3 Re-thinking Indonesia's FDI regime

This chapter focuses on barriers to entry and operation of foreign investors in Indonesia. It explains why reducing barriers and facilitating operations for investors from abroad matter for Indonesia in a world of global value chains. The chapter analyses Indonesia's regulatory regime for foreign investors in comparison to its regional peers and worldwide experience, and identifies a number of policy options for consideration by the authorities for improving Indonesia's attractiveness to foreign direct investment.

Summary and main recommendations

Indonesia has a number of attributes that makes it a naturally coveted destination for foreign direct investment (FDI). Yet, it has never really taken off as a leading FDI destination (see next section and Chapter 2 on trends and impacts of FDI). Foreign investors have been somewhat timorous of Indonesia's complex business environment, not least because of remaining FDI restrictions and entry conditions. But also because of the still strong political appetite for 'economic and resource nationalism', the strong role of state-owned companies (SOEs) in the economy and the heavy bureaucracy and decision-making processes for obtaining needed approvals, licences and permits from authorities at all levels of government (see Chapter 6 on investment promotion and facilitation), which have also at times added to keeping some investors at bay (World Bank/IFC, 2019).

The recent Sino-US trade tensions, which led to the relocation of some export-oriented investments out of China, once again drew attention to Indonesia's challenges in attracting FDI, although more recently some factories have announced plans to relocate production to Indonesia (JETRO, 2020; Nomura, 2019; Jakarta Post, 2020a, 2020b). The situation prompted a strong reaction from President Joko Widodo, who called out members of his cabinet for the country's failure to capture a 'fair share' of such relocations (Jakarta Globe, 2019; Katadata, 2019).

Increasing foreign investments and improving the ease of doing business became a key priority for the current administration, which in early 2020 submitted to Parliament a draft Omnibus Law on Job Creation aimed at streamlining and repealing dozens of overlapping regulations considered to be hampering investments and job creation. Among other issues, the law seeks to lift restrictions and conditions placed on FDI, centralise and streamline business licensing and land acquisition procedures, including by adopting a risk-based approach to business licensing and making it a more transparent and fully online process (see Chapter 6 for a discussion on investment facilitation measures) and significantly reform Indonesia's labour market.

Coupled with the upcoming omnibus law on taxation, it is perceived by the government as critical for strengthening economic competitiveness and particularly for revitalising Indonesia's manufacturing sector, which has steadily shrunk more than 10 percentage points as a share of GDP over the last decade and a half. The law was enacted in October 2020 despite strong opposition by labour unions, regional administrations and civil society, who expressed concerns over the law's amendments to the 2003 Labour Law, the recentralisation of administrative power in the hands of the executive and the lack of public hearings among others. Implementing such an 'all-in-one' law reform package will be a challenge but there are compelling arguments for revising the current FDI regulatory regime once the pandemic is controlled. This chapter focuses on the implications of the Omnibus Law for foreign investment restrictions in Indonesia. Other, more contentious areas of the new law are considered elsewhere in the review (see, for example, chapter 5 on responsible business conduct).

Over time, Indonesia has significantly liberalised its foreign investment regime, but it remains one of the most restrictive countries to FDI as measured by the OECD *FDI Regulatory Restrictiveness Index*, with many primary and services sectors still partly off limits to foreign investors (*e.g.* agriculture, fisheries, oil & gas, power, construction, hospitality, distribution, transportation, telecommunications insurance and other financial services). Beyond extensive sector-specific foreign equity restrictions, it maintains a range of discriminatory policies that apply across the board, such as higher minimum capital requirements for foreign-invested companies, stringent conditions on the employment of foreigners in key management positions, limitations on branching and access to land by foreign legal entities and preferential treatment accorded to Indonesian-owned entities in public procurement. Indonesia also makes extensive use of local content requirements, which add to the hurdles of carrying out foreign investments in Indonesia.

In addition to diverting potential FDI away and depriving Indonesia of a relatively more stable source of capital and foreign exchange for financing its structural current account deficit compared to portfolio

investments, these restrictions contribute to holding back potential economy-wide productivity gains (OECD, 2019a, 2015; Duggan et al., 2013; Rouzet and Spinelli, 2016). As shown below, Indonesian manufacturers are among the most affected worldwide by FDI restrictions in services sectors. This is ever more pressing given the level of ('premature') de-industrialisation, which may weigh heavily on Indonesia's goal of becoming a high-income economy in the medium-term (Rodrik, 2015). In the modern context of intensified regional and global value chains (GVCs), FDI policies can no longer treat services and manufacturing separately.

A comprehensive overhaul of Indonesia's FDI regime may not be easy to achieve, but only a bold and comprehensive reform package would allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness as an investment destination. Out of six hypothetical FDI reform scenarios simulated using the OECD *FDI Regulatory Restrictiveness Index,* only the elimination of all sector-specific foreign shareholding restrictions, all other restrictions held constant, could bring Indonesia significantly closer to OECD levels of openness. The impact of substantial FDI liberalisation can be sizeable (Mistura and Roulet, 2019). Indonesia's inward FDI stocks, for instance, could be 25% to 85% higher if it were to reduce the level of FDI restrictiveness to the 50th and 25th percentile levels of the *OECD FDI Regulatory Restrictiveness Index, ceteris paribus*. Stringent barriers to FDI also make other doing business impediments, and reforms therein, less relevant as these may not bring about the intended benefits.

