximise the development impact of FDI, including with criteria such as the impact of the potential investment projects on jobs, wages, exports, innovation, regional and sustainable development (Table 6.3). BKPM puts a stronger emphasis on these potential outcomes than on other upstream criteria to select projects, such as the country of origin, the mode of entry or the type of investor, which are being considered in other IPAs (e.g. Australia, Brazil, Korea, Turkey or the United Kingdom).

Table 6.3. Criteria used for prioritisation of FDI projects by BKPM and selected other IPAs

	Indonesia	Australia	Brazil	Korea	Myanmar	Turkey	UK
Priority Sector	√	√	√	√	√	√	√
Priority Country of Origin		√	√			√	√
Mode of Entry		√	√	√		√	√
Size of Investment	√	√		√		√	√
Investment Horizon / Duration	√	√					√
Type of Investor		√	√				√
Size of the Company	√					√	√
Nationality of Investor		√					√
Company's Engagement in FDI		√	√			√	√
Impact on Job Creation	√	√	√	√	√	√	√
Impact on Wages	√	√					
Impact on Exports	√	√	√	√	√	√	√
Impact on Innovation	√	√	√	√	√	√	√
Impact on Regional Development	√	√	√	√	√	√	√
Impact on Tax Revenue	√				√		
Impact on Country's Image	√	√	√		√	√	
Impact on Local Firms' Capacities	√	√	√		√	√	
Impact on Competition	√	√	√	√	√	√	
Sustainability	√	√	√	√	√	√	√

Source: Based on OECD-IDB Survey of Investment Promotion Agencies (most recent years available).

While the intention is laudable to focus on development outcomes, it might also require a strong monitoring and evaluation system and well-targeted performance indicators to ensure that the agency's investment generation efforts are leading to the expected results. Making sure to work with manageable and meaningful indicators (i.e. that can help determine whether the IPA actions generate expected economic and social outcomes) would help evaluate BKPM's contribution to sustainable development and responsible business conduct.

Overall, BKPM could dedicate more efforts to its investment promotion and attraction activities, with more focused and prioritised investment generation efforts. Criteria to select those sectors should strike a balance between the government's desire to diversify the economy and the possibility of relying on strong domestic capacities. Focus could be given to emerging and sustainable sectors such as the digital industry, clean energy and eco-tourism. Drawing on Chapter 2 of this *Review* on trends and impacts of FDI in Indonesia, BKPM should also focus on projects in sectors where foreign investments' performance is higher than domestic ones, notably in terms of productivity and innovation (e.g. chemicals, food), wages and skills development (e.g. energy, transport services), and environmental performance and clean technologies (e.g. energy efficiency) as well as on sectors that are more likely to generate linkages with domestic firms (e.g. automotive and electronics). The chapter provides an in-depth analysis of foreign investments' contribution to sustainable development goals in Indonesia, which could guide BKPM's prioritisation efforts in attracting FDI.

Chapter 2 also highlights that FDI is highly concentrated in terms of origin, as the bulk of foreign investments originates in Singapore and Japan. While there is evidence that some OECD multinationals invest in Indonesia through their operations in Singapore, reliance on FDI from a small group of investors increases Indonesia's exposure to changes in macroeconomic conditions in those countries. BKPM could thus actively target firms from other countries and regions to reduce Indonesia's vulnerability to external shocks. The prioritisation of countries should go hand in hand with the prioritisation of sectors and projects addressed above.

The COVID-19 outbreak, and the risk of reduced FDI flows as a consequence, makes it even more important for the government to focus its investment promotion strategy on targeted projects with a high developmental impact and likely to support a sustainable recovery in Indonesia. Many IPAs in the OECD area and elsewhere are rapidly shifting their activities accordingly and adopting new strategies (Box 6.5).

Box 6.5. OECD IPAs' evolving strategies in light of the COVID-19 outbreak

IPAs' capacity to adapt to new situations makes them key actors in governments' responses to the COVID-19 crisis. By working closely with the private sector and on different policy areas, IPAs are often flexible and prone to adapt to new situations but need to rethink their strategic orientations to better respond to both public and private sector needs.

In the short term, the nature of services provided by IPAs in the OECD area has changed radically by shifting away from marketing to intense aftercare. While IPAs are immediately and significantly scaling down their marketing campaigns and activities, focus is now given to engaging and maintaining contact with existing investors. Informing them about government programmes, helping them to cope with the crisis and supporting their ongoing investments or operations are the IPAs' immediate priorities. Focus is given on hardest hit sectors, notably SMEs and export-oriented investors. IPAs have also activated their existing business networks, particularly in the health sector, to help the government fight the crisis.

In the medium to long-term, the COVID-19 response has drastically accelerated the trend towards greater digitisation of IPAs. While many IPAs have seen an immediate impact of the crisis on the way

of doing business, digital means will allow them to continue servicing and identifying future clients, which requires access to different digital tools. For example, digital client prospecting, capable of correctly identifying potential leads, and virtual-reality solutions for site visits can gain in importance. IPAs are already planting the seeds of, or speeding up, this transformation. For example, CINDE Costa Rica has accelerated its digital plans, including artificial intelligence-based marketing, providing services and products online. IDA Ireland will include more digital solutions and services in its new strategy. Business Sweden provides investors with access to online interactive maps of different industrial clusters and proximity of key infrastructure, and plans to expand them.

IPAs are also rethinking their investment promotion strategies to increase the impact of inward FDI. Prior to the crisis, several IPAs had been developing tools to better identify and support FDI projects that can have the highest impact on the local economy and support sustainable and green growth. This trend is likely to be accentuated as the pressure on IPA budgets increases and the recovery requires a concerted effort to create and sustain jobs. For example, Business Sweden has used for years a qualitative evaluation system to identify "high-quality" projects and the UK Department for International Trade will continue to build on its work to maximise its economic impact through the use of economic analysis and intelligence driven prioritisation, ensuring FDI plays an effective role in economic recovery. Many other IPAs have expressed a strong interest in better prioritisation that is evidence-based and centred around sustainable development.

Source: OECD (2020b).

The role of zones-based policy in promoting FDI

Indonesia has a longstanding experience in relying on different types of economic zones to promote foreign and domestic investment. Since the beginning of President Widodo's first term in 2014, the development of industrial parks (or industrial estates) and special economic zones (SEZ) has been used extensively by the government to revamp the economy's industrialisation and promote labour-intensive investments (Octavia, 2016).