While revisiting the FDI regime is certainly warranted, the Omnibus Law on Job Creation should also ensure that past achievements are preserved. The transparency of Indonesia's policy framework for investment improved with the adoption, pursuant to the 2007 Law on Investment, of a 'negative list' approach for listing sectors that remained closed or open with certain conditions to foreign or domestic investors. A shift to a 'positive list', as it has sometimes been reported by the media, would represent a setback to transparency and on-going and future efforts of maintaining an open business environment if technically implemented. The authorities, however, have confirmed during this review that the 'negative list' approach will continue to be used for the regulation of market access. Improvements could thus be considered on the institutional setting and procedures for its formulation. Greater transparency and technical support, as well as a more inclusive consultation and institutional setting could help to broaden the information-base supporting discussions and deliberations in this regard.

The announced global economic downturn scenario – the OECD (2020a) projects a 4.5% contraction of the global economy in 2020 – might perhaps work in favour of pushing reforms forward. The pace of Indonesia's FDI reforms have historically been largely shaped by crises. If it were not for the current unique situation, past perspectives about FDI liberalisation reforms would be comforting in suggesting a pick-up in FDI activity. But this may prove particularly difficult this time. It might be challenging even to hold on to existing FDI considering the expected negative impact of the pandemic on global FDI activity (see Chapter 2).[1] ASEAN as a region is likely to remain well positioned to compete for investments, which could also benefit Indonesia. But without reforms, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI in the immediate aftermath of the pandemic may be slim.

Main policy recommendations

- In view of Indonesia's extensive list of activities restricted to foreign investment: undertake a comprehensive regulatory impact assessment of existing restrictions on FDI, including assessments of potential substitutive non-discriminatory policies where relevant, and subject the assessment to ample stakeholder scrutiny to identify priority areas for reform and inform policymaking in the context of the omnibus reform on job creation and further implementing regulations.
- In advancing FDI reforms, consider prioritising further liberalisation of FDI in services sectors due to their economy-wide productivity implications. In the current context of GVCs and the intensified 'servicification' of manufacturing activities, restrictions on FDI in service sectors end up

discriminating against domestic manufacturing producers and consumers, who may have to pay relatively higher prices for quality-adjusted services inputs. Accompanying reforms to behind-the-border services regulations should go hand in hand with FDI liberalisation for these to fully bring about their potential benefits.

- Eliminate discriminatory requirements against foreign direct investors in horizontal regulations to support enhanced competitiveness and efficiency and ensure a level playing field for all investors in Indonesia. In this respect:
  - Align the general minimum capital requirement for foreign-invested companies with capital requirements for domestic investors. The currently discriminatory minimum capital policy is particularly stringent for investors in less-capital intensive activities. Worldwide, where minimum capital requirements still exist, they are rarely discriminatory – in 2012 only eight countries out of 98 assessed in the World Bank's Investing Across Borders imposed a discriminatory minimum capital requirement – and typically much lower than what is required from foreign investors in Indonesia (about 17 times lower for the average OECD economy). This is the case even across economies with a level of income per capita much greater than that of Indonesia.
  - Promote a more level playing field in public procurement for foreign direct investors by eliminating preferential treatment accorded to Indonesian-owned entities, notably in the procurement of services. According preferential treatment to resident enterprises in public procurement is relatively common, but discriminating against foreign-owned firms established in the procuring jurisdiction is rather exceptional. As for other discriminatory measures, these might hinder competition and contestability in the affected markets and may drive up costs of goods and services procured by the government.
  - Reconsider the use of local content requirements for developing local industries and supporting domestic investors. Stringent local content requirements in some sectors add to the hurdles of carrying out foreign investments in Indonesia. By establishing hard to achieve local requirements, it may restrain competition and potential short-term gains in targeted industries can act as a drain on the rest of the economy. In pursuing such objectives, horizontal policies addressing deficiencies of the business and regulatory environment, trade and investment barriers, innovation policy, and infrastructure development, can offer an alternative to local content policies and have less negative economy-wide effects on output, exports and jobs.
- Preserve and improve Indonesia's current 'negative list' approach to regulating market access and treatment accorded to foreign investment in the on-going Omnibus law reform. Such an approach provides greater clarity and security for investors than the alternative 'positive list' approach sometimes mentioned in the context of the on-going reform. Investors have at times expressed discontent with the pace of liberalisation in past years and questioned the capacity of the 'negative list' revision process to encourage liberalisation, but this would likely be more challenging under the alternative 'positive list' proposal. Improvements could be considered on the institutional setting and procedures for the regular revision of such a 'negative list'. In these respects:
  - Continue to allow foreign investment without discrimination unless designated as restricted in a separate 'negative list' indicating a complete list (without carve-outs and exceptions) of activities closed to private investment (foreign or domestic), activities closed only to foreign investors, and activities where foreign investment is permitted under discriminatory conditions. Such a list should be clear and concise, describing any imposed condition with clarity and specifying where appropriate the relevant underlying provisions in national laws and regulations. Explicit reference to an international standard industry classification (on top of Indonesia's standard industrial code (KBLI) as currently the case) for accurate documentation of closed or restricted activities is also recommended. As currently the case, it should continue to be placed in an executive-level order for ease of amendments over time. It should also be

immediately updated whenever any relevant underlying legislation is introduced or modified to make sure every new or modified restriction and condition is not enforceable until appropriately reflected in the 'negative list'.