The development of industrial estates was initiated in the 1970s in certain cities (Jakarta, Surabaya, Cilacap, Medan, Makassar and Lampung) at the joint initiative of local and provincial governments to promote investments in the manufacturing sector (EIBN, 2017). Industrial estates provide land and facilities to manufacturing companies, which do not benefit from extra tax incentives. Presidential Decree 53/1989 opened up the possibility of developing industrial estates to private companies and set the related legal and technical standard requirements for their development and operation. The first guidelines were established in 1996, which were then successively revised in 2009 and 2015.

According to the Industrial Estates Association, there are 87 industrial estates in Indonesia, a majority of which are being located in Java (and close to Jakarta). They cover over 86 000 hectares with approximately 9 600 firms employing 4.5 million workers. Industrial estates are mostly used by manufacturing companies, both domestic and foreign, notably in the automotive, electronics and food industries. Industrial estates can be privately or publicly-owned. Local authorities are in charge of preparing a masterplan, which is then submitted to and approved by the Ministry of Industry. The business community tends to recommend the use of industrial estates, especially by SMEs, notably because of the ease in generates in terms of land procurement, permitting and infrastructure facilities.

The development of SEZs have also been an important part of the Indonesian economic development policy. One of the major differences with industrial estates is that SEZs, in addition to land and facilities, also provide tax incentives to investors (see section below). Successive programmes have been put in place, one of the most ambitious of which has been the Integrated Economic Development Zones (KAPET) created in 1996. While the stated objective of this programme was to promote development and inclusive

growth in lagging regions, the programme seemed not to have achieved its intended outcome (Rothenburg et al., 2017). Districts benefitting from the KAPET programme experienced no better development outcomes than others. Although firms paid lower taxes, it did not promote business activities or led to development outcomes. Co-ordination challenges between local governments and the central government over administrative authority were partly behind the implementation issues that the KAPET programme faced (See Chapter 7 for more information).

Currently, SEZs are located in strategic locations, close to boundaries and often in regions endowed with natural resources. The objectives of SEZs are to attract investments outside of Java and to encourage mining and other natural resource companies to transform locally. There are currently 12 SEZs and the government intends to create 25 under the Mid-term National Development Plan. The regime for FDI applies differently in SEZs, as the Negative Investment List does not apply in SEZs. Only prohibited sectors and SMEs are restricted for FDI, like under the general regime.

The development and management of SEZs is the joint responsibility of the central government, regional governments and private promoters. At the central level, a multi-ministerial council supervises the SEZ programme and planning. It is chaired by the Coordinating Minister for Economic Affairs and includes the Ministry of Finance, the Ministry of National Development Planning, the Ministry of Transport, the Ministry of Land and BKPM. Each individual SEZ is governed by a regional council chaired by the Governor. While the intention to create zones to attract FDI in remote areas and promote industrial activity through local processing of natural processing are valuable objectives, the government should make sure not to replicate the failure of the KAPET programme. The authorities should also ensure that the efforts made to develop SEZs do not overshadow the more important objective of improving the business environment throughout the country.

The management and expansion of industrial estates and SEZs have important implications on local economic development, which is being further examined in Chapter 7 on investment policy and regional development in decentralised Indonesia.

An overview of corporate taxation in Indonesia

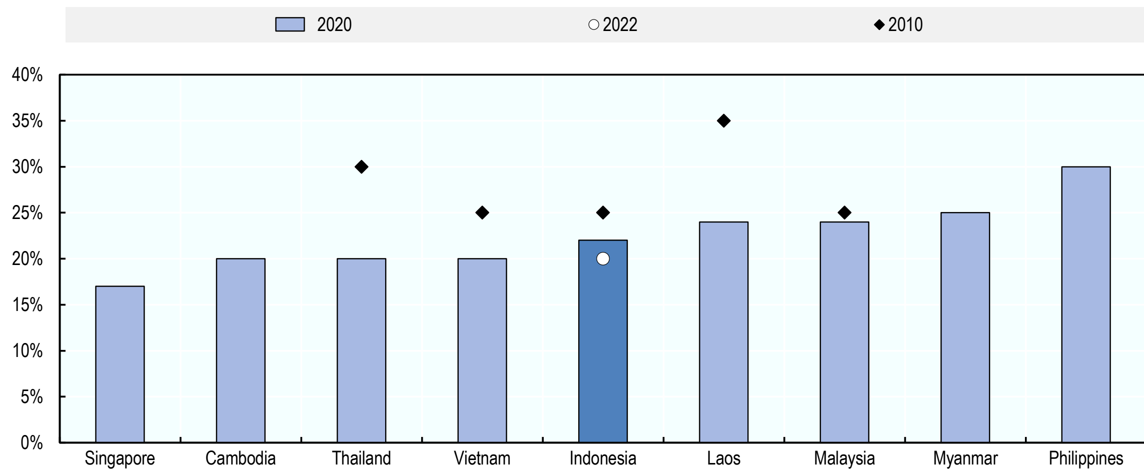
Corporate income tax rates are in line with the ASEAN average

Statutory corporate income tax (CIT) rates are the first reference point for foreign and domestic investors when evaluating the tax treatment of a jurisdiction and carry an important signalling role. With a further rate reduction planned in 2022, Indonesia's CIT rate (22%) is regionally competitive and in line with the ASEAN 22% average (Figure 6.7).[3] It is lower than the OECD average (23%) and than that of similar income level countries (25%).

The statutory CIT rate was lowered in 2020 as part of the policy response to the COVID-19 outbreak and its economic impacts. A rate reduction – already envisaged under the Omnibus bill on taxation proposed in 2019 – was anticipated to provide tax relief to businesses affected by the crisis (Box 6.6). The COVID-19 policy response accelerated other tax reform measures, such as the electronic transaction tax. Income tax applies on businesses registered in Indonesia. As of 2020, an electronic transaction tax applies on e-commerce income of foreign registered digital companies with a significant economic presence. The rate and definition *of significant economic presence* will be regulated in a future government regulation.

Figure 6.7. Statutory corporate income tax rates in Indonesia and ASEAN

Statutory corporate income tax rate (in %)



Source: OECD based on OECD Corporate Tax Statistics and EY (2019).

Box 6.6. Omnibus bill on taxation and COVID-19 tax response

Taxation regulations are spread out across many applicable laws and regulations in Indonesia. The Omnibus bill on taxation proposed to introduce several changes to multiple tax laws and regulations through a single new bill. Part of tax policy changes were anticipated as part of the policy response to the COVID-19 pandemic, including:

- Statutory CIT rate reduced to 22% in 2021-22 and 20% from 2023 onwards;
- Electronic transaction tax applies to foreign registered digital companies with a significant economic presence; and
- Value-added tax (VAT) applies on use of foreign intangible goods or services.

Other tax reforms planned under the bill but not yet introduced include:

- Unifying regional taxes and sanctioning regional administrations that impose by-laws deemed not in line with national policy;
- Extending taxation to long-stay expatriates in Indonesia (over 183 days per year);
- Reducing interest on late tax payments; and
- Removing withholding tax on dividends, as long as they are reinvested in Indonesia.

Source: PERPPU 1/2020 and Minister of Finance Regulation 23/2020.

Tax reform and COVID-19 policy response

Indonesia is implementing a comprehensive tax and tax administration reform that seeks to create a more open and attractive business climate for investors. Partially implemented, the tax reform seeks to unify, simplify and lower corporate taxation. The reform took a new dimension with the start of the COVID-19 health crisis. Indonesia decisively acted to provide temporary tax relief and financial support to its business sector as part of its national economic recovery strategy. Specific measures targeted the health sector and introduced income tax exemption in the provision of good and services to combat COVID-19, as well as tax deductions for acquisition of medical equipment.[4] Accelerated VAT refunds, tax deferral and financial subsidies for SMEs, and import tax reduction were extended to almost sector of the economy. Support to SMEs is of particular importance as they may be less able to withstand liquidity and solvency risks, as well as to highly impacted sectors (e.g. tourism industry).

Tax policy response plays an important role in limiting the adverse effects from containment and mitigation measures. Public deficit is expected to increase in short run and tax revenues are likely to be significantly reduced for a number of years, due to the direct effects of the crisis as well as to policy action during the crisis. Forgone tax revenue and additional spending is estimated to reach 2% of GDP in 2020 (IMF, 2020). Fiscal consolidation will be needed, but Indonesia advance carefully so as not remove its support to business too early and maintain the economy's ability to rebound.

A particular challenge to Indonesia stems from the country's historically low tax base. Indonesia has persistently had difficulty to increase its tax-to-GDP ratio, despite government efforts. In 2018, Indonesia's tax-to-GDP ratio was 11.3%, the lowest tax-to-GDP ratio among G20 countries and particularly low relative to other countries at a similar income level. The tax-to-GDP ratio of lower middle-income countries is on average 18.5%. In the same year, corporate income taxes in Indonesia accounted for 23% of the total tax revenue (2.6% of GDP). The lower CIT rate risks eroding Indonesia's tax base if not accompanied by base-widening measures in the medium-run. The 2 percentage-point CIT rate cut The Ministry of Finance estimated that the reduction of the CIT rate alone could lower tax revenue by up to IDR 86 trillion annually prior to the onset of the COVID-19 crisis (Akhlas, 2020). Lower tax revenues can constrain government spending on infrastructure and social services, which in turn can hamper progress toward improving the business environment in the long run.

The role of investment incentives in Indonesia

Tax incentives are a widely used tool to promote investment, particularly FDI. Tax incentives attempt to influence the size, location or industry of an investment project, reducing the cost or risk attached to the investment decision. Indonesia has a long history of use of tax incentives. In recent years, they have been extensively reviewed and expanded to attract investment, as well as being been extended to additional business segments and activities.

Tax incentives can take many different forms. Indonesia's tax incentive schemes include tax holidays, investment tax allowances, enhanced deductions, accelerated depreciation and special customs regimes for firms in SEZs.[5] Tax incentives mainly support the development of key industries (pioneer industries), activities with socio-economic spillovers (R&D and vocational training) and those that contribute to regional development through SEZs.

Tax incentives for investment in Indonesia target companies incorporated in the country and do not distinguish between domestic and foreign ownership. Incentives regulations adopt a number of measures that limit the administrative cost of processing the incentive applications. When applying for incentives (e.g. tax holidays or investment allowances), investors must opt for one incentive scheme and may not apply again if their application is rejected. If an investor receives one incentive, they may not receive any other main incentive.

Applications for most tax incentives are submitted through the OSS system and, if eligible, passed on to the Ministry of Finance, which has the sole authority to grant tax incentives. The OSS has been an important step in cutting the red tape that is involved in applying for tax incentives by streamlining the requests together with those to obtain business permits in Indonesia (see above). The central online system also facilitates keeping records of incentive requests and approvals, as well as streamlining the selection process.[6] The move to electronic services also strengthens monitoring and detection of non-compliance.

The gradual shift to cost-based incentives is a positive development

International organisations often argue that cost-based tax incentives should be preferred over profit-based ones, as they are generally more efficient (IMF-OECD-UN-World Bank, 2015; OECD, 2015a). Profit-based incentives – such as CIT holidays and reduced CIT rates – are determined on already secured profits, while cost-based incentives reduce the cost of capital (Box 6.7). Indonesia has traditionally relied more on profit-based incentives than on cost-based ones. Past OECD recommendations have suggested shifting from profit-based to cost-based tax incentives (OECD, 2018b; OECD, 2010).

Box 6.7. Profit-based and cost-based tax incentives

Profit-based incentives are determined as a percentage of the investment project's profit. As a result, they benefit investments that were already profitable before the incentive was granted, and which are more likely to have occurred independently of receiving the incentive. Profit-based incentives have the advantage to be simpler to implement and to require lower tax administration capacities.

Cost-based incentives are generally less biased towards firms that are already profitable. They allow investors to recover their investment faster through additional deductions from their taxable income (e.g. investment allowances) or directly from their payable taxes (e.g. tax credits), lowering the cost of capital. By lowering the cost of capital, cost-based incentives make more investment projects economically viable at the margin – that is, investments that would not have been profitable without the incentive. As a result, they generally have the potential to mobilise more investment per dollar of forgone tax revenue compared to profit-based incentives (Clark & Skrok, 2019). Cost-based incentives may have a higher likelihood of generating positive spillovers if well implemented. Incentives vary according to investors' spending and performance, which allows for targeting certain activities (e.g. SME linkages, skills development etc.). Cost-based incentives, therefore, can be important to support specific policy objectives and to generate longer-term impact on investment.

Source: OECD (2014).