- Strengthen the process for assessing and revising the 'negative list' on a regular basis including by consulting more widely and systematically with relevant stakeholders, relying more on technical assessments by independent qualified institutions and publicising relevant documents supporting deliberations. A broader involvement of relevant stakeholders, as well as more transparency and technical inputs to the formulation of the 'negative list' would help to broaden the information-base supporting discussions and deliberations and facilitate dialogue with interested stakeholders, ultimately contributing to improved policy-making.

Why do barriers to FDI matter for Indonesia?

Indonesia has long been a challenging destination for foreign investment. It has a number of attributes that makes it a naturally coveted destination for FDI: the largest consumer market of Southeast Asia in one of the fastest growing regions in the world, abundant natural resources and a large and relatively young workforce, among other advantages. Yet, it has never really taken off as a leading FDI destination, especially considering the increasing importance of the Southeast Asia region as a world investment destination (Table 3.1). For the world's 16th largest economy in 2018 and which is still 2.5 times more populous than the second largest ASEAN peer, it is surprising that it featured among the top 3 ASEAN recipients of FDI in absolute dollar terms in only two periods over the past three decades (1990-1995 and 2016-2018). In relative terms, Indonesia's performance has been weaker, but overall improving since the mid-2000s, similarly to its performance in absolute terms.

Table 3.1. Indonesia's comparative performance in attracting FDI, 1995-2018

(World rank in parenthesis)

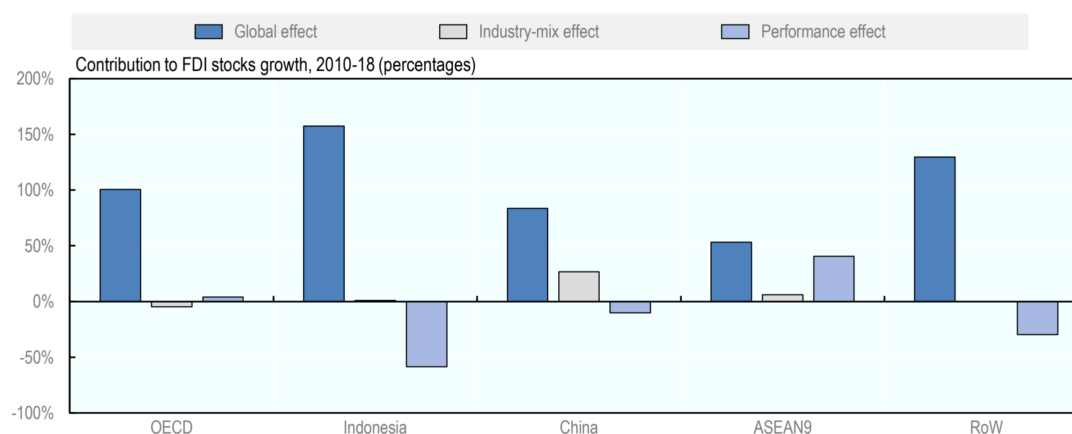
FDI inflows (% of world total)	1990-1995	1996-2000	2001-2005	2006-2010	2011-2015	2016-18
Brunei Darussalam	0.1 (90)	0.2 (63)	0.2 (61)	0.1 (125)	0.1 (116)	0.1 (122)
Cambodia	0.1 (98)	0.1 (86)	0.1 (120)	0.1 (98)	0.2 (73)	0.2 (58)
Indonesia	**1.1 (19)**	0.5 (38)	-0.2 (190)	0.4 (50)	0.6 (37)	**1.3 (19)**
Lao PDR	0.1 (114)	0.1 (116)	0.1 (167)	0.1 (135)	0.1 (121)	0.1 (80)
Malaysia	2.4 (13)	0.9 (21)	0.5 (40)	0.5 (45)	0.8 (27)	0.7 (32)
Myanmar	0.1 (66)	0.1 (64)	0.1 (81)	0.2 (80)	0.1 (93)	0.3 (49)
Philippines	0.5 (37)	0.3 (47)	0.2 (70)	0.2 (69)	0.3 (54)	0.5 (35)
Singapore	2.8 (9)	2 (13)	2.3 (13)	2.4 (13)	3.8 (7)	5 (5)
Thailand	1 (23)	0.7 (28)	0.8 (27)	0.7 (33)	0.5 (40)	0.5 (36)
Viet Nam	0.5 (40)	0.4 (44)	0.3 (58)	0.5 (41)	0.6 (35)	1 (22)
FDI inflows (% of GDP)	**1990-1995**	**1996-2000**	**2001-2005**	**2006-2010**	**2011-2015**	**2016-18**
Brunei Darussalam	2.4 (57)	11.9 (13)	15 (12)	2.8 (124)	3.5 (85)	2.1 (110)
Cambodia	2.7 (52)	6.4 (36)	3.5 (79)	9.5 (38)	12.2 (19)	12.6 (12)
Indonesia	1.3 (90)	0.1 (177)	1.1 (144)	1.5 (157)	2.2 (114)	1.6 (126)
Lao PDR	2.5 (56)	4.4 (56)	0.9 (162)	4.7 (82)	4.7 (62)	7.7 (27)
Malaysia	7.7 (12)	5.3 (47)	2.6 (107)	3.2 (113)	3.5 (83)	3.1 (79)
Myanmar	2.9 (45)	6.9 (32)	5.5 (46)	4.8 (80)	2 (119)	5.4 (42)
Philippines	1.7 (70)	2 (114)	1.1 (146)	1.5 (160)	1.3 (157)	2.4 (100)
Singapore	9.6 (8)	14.4 (9)	15.2 (11)	17.9 (11)	19.4 (10)	23.2 (8)
Thailand	1.5 (76)	3.6 (73)	3.6 (77)	3.3 (109)	1.8 (127)	1.4 (132)
Viet Nam	7.5 (14)	6.7 (34)	3.7 (73)	7.3 (50)	5.5 (53)	6.3 (37)
FDI inflows per capita (USD million)	**1990-1995**	**1996-2000**	**2001-2005**	**2006-2010**	**2011-2015**	**2016-18**