Since 2018, Indonesia has been extensively reviewing its tax incentive schemes. Since 2019, all new CIT incentives have been cost-based, which marks a positive shift in the tax incentives' design. During the same period, existing profit-based incentives were also expanded to benefit additional sectors. Eligible business segments were increased from 145 to 179. The authorities could consider limiting profit-based incentives to high priority investments in the future and continue to shift toward cost-based incentives. Given their potential disadvantages, rigorous impact evaluations should be used to assess whether profit-based incentives are achieving their intended policy objectives.

Pioneer industries are eligible for generous tax holidays

New investors in so-called pioneer industries are eligible to receive tax holidays.[7] A tax holiday is a complete exemption from taxation of corporate income, usually over a defined period of time, starting at the beginning of the investment lifecycle. Companies can only apply for the tax holiday once within the first

year of receiving their New Business Licence, which reduces the administrative burden of processing applications.

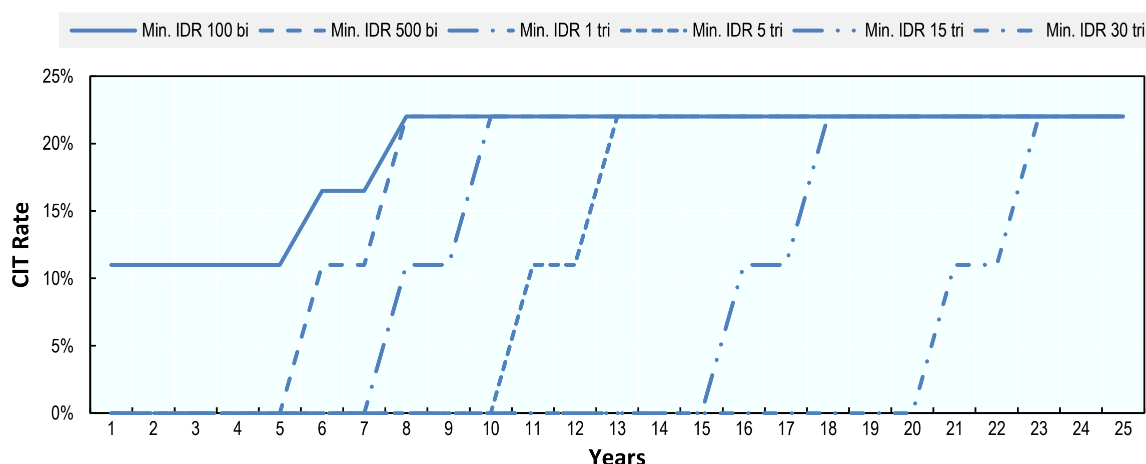
Pioneer industries refers to 18 broadly defined industries, selected based on their development potential and benefits to the economy. [8] In addition to belonging to one of these industries, investment projects must also produce extensive economic linkages, generate value-added and high positive externalities, and have strategic value for the national economy. Criteria used to determine the fulfilment of these conditions could be made more evident, in order to reduce discretionary decision-making when according incentives and to increase transparency. The list of pioneer industries has gradually expanded over time. For example, in 2018, an amendment to the regulation included economic infrastructure and the digital economy as pioneer industries.

The tax holiday's length varies according to the initial investment and ranges from 5 to 20 years (Figure 6.8). Investment projects of IDR 30 trillion or more receive 20-year tax holidays, the longest among ASEAN countries (OECD, 2018b). A reduced CIT rate applies for two years after the holiday period ends. Mini tax holidays are available for investment projects of at least IDR 100 billion and offer a 50% reduced CIT rate for five years combined with a 25% reduced CIT rate for two years after the holiday period ends.

The larger the project, the more generous the incentive and the higher the tax revenue forgone. Therefore, it is important for policy makers to evaluate the cost and benefits of each incentive. For certain investments, the authorities could consider coupling incentives with contractual obligations to undertake subsequent investments to deter footloose investments and encourage companies to develop long-term investment strategies (OECD, 2003).

Figure 6.8. CIT holidays and reduced rates for investments in pioneer industries

Year of reduced CIT rate according to investment project size



Note: Company must be incorporated in Indonesia, Debt Equity Ratio for income tax purposes must be below value stipulated on MoF Regulation No. 105/2018. Tax holiday and mini tax holiday introduced by MoF Regulation No. 150 of 2018.
Source*:* OECD elaboration based on national legislation.

Investment allowances were expanded to more investors

Indonesia offers several cost-based tax incentives to investors that apply under different conditions (Box 6.8 and Table 6.5). Two investment allowances are available: the first allows investors to deduct an additional 30% of the investment cost in "certain industries" and the second allows them to deduct an additional 60% of the investment cost.

Box 6.8. Definitions: cost-based tax incentives

- **Investment allowances** give the taxpayer the right to deduct a percentage of the cost of the investment beyond the regular tax depreciation that applies. For example, if an investor spends USD 100 and the investment allowance is 30%, the investor will be able to deduct an additional USD 30 from its taxable profits in the first year or years of the investment.
- **Accelerated depreciation** allows for depreciation at a faster schedule than is available for the rest of the economy. It reduces the cost of capital by allowing the investors to recover the investment cost faster. If the asset costs USD 200 and the standard depreciation period is 10 years, the investor can deduct USD 20 from its taxable income each year for 10 years. A 200% accelerated depreciation rate would allow the investor to deduct the cost of the investment twice as fast and deduct USD 40 each year for five years. This means the project will pay less tax in the first five years and therefore recover its costs more quickly, even if the final deducted value is the same.
- **Enhanced deductions.** Some countries, allow investors to deduct more than 100% of certain categories of expenses such as approved training programmes and R&D. This allows for decreasing the tax base amount that is taxed by deducting a certain expense at a higher rate than actual costs. An enhanced allowance of 200% allows a certain expense to be deducted twice as cost: its actual cost and a second time, for taxation purpose.
- **Loss carry-forward**. The general tax code usually allows operating losses to be carried forward to offset taxable income in a future year, with a limit on the loss carry-forward period. This reduces tax revenues where losses that would have otherwise expired can continue to be carried forward to reduce taxable income in future years.

Source: OECD and IGF (2018).

Policy objective of the 30% investment allowance is less clear

The 30% investment allowance – originally introduced through the 2008 income tax law[9] (Table 6.4) – was significantly expanded in 2019: (i) eligible industries increased from 145 to 183; (ii) geographic location requirements were removed, except for 17 industries; and (iii) the incentive was expanded to apply to any new investment project, while under the previous regulation it was only available to newly registered firms.

When possible, authorities should apply incentives in a uniform and consistent way across all investments or clearly target specific investments to achieve intended policy objectives. Industries targeted by the investment allowance are very broad, especially since the removal of the geographic location and of the newly registered firm requirements. The broad investment tax allowance creates an unequal playing field among investors, reducing the effectiveness and efficiency of the investment allowance. Indonesia could consider more clearly defining the policy objective of its “certain industry” incentive to avoid creating an uneven playing field.

The second investment allowance of 60% is targeted to develop labour-intensive industries and is well aligned with Indonesia’s broader policy to boost job creation in these industries. Under more restrictive conditions, the incentive is limited: (i) to 45 labour-intensive business segments; (ii) investors with a new business licence; and (iii) new projects that will employ at least 300 workers and investors. While the policy does not require any minimum investment (as the tax holiday policy does), it targets new medium and large investment projects by adding a minimum number of employed workers for the project to qualify.

Accelerated depreciation rates allow investors to recover their investment more quickly and apply under the same expanded conditions offered under the 30% allowance. Whether investor are more likely to opt for one or the other incentive is likely to vary according to the type of the investment project. The accelerated depreciation incentives apply to both tangible and intangible assets, while investment allowances apply to only tangible ones. This difference between the two incentives could be more clearly communicated to investors, as it is relevant for high-tech and digital industries.

Table 6.4 Description of cost-based tax incentive schemes in Indonesia

Incentive	Qualified Expenses	Deduction	Conditions
Investment Allowance ("Super deduction")	Capital Investment in tangible fixed assets, including land	60% of capital expense (10% per year, over 6 years)	Labour intensive industries (45 business fields) At least 300 employees New business licence
Investment Allowance	Capital Investment in tangible fixed assets, including land	30% of capital expense (5% per year, over 6 years)	Certain business fields (183 fields) Investment has a high investment value, is export-oriented, employs a large workforce or has high local content in its production. New investment project
Accelerated Depreciation	Capital Investment in tangible or intangible fixed assets	200% of tax code rate	*Certain area* business fields (183 fields) Investment has a high investment value, is export oriented, employs a large workforce, has high local content New investment project
Loss carry-forward extension	No applicable	5-10 extension (beyond 5 years specified in investment law)	*Certain area* business fields (183 fields) Investment has a high investment value, is export oriented, employs a large workforce, has high local content New investment project
Skill Development Enhanced Allowance	Costs from work practice, apprenticeship, and/or learning activities Building, physical facilities for trainings	200% of expense Applies to current expenses or asset lifetime for buildings	Internship or vocational training program in certain competencies to upskill human resources as part of the investment and fulfilment of workforce demand Limited to manufacturing (automotive, furniture, shipping, textile and garments) and industrial logistics
R&D Enhanced Allowance	Research and development spending*	300% of expense Applies to current expenses or for 5 following years when intellectual property is produced	Activities that produce new invention and innovation, master a new technology, or transfer of technology.

Note*:* The table only include cost-based CIT incentives. * Expenses not eligible for enhanced deduction include cost of quality control, seasonal design changes, routine equipment design, construction engineering/ relocation/ start up facilities, market research, etc.
Source: OECD elaboration based on national legislation (Government Regulation (PP) No. 45/2019, MoF Regulation No. 128/2019, Government Regulation No. 78/ 2019, Government Regulation No. 45/2019, MoF Regulation No. 128/2019, MoF Regulation No. 16/2020).

Enhanced deductions target skill development and innovation

Indonesia introduced enhanced deductions to support R&D activities and skills development. Spending on R&D and vocational training receives respectively a 200% and 300% enhanced tax deduction (Table 6.4). Investment in R&D is a key driver of innovation and has the potential to produce positive externalities. As private returns are lower than social returns, governments can incentivise R&D investment to bring it up to the social optimum. As a result, R&D is the focus tax incentive policy in many countries including OECD economies.

For R&D enhanced deductions, the regulation includes a number of good practice measures, such as clearly limiting eligible expenses to only those closely related to R&D (e.g. contracts with university and research labs, hiring of researchers and technicians, external consulting and training activities). Clearly defining targeted expenses is central to ensuring the policy benefits the activities with potential positive externalities. While the legal basis for the enhanced tax deduction for R&D spending was introduced in mid-2019 (Government Regulation No. 45), the implementing regulations have still not operationalised the incentive. Indonesia could consider limiting the delay between the introduction and operationalisation of new incentives, so as to reduce investor uncertainty.

Tax deductions linked to skills development can contribute to human capital development and firm competiveness under the right conditions. Tax incentives for vocational training are expected to benefit both newly entering investors and already established ones in Indonesia. New investors – particularly foreign ones – need to develop their pool of skilled labour to start production and the incentive can reduce this initial cost. Established businesses who already undertake regular training of their workers may have an additional incentive to expand worker training, which could help increase production efficiency.

Tax incentives – such as those for R&D and skills development – can enhance FDI spillovers on the domestic economy under the right conditions. SME-FDI linkages are another important channel for spillovers from FDI. Tax and other incentives that foster linkages with SMEs and upgrade their skills have proven effective in several countries in establishing linkages and boosting SME productivity (Perera, 2012; UNCTAD , 2011; Christiansen & Thomsen, 2005). In Indonesia, business linkages between foreign and domestic firms are already significant, suggesting that the potential for productivity spillovers is high (see above and Chapter 2 for more information of business linkages).

Box 6.9. Fostering FDI-SME linkages through tax incentives: Malaysia and Singapore

Malaysia and Singapore offer two examples of ASEAN countries that support FDI-SME linkages through tax incentives. In Malaysia, under the Industrial Linkage Programme, investors can claim tax deductions for costs involved in providing support to local suppliers, including training, product development and testing, and factory auditing to ensure the quality of local suppliers. A Global Supplier Programme also offers financial and organisational support to multinational enterprises, if specialists from their foreign affiliates are seconded to local firms (for up to two years).

Singapore's Local Industry Upgrading Programme had a similar design, but it has now been replaced by the Pioneer Certificate Incentive and the Development and Expansion Incentive. These two tax incentives offer corporate tax exemption or a reduced concessionary tax rate on eligible income if the multinational enterprise sets up locally upstream and downstream activities previously conducted internally. The aim of the programme is to foster technology transfers and the scale-up of local businesses.

Source: OECD (2019).