FDI inflows (% of world total)	1990-1995	1996-2000	2001-2005	2006-2010	2011-2015	2016-18
Brunei Darussalam	410.8 (14)	2026.3 (11)	3046.2 (8)	983.7 (37)	1524.8 (19)	626.9 (36)
Cambodia	7.5 (128)	18.9 (124)	13.8 (142)	66.1 (125)	123.6 (110)	174.1 (86)
Indonesia	12.4 (106)	4.7 (155)	14.2 (139)	33.6 (145)	76 (129)	58.5 (121)
Lao PDR	8.4 (122)	14.9 (129)	3.4 (175)	39.9 (139)	87.4 (125)	190.2 (84)
Malaysia	259.2 (24)	219.7 (50)	119.7 (77)	238.9 (86)	367.8 (61)	304.4 (64)
Myanmar	4.4 (135)	11.4 (138)	11.5 (145)	32.2 (146)	23.1 (163)	68 (115)
Philippines	16.7 (97)	21.4 (121)	11.4 (147)	23.5 (157)	33.3 (148)	70.2 (114)
Singapore	1930.8 (3)	3562.4 (4)	3701.3 (6)	6924.2 (6)	10783.5 (6)	13269.1 (4)
Thailand	32.4 (80)	75.3 (77)	85.1 (91)	136.2 (109)	107 (113)	90.7 (106)
Viet Nam	15 (102)	23.1 (117)	18.7 (134)	79.5 (118)	99.9 (118)	147.2 (90)

Note: Highlighted cells indicate where Indonesia features among the top 3 performers in ASEAN.
Source: UNCTAD FDI Statistics.

Much of the growth in inward FDI observed recently, notably since 2010, can be explained by the widespread growth of FDI worldwide (Figure 3.1). Indonesia's competitiveness factor in attracting FDI, measured as the difference between the actual change in FDI stock and the expected change in FDI stock had the FDI stock of each of its industry grown at the world industry FDI growth rate, was actually negative over the 2010-2018 period, denoting a loss of competitiveness in world FDI markets. Essentially, had Indonesia's competitiveness been sustained over the period and other factors held constant, its share in world FDI markets would have remained constant over time. But global FDI in industries holding a prominent share of Indonesia's FDI stocks has grown faster than in Indonesia. This is the case of manufacturing and services, for example.

Figure 3.1. A Shift-Share Decomposition of Indonesia's FDI inward stock growth, 2010-18

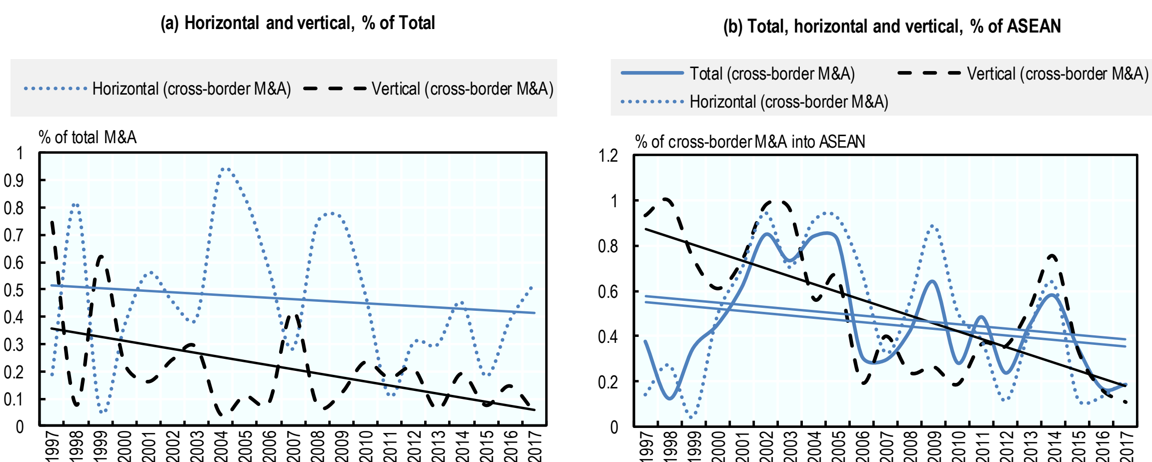


Note: see Annex 3.A. Technical Notes.
Source: author's elaboration, based on various data sources (see Annex 3.A. Technical Notes).