Linkage-development tax incentives, if integrated into a broader linkage development programme, could further encourage integration with the domestic economy, enhancing spillovers and promoting upgrading of local suppliers.[10] One option involves tax breaks for foreign investors who invest in the upgrading of local suppliers through training, mentoring or staff secondment programmes (OECD, 2018c). In the ASEAN region, Malaysia and Singapore have already used this policy with generally positive results (Box 6.9). Given Indonesia's recent expansion of tax incentives, any linkage incentive should replace another incentive – representing a design improvement – rather than the introduction of a new incentive.

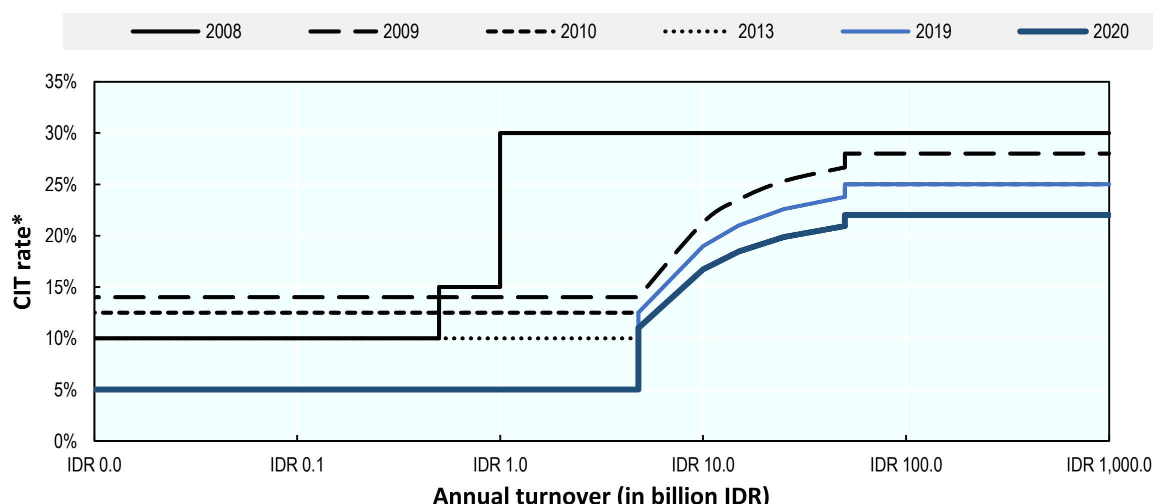
Preferential rates apply to newly listed companies and SMEs

Preferential CIT rates – rates lower than the statutory rate – apply to certain businesses. Newly publicly listed companies receive a 3-percentage point reduction on CIT payment (19% CIT rate), limited to a period of five years after listing. Indonesian SMEs also receive preferential tax treatment. Companies with a gross annual turnover of up to IDR 50 billion receive a 50% CIT rate reduction (11% CIT rate) on part of their income, while businesses with an annual turnover less than IDR 4.8 billion (small enterprises) may opt for a unified rate of 0.5% on their monthly turnover.

The preferential tax policy for SMEs seeks to promote small business formalisation. By mid-2018, it succeeded in encouraging 1.5 million small companies to formalise (OECD, 2018c).[11] Special tax regimes for SMEs are common among OECD and G20 countries, where the difference between the statutory and preferential CIT rate is on average 4 percentage points (OECD, 2015b). In Indonesia, the difference between the two rates is much higher (Figure 6.9). Support to SMEs will continue to be important as Indonesia moves toward economic recovery, but raising the upper limit of companies benefitting from the special tax regime for SMEs could serve as a source of new revenue in the medium-run.

Figure 6.9 CIT rates for SMEs have progressively been reduced over the past decade

Corporate income tax (in %) applied according to enterprise annual turnover (in IDR billion)



Note: CIT rate* refers to the relevant CIT rate or the CIT-equivalent rate under the assumption of a 10% profit rate on turnover. The unified tax as a share of revenue for SMEs (2013 and 2018) is calculated as CIT-equivalent and profit-based tax brackets (2008) are presented as turnover-equivalent.
Source: OECD elaboration based on national legislation.

Indonesia's Fiscal Policy Agency (*Banden Kebijakan Fiskal,* BKF), under the Ministry of Finance, does not consider the preferential taxation of SMEs as a tax incentive, but rather as part of the benchmark tax system – a characteristic of the general tax treatment (BKF, 2019). It may nevertheless still have significant implications for tax revenues even as part of the benchmark system. VAT exemptions for small enterprises alone represented 40% of forgone tax revenues from incentives for businesses in 2018 (BKF, 2019). CIT revenue implications could be larger. Furthermore, policy costs will continue to increase as SME formalisation grows. Given its relevance, the SME tax regime could be systematically evaluated to ensure it continues to achieve its intended policy objective.

Tax incentives in Special Economic Zones

Indonesia has introduced changes to its major tax incentives in recent years, including tax incentives in SEZs. In early 2020, Government Regulation 12/2020 on "Facilities in the Special Economic Zones" revoked the previous regulation on tax incentives in SEZs (GR 96/2015). The regulation introduces a similar basis for CIT facilities. The implementing regulation detailing the amount, duration, submission process of the incentives have not yet been published.[12]

The regulation provides details on the governance of tax incentives in zones, including a number of good practice measures relating to the use of CIT incentives. Tax incentives are limited to incomes resulting from the enterprise's main activity, capital goods eligible to receive incentives are clearly specified and the policy includes a clawback measure on incentives given in the case of non-fulfilment of requirements.

In addition to CIT incentives, incentives applying on other taxes are also available to investors in Indonesia within economic zones. VAT on inputs, excise tax, luxury goods sales tax (PPnBM) and custom duties exemptions apply on imports of certain goods within Special Economic Zones (KEKs), Integrated Economic Development Zones (KAPETs) and Bounded Zones. Import duty postponement on capital good and equipment and material for processing is available for investment in KEKs and KAPETs.[13] In addition, all machinery and equipment acquired by taxable entrepreneurs (PKP) and to be used for production in Indonesia is VAT exempt.[14]

Creating bonded areas with high-quality infrastructure, human resources and administration is an important policy tool to promote economic development, considering that Indonesia is geographically too large to improve infrastructure across the whole country in a short period of time. Place-based policies have the potential to generate positive local spillovers and serve as a tool to promote local economic development. Chapter 7 discusses the relevance of SEZs for regional development in Indonesia in further detail.