Location-based investments in extractive industries and agricultural activities, and to a lesser extent, domestically-oriented investments, such as in construction activities, have fared better, but these have not allowed Indonesia to compensate for its loss of market shares in worldwide FDI. Particularly, and in contrast to the upward trend observed in the other ASEAN Member States collectively, Indonesia seems to be failing to attract the more efficiency-seeking type of investments. This is partly exemplified by the downward trend observed in vertical cross-border mergers and acquisitions of Indonesian firms as a share of all cross-border deals targeting Indonesia (Figure 3.2, panel a) and ASEAN firms (Figure 3.2, panel b). While investment projects might often serve multiple purposes, investments where efficiency-seeking

motives prevail tend to be more export-oriented and typically outperform domestically-oriented FDI in a number of key development outcomes, such as labour productivity and wages, innovation capacity and invested capital (World Bank, 2019), although sometimes these may not translate into greater linkages and spillovers to the domestic economy.

Figure 3.2. Trends in horizontal and vertical FDI in Indonesia: 1997-2017



Note: see Annex 3.A. Technical Notes.
Source: author's elaboration, based on Dealogic Merger & Acquisitions data.

Hosting efficiency-seeking FDI is also a signal of the quality of the business environment as these investors are also more footloose. They are typically more sensitive to investment climate conditions because they seek to explore plant-level economies of scale, such as factor costs savings, besides vertical integration and other location-based opportunities associated with market access and geographical distribution, institutional arrangements and economic policies allowing the firm to rationalise its operational structure. Realising these potential gains, however, depends on the extent of costs arising from the fragmentation of the value chain, such as international trade costs and technical efficiency losses. The more efficient is the co-ordination and the business environment (e.g. in terms of obtaining licenses and permits, trading across borders, paying taxes, enforcing contracts etc.), the higher are the relative returns, and the higher is a location's competitiveness and attractiveness to investors.[2]

Foreign investors have long been somewhat cautious about Indonesia's complex business environment, not least because of remaining FDI restrictions and entry conditions discussed in the next section, such as foreign shareholding limitations and local content requirements, which might impinge on their ability to operate efficiently. But they are also concerned about the prevailing heavy bureaucracy and decision-making processes for obtaining needed approvals, licences and permits from authorities at all levels of government (see Chapter 4, Chapter 6 and Chapter 7) which have, together with the strong role of SOEs in the economy and the still strong political appetite for 'economic and resource nationalism' (see Chapter 1), added to keeping some investors at bay at times.

The recent Sino-US trade tensions, which led to the relocation of some export-oriented investments out of China, once again drew attention to Indonesia's challenges in attracting FDI. Anecdotal evidence and analysts seem to suggest that relocating investors have largely overlooked Indonesia in preference for some of its regional peers, such as Viet Nam, Thailand and Malaysia (JETRO, 2020, Nomura, 2019), although more recently several factories have announced plans to relocate production to Indonesia (Jakarta Post, 2020a, 2020b). The situation prompted a strong reaction from President Joko Widodo, who called out members of his cabinet for the country's failure to capture a 'fair share' of such relocations (Jakarta Globe, 2019; Katadata, 2019).[3]

Box 3.1. Global value chains and FDI

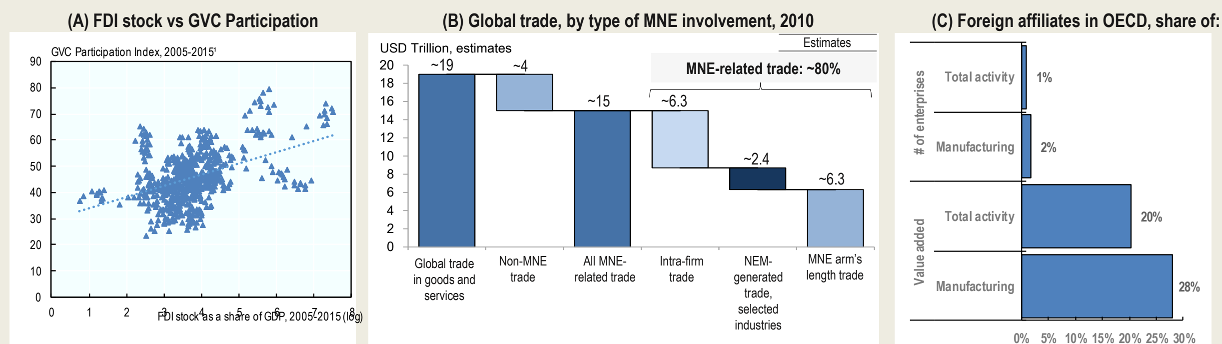
FDI restrictions might be further contributing to limited GVC development in Indonesia

GVCs have become an important driver of productivity and economic growth across countries, both in developed and developing countries (OECD, 2015b; World Bank, 2019; Kowalski et al., 2015). The increased international fragmentation of production processes associated with GVCs can be observed in the significant growth in intermediate goods and services trade in the past decades. Recently, more than 70% of world service imports were estimated to be intermediate services, and more than 50% of world manufactured imports were intermediate goods (OECD, 2013). Now more than ever firm competitiveness, and consequently that of countries, depends as much on the capacity to access cheaper, more differentiated world-class quality inputs as on the capacity to export – in other words, countries import in order to export successfully.

Multinational enterprises (MNEs) play a central role in GVCs, with a large share of cross-border trade taking place within affiliated networks (Figure 3.3). UNCTAD (2013) estimates that MNEs account for about 80% of global trade in goods and services, about 42% of which is intra-firm trade (Figure 3.3, Panel B). Cadestin et al. (2019) estimates a smaller participation but nonetheless important: roughly one half of international trade. FDI is therefore an important channel through which countries integrate and benefit from GVCs (Figure 3.3, Panel A). MNEs and their foreign affiliates are typically only a small fraction of the enterprise population but play a much greater role in terms of outcomes, partly because they are typically engaged in more capital- and scale-intensive industries (Figure 3.3, Panel C; OECD, 2013 and 2019). They usually account for a large share of exports and value added, and while part of the value added created may be repatriated, the rest stays in the host country in the form of labour compensation, taxes and reinvestments.

Depending on how strongly they are integrated into domestic economies, MNEs also represent a source of access to international markets and new technologies for their domestic suppliers and buyers, including SMEs, besides contributing to knowledge spillovers for domestic value chains. Every USD 1 of extra sales by foreign affiliates generates, on average, another USD 0.62 for the domestic economy in which they are located (Cadestin et al., 2019).

Figure 3.3. The importance of FDI in global value chains



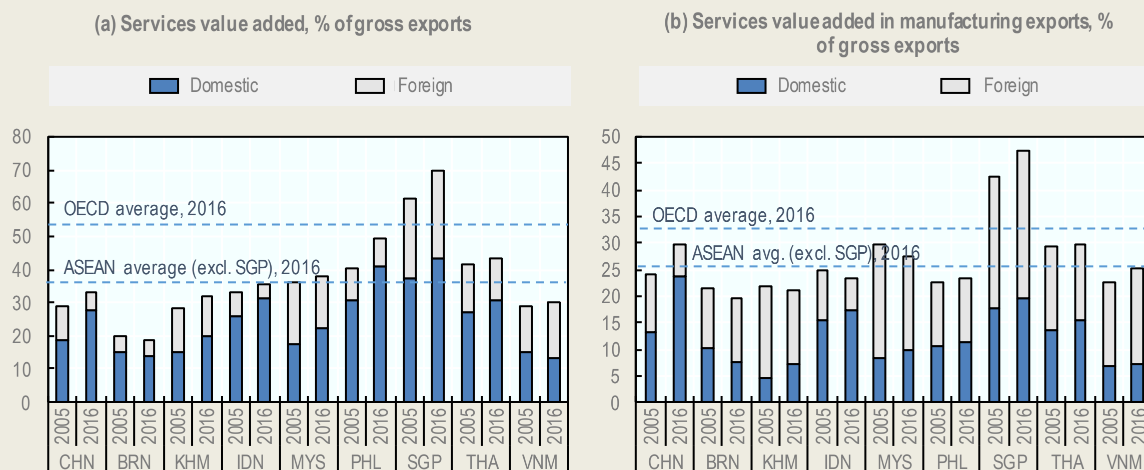
Note: [1]GVC participation index refers to the share of foreign inputs (backward participation) and domestically produced inputs used in third countries' exports (forward participation) in a country's gross exports. See Koopman et al. (2010) for more information.
Source: OECD (2014); UNCTAD statistics; UNCTAD (2013) and OECD AMNE Statistics (data for 2014).

The performance of service sectors plays an important role in this context. Services are a significant channel for value added generation in the context of GVCs. Worldwide, while the share of services in

gross exports is relatively small, service sector activities contribute almost half of the value added inputs to exports (De Backer and Miroudot, 2013). In ASEAN, despite recent improvements, services value added embodied in exports, whether supplied locally or imported, remain subdued (38% excluding Singapore) compared to the OECD average (54%). In Indonesia, the share of services valued added in gross exports stood at 36% in 2016 (Figure 3.4, Panel A).

In addition, services play an increasingly important role in value added generation in manufacturing activities, either as inputs for production of manufacturing goods or corporate services activities within firms, as well as bundled together with goods sold (Miroudot and Cadestin, 2017). This "servicification" of manufacturing activities is clearly evidenced when one looks at the decomposition of value added embodied in manufacturing exports (Figure 3.4 Panel B). In OECD economies for instance, services inputs account for about 33% of the value added embedded in manufacturing exports, and adding the in-house provision of services in manufacturing firms, the share of services in manufacturing exports increases to 50% (Miroudot and Cadestin, 2017). In ASEAN (excluding Singapore) and Indonesia, the share of services value added embedded in manufacturing exports (excluding in-house services) stands at 26% and 23%, respectively. In OECD economies, about 90% of the embedded services value added is domestically generated. In Indonesia: about 75% is domestically produced by Indonesian or foreign-owned companies established in Indonesia; the rest is imported. This is remarkably high in comparison to other AMS and can be principally explained by Indonesia's exports being largely driven by natural-resource based industries, such as food products and chemicals and minerals, which make use of Indonesia's raw materials and domestic distribution and transport services throughout the chain.

Figure 3.4. Services value added share of exports and of manufacturing exports



Note: Domestic refers to the share of value added produced in the country either by locally-owned services providers or foreign affiliates in the country. Foreign refers to the share of imported value added from service providers located abroad. Service industries include construction, wholesale and retail, hotels and restaurants, transport and communications, finance, real estate and business services as well as public services, *i.e.* ISIC Rev.4 Divisions 41 to 98.
Source: OECD TiVA database.