Consolidating incentives in tax laws increases transparency

To create an attractive business environment, transparency, simplicity and clarity in the provision of the legal and regulatory framework are important. In Indonesia, tax incentives are regulated through a combination of laws, decrees and implementing regulations (Table 6.5). The complexity of multiple regulations and of eligibility criteria creates additional costs to investors (e.g. requiring specialised tax advice) and deters investors from applying for the regime, which risks reducing its effectiveness and efficiency.

Indonesia could consider consolidating all the tax incentives provided, along with their eligibility requirements, to increase transparency and legal certainty.[15] The OECD *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries* (OECD, 2013) recommends that tax incentives and their eligibility criteria be consolidated and published in the tax law. Corporate tax incentives (such as the investment allowance) would best be provided through the Income Tax Law, whereas exemptions from VAT and customs should figure in the VAT and Customs law respectively.

BKPM's website provides a good overview of the main tax incentives offered to inward investors, but access to original regulations could be enhanced and official translations more systematically provided. A detailed overview of eligibility criteria, including easy access to a business segments list, could also be expanded.

Multiple tax incentives co-exist in Indonesia. Investors – under certain conditions – may be eligible to apply to more than one incentive scheme. The actual tax benefit received under each scheme may vary substantially and create an incentive for tax planning, creating an uneven playing field across investors. Identifying cases where overlapping incentives may occur can support the understanding to what degree the tax incentive framework is fragmented and where unequal treatment of investors occurs.

Table 6.5 Relevant laws and regulations regulating tax incentives in Indonesia

Incentive	Relevant laws and regulations
Tax incentives (legal basis)	Law No. 25 of 2007 on Capital Investment (Article 18) Law No. 36 of 2008 on Income Tax Law No. 39 of 2009 on Special Economic Zones Law No. 42 of 2009 on Value Added Tax
Tax Holiday	Government Regulation No. 24 of 2018 Minister of Finance Regulation No. 150 of 2018 (introduction of mini tax holiday) Minister of Finance Regulation No. 105 of 2018 (debt-to-equity ratio) Minister of Finance Regulation No. 35 of 2018 (pioneer industry broad business segments) BKPM Regulation No. 1 of 2019 (pioneer industry detailed business segments)
Investment allowances	Government Regulation No. 78 of 2019 Government Regulation No. 45 of 2019 Minister of Finance Regulation No. 11 of 2020 (new investment tax allowance) Minister of Finance Regulation No. 16 of 2020 (labour-intensive investment allowance)
Enhanced tax reductions	Government Regulation No. 45 of 2019 Minister of Finance Regulation No. 128 of 2019 (vocational and R&D)
SEZs	Government Regulation No. 96 of 2015
Import duty facilities	Minister of Finance Regulation No. 76 of 2012 Minister of Finance Regulation No. 110 of 2005 BKPM Regulation No. 16 of 2015
Reduced CIT rate for public companies	Government Regulation No. 29 of 2020

Source: OECD elaboration based on national legislation.

Regular review of tax incentives enhances policy efficiency

Promote regular reviews of benefited sectors and activities

Indonesia's main tax incentives are sector-specific and could benefit from a regular review of the list of sectors that qualify for incentives. This would ensure that policies are up-to-date, reflect wider changes in the government strategy and can quickly reflect new priorities. This is particularly relevant in the context of the COVID-19 crisis, which has led countries to prioritise investments in health industries. For example, Thailand has already introduced health industry sub-sectors in its sector-specific tax incentives, following

the outbreak of the pandemic (OECD, 2020d). Regular review of benefiting sectors also encourages incorporating new medium-term priorities, such as sectors contributing to a green transition and building resilient infrastructure.

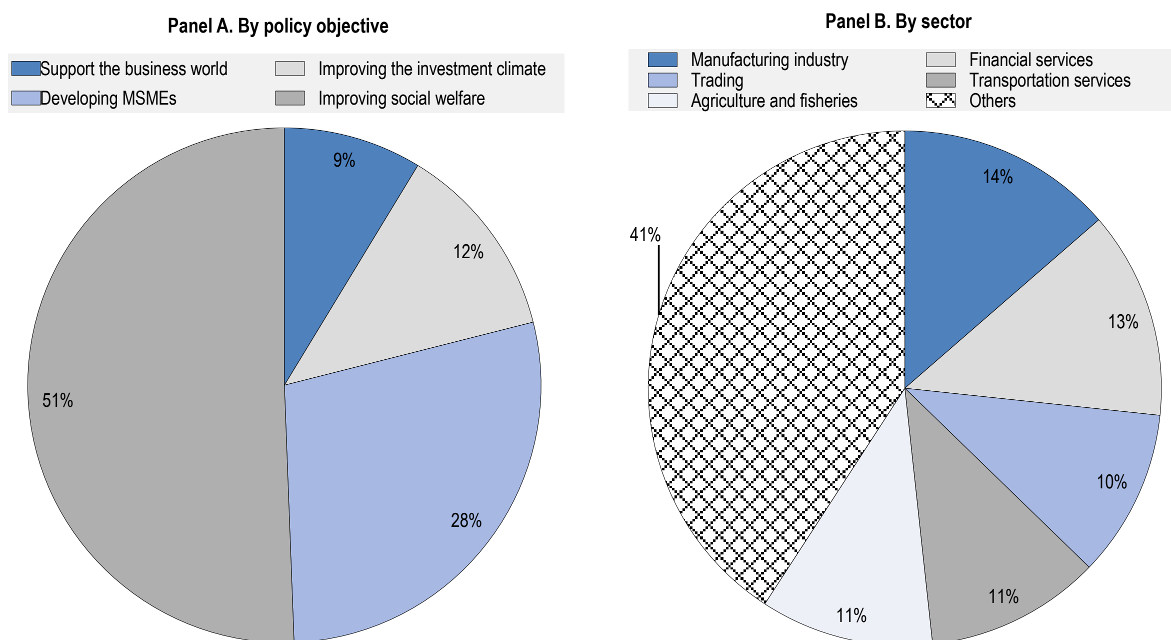
Well-designed and implemented sunset clauses can enhance the effectiveness of tax incentives by creating a natural break for periodic evaluation of incentives. While sunset-clauses can increase investor uncertainty and tax system complexity, they can also improve alignment with the intended policy objective. Regular and detailed review of policies can help identify new sector priorities, as well as incentives that are no longer needed. Indonesia could consider introducing sunset clauses for the most generous sector-based incentives.

Continue annual tax expenditure reporting and expand cost-benefit analysis

Tax incentives contribute to improving a country's socio-economic welfare, so long as the societal benefits generated exceed the associated costs. Careful and regular monitoring of tax expenditures (forgone tax revenues from tax incentives) is key to ensure that policy benefits outweigh costs. Reporting creates accountability over the use of public funds and provides inputs for policy makers to evaluate effectiveness and efficiency of tax incentives. Close monitoring of tax expenditures is of particular importance, as the COVID-19 crisis will deeply affect economic growth. As tax revenues are expected to drop by 10% in 2020, there is a need to carefully use public resources in the recovery process to maximise societal benefits through effective policies (Akhlas, 2020).

BKF published tax expenditure reports for the 2016-18 period.[16] Tax expenditures represented 1.5% of GDP in 2018, almost half of which was allocated to supporting businesses, improving the investment climate and fostering SME development (Figure 6.10, Panel A).[17] The manufacturing sector is benefiting the most from tax incentives (Figure 6.10, Panel B).

Figure 6.10 Tax expenditure in Indonesia, 2018



Note: CIT forgone tax revenues are estimated using static micro-simulation models. Static models do not take into account behavioural changes, economic impacts and policy reactions.
Source: BKF(2019).

Only a limited number of emerging economies publish tax expenditure reports (Redonda & Neubig, 2018). Indonesia's report is a welcome first step. It introduces several good practice elements in tax expenditure reporting, including identifying intended policy goals and legal references of each tax incentive (IMF-OECD-UN-World Bank, 2015). The most recent tax expenditure report introduced several extensions compared to the previous report, expanding regulations and sectors covered in forgone tax revenue estimates. Future reports may benefit from further details and the inclusion of additional tax incentives. Estimating forgone tax revenues of incentives in SEZs should also be prioritised.

A second area of interest could be to expand the analysis of the benefits of tax incentives, as the current tax expenditure report focuses on the costs. For the moment, the inclusion of possible benefits varies according to the estimation method used for each incentive. Finally, tax expenditure reports could provide additional details on the major differences of the multiple methods of tax expenditure evaluation used to increase transparency and interpretability of results.[18]

Increasing regional dialogue on use of tax incentives

International organisations and other entities have often advised countries to avoid an overreliance on tax incentives or at least to improve their design, transparency and administration (IMF-OECD-UN-World Bank, 2015). Unilaterally removing tax incentives may be politically difficult due to vested interests of policy beneficiaries and tax competition among countries. ASEAN economies extensively rely on tax incentives, resulting in heavy tax competition in the region (OECD, 2019). Countries may end up in a race-to-the-bottom competition, where tax incentives become increasingly generous and less effective at the same time.[19] Regional investment competition can result in further tax base erosion that may hamper improving countries' business climates in the long-run.

Since incentives in one country may affect others, international co-operation can be beneficial. Co-ordinating granting of tax incentives at the regional level would help address potentially harmful tax competition. Regional initiatives promote a better understanding of tax standards and practices of neighbours and contribute to this purpose (ESCAP, 2016).

The Study Group on Asian Tax Administration and Research is an important regional platform promoting co-operation in Asia-Pacific. The forum – in which Indonesia has participated actively since 1970 – seeks to share best practices among member countries and promotes bilateral or multilateral co-operation in taxpayer compliance. The ASEAN Forum on Taxation provides since 2011 a platform for dialogue on taxation in support of the ASEAN Economic Community. Sub-forum 2 on Enhancing Exchange of Views and Dialogue shares experiences on best practices in taxation systems, developing strategies for co-operation, and providing capacity building and training for tax administrations.

Regional dialogue and tax co-operation will be even more important in the COVID-19 context, to avoid that tax disputes harm economic recovery (OECD, 2020e). Indonesia should continue to actively engage in regional and international forums and exchange best practices in the current unprecedented environment.

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Notes

[1] The five national development priorities set by the President are the following: 1) infrastructure; 2) human capital; 3) simplification of regulations; 4) de-bureaucratisation; and 5) economic transformations.

[2] Government Regulation No. 24 of 2018.

[3] Regulated in Article 5 PERPPU I of 2020 and ratified into Law Number 2 of 2020.

[4] Government Regulation No. 29 of 2020, Ministry of Finance Regulations No. 23 and No. 83 of 2020.

[5] Government Regulations No. 45 and No. 78 of 2019.

[6] For incentives, the decision time should be of up to eight working days, which represents a quick decision process.

[7] Tax incentives for pioneer industries were introduced by MoF Regulation No.159/PMK.010/2015. Regulation was amended by MOF Regulation No.103/PMK.010/2016, by MOF Regulation

No.35/PMK.010/2018 and by MOF Regulation No.150/PMK.010/2018. Investment allowance introduced through (Government Regulation No. 78/2019.

[8] Introduced under the current regulation No.35/PMK.010/2018. A BKPM regulation matches the broadly defined industries to an Indonesian Standard Industrial Classification code (KBLI). Assigning KBLI codes to pioneer industries increases the policy's transparency. A complete list of the 179 business segments can be found in: https://oss.go.id/portal/insentif/content/tax_holiday

[9] Law No. 36/2008 on Income Tax, Article 31A

[10] See OECD (2018c) for additional information on SME and Entrepreneurship Policy in Indonesia.

[11] A progressive rate applied on revenue between IDR 4.8-50 billion that increases the effective tax rate gradually for firms. See the OECD report on SME and Entrepreneurship Policy in Indonesia 2018 for a detailed discussion: http://www.oecd.org/publications/sme-and-entrepreneurship-policy-in-indonesia-2018-9789264306264-en.htm

[12] Ministry of Finance Regulation No. 104/PMK.010/2016 on the "Treatment of Taxation and Customs at Special Economic Zones" has not been revoked as of late March 2020.

[13] Ministry of Finance Regulation 131 of 2018.

[14] Government Regulation No. 81 of 2015.

[15] Under the planned New Tax Law, the legal and regulatory frameworks for Indonesia's various incentives will be consolidated into one part of the law.

[16] Publication of the 2019 report is planned for late 2020.

[17] Forgone revenues from referential CIT rates and turnover tax are not included.

[18] Current report combines micro-simulation, input-output, CGE and mixed methods. When possible, align estimation methods to increase comparability of results across tax incentive measure.

[19] A KPMG (2014) study also warned that the paucity of coordination and harmonisation on tax matters in the ASEAN region, especially in light of the AEC, could result in continued tax competition that will have adverse effects on tax bases in the region

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