Without a more thriving business environment for foreign investors, Indonesia might miss out on potential development opportunities associated with global value chains (Box 3.1). GVCs have become an important driver of productivity and economic growth across countries, both in developed and developing countries (OECD, 2015b; World Bank, 2019; Kowalski et al., 2015); and services sectors, which still largely restrict FDI in Indonesia, play an important role in this context as they account for a significant share of value added in the context of GVCs. The extent to which countries can provide the necessary conditions for

global production networks to operate efficiently at each stage of the production chain, including in relation to access to world-class services inputs, is, therefore, a key determinant of their success in linking to and upgrading within GVCs.

FDI restrictions in service sectors in this context might deter GVC integration and development by hampering the development of competitive services and downstream manufacturing activities. Statutory restrictions on FDI (e.g. foreign equity limitations and discriminatory screening and approval mechanisms) are found not only to have a significant negative effect on a country's ability to attract FDI (Mistura and Roulet, 2019; Fournier, 2015; Nicoletti et al., 2003), there is also evidence that consumers and manufacturing sectors are also negatively affected by FDI restrictions in services sectors. Restrictive services regulations typically enable service providers to charge higher mark-ups in a majority of service sectors, affecting downstream activities and end-consumers (Rouzet and Spinelli, 2016).

This has economy-wide productivity implications given the increased importance of services as inputs for downstream manufacturing industries (Box 3.2). Previous OECD (2019a) work, for instance, demonstrates that ASEAN manufacturing firms in industries relying extensively on services, such as in machinery and transport equipment industries, would greatly benefit from further services FDI liberalisation. Such productivity benefits are greater for SMEs and for domestic market oriented and domestically-owned firmsthan for large, export-oriented and foreign-owned firms. Service sector reforms could also translate into significant economic gains in the long run. The IMF (2018) estimates that Indonesia's potential long-term real GDP gain from reducing trade and FDI restrictions to the global average would amount to roughly 10% in the medium-to-long term. Nearly 6 percentage points is attributable to FDI liberalisation in the estimation.

Box 3.2. Services reforms raise manufacturing productivity

Recent empirical literature has identified a clear association between services reforms and productivity growth in the economy as a whole; as well as specifically in manufacturing (Low, 2016). A study of 15 OECD countries illustrates that anti-competitive upstream regulations in services and other non-manufacturing sectors curbed multi-factor productivity growth in downstream sectors between 1985 and 2007 (Bourlès et al., 2010). A recent study of Lao PDR confirms that services liberalisation benefits economic development across economic sectors, not just in services (Isono and Ishido, 2016).

Focusing on manufacturing, Duggan et al. (2013) employ the OECD FDI Index to assess the effects of FDI restrictions in services on the manufacturing productivity of Indonesian firms and find that service sector FDI liberalisation accounted for 8% of the observed increase in Indonesian manufacturers' total factor productivity (TFP) from 1997 to 2009. Shepotylo and Vakhitov (2015) analyse the impact of services liberalisation on manufacturing productivity in Ukraine over 2001-07 and find that a one standard deviation in liberalisation in services is associated with a 9% increase in the TFP of manufacturing firms. The authors also find that the effect of services liberalisation is stronger for domestic and small firms. Arnold et al. (2012) find that India's policy reforms in banking, telecommunications, insurance and transport services all had significant and positive effects on the productivity of Indian manufacturing firms from 1993 to 2005. Both foreign and domestic firms benefited from services reforms, but the effects were stronger for foreign-owned firms. A one standard deviation increase in services liberalisation resulted in a productivity increase of approximately 12% and 13% for domestic and foreign manufacturing firms, respectively. Relatedly, Berulava (2011) finds that liberalisation in telecommunications, electric power, transport, water distribution and banking stimulated the expansion of export activities of manufacturers in 29 transition economies from 2002 to 2009.

These findings are qualified by a recent study that argues that the effect of restrictions in upstream services is conditional on institutional quality (Beverelli et al., 2015). Using sector-level data in a panel dataset of 58 countries spanning all stages of economic development, the study finds that countries

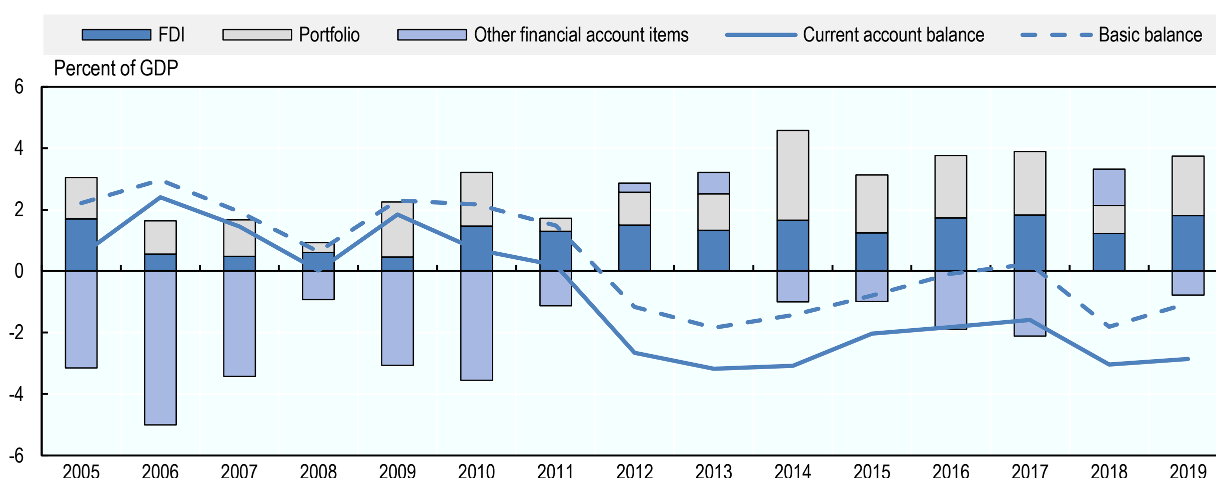
with better economic governance benefit more from open services policies. That is, higher quality institutions attract more productive service providers and support higher levels of services performance, which then affect downstream manufacturing sectors.

A number of studies also show a positive association between FDI in services and manufacturing productivity. Arnold et al. (2011) illustrate that increased foreign participation in services improved manufacturing productivity in the Czech Republic from 1998 to 2003. A one standard deviation in foreign presence in services is associated with an approximately 8% increase in the productivity of Czech manufacturing firms relying on services inputs. Fernandes and Paunov (2012) conduct a similar study on the effects of FDI in services sectors on the productivity of Chilean manufacturing firms between 1995 and 2004. A one standard deviation increase in service FDI would increase Chilean firms' TFP by 3%, and forward linkages from FDI in services explain 7% of the observed increase in the TFP of Chile's manufacturing firms during the period. Forlani (2012) finds that increased competition in network services in France improves the productivity of manufacturing firms.

Source: reproduced from OECD (2019a).

By limiting Indonesia's ability to attract more FDI, restrictions also have implications for the financing of Indonesia's current account deficit observed recently (Figure 3.5). Since 2012, the current account has had an average negative balance equivalent to 2.5% of GDP, mostly due to a deterioration of Indonesia's goods trade balance.[4] The basic balance has also turned negative since then as FDI has not been enough to cover the current account deficit, meaning that Indonesia has become more dependent on more volatile portfolio investments for the financing of its current account deficit. In this respect, the sharp reversal of portfolio investments in emerging economies following the COVID-19 outbreak, combined with an expected slowdown on FDI worldwide (OECD, 2020a; 2020b; 2020c), might become a further challenge for Indonesia, although financing pressures might be attenuated by a small reduction in the current account deficit according to World Bank (2020a) projections.

Figure 3.5. Indonesia's current account financing structure (% of GDP)



Note: Basic balance refers to the sum of the current account balance and net FDI.
Source: International Monetary Fund, Balance of Payments and World Economic Outlook (October 2019) Databases.

Overall, even if restrictions may not deter some investments altogether, they might affect the nature of the FDI coming to Indonesia. Joint-venture requirements, for instance, raise the issue of finding suitable local partners with adequate capacity and skills and of guarding against undue technology appropriation by

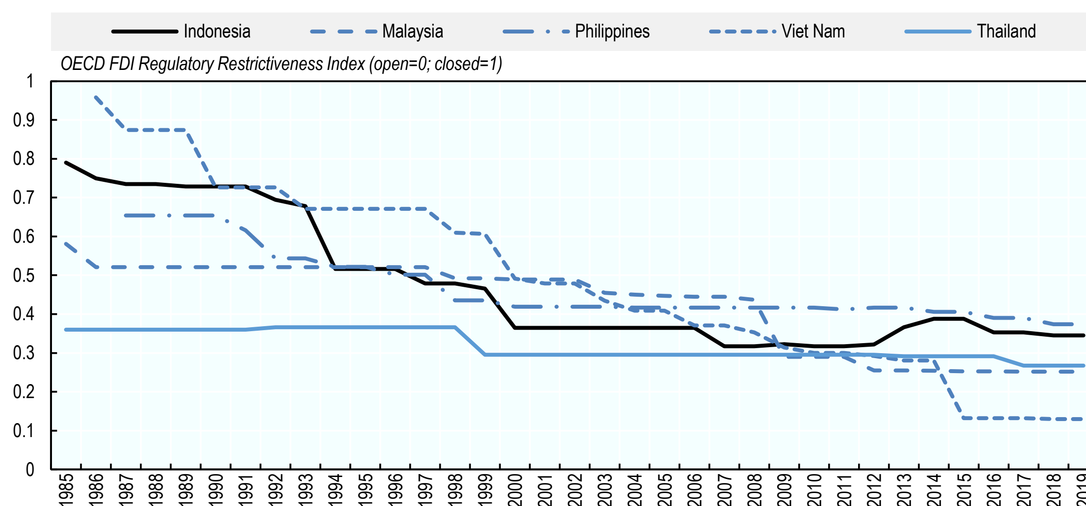
partners and competitors. This, at times, may end-up reducing the potential surplus of a project by inducing the inefficient use of local resources or by simply limiting their potential spillovers vis-à-vis the case where no conditions are imposed. Foreign investors may opt for deploying older technologies and production techniques as compared to the international industry frontier when faced with foreign equity restrictions or joint-venture requirements (Moran, Graham and Blomström, 2005).

All the potential implications of FDI restrictions discussed above reinforce the importance of weighing their benefits against the costs on a regular basis and in light of the country context and circumstances. The right of governments to favour some investors over others in order to achieve social, economic or environmental goals is widely accepted, but any policy that discriminates against one group of investors involves a cost. Discriminatory measures against foreign investors can thus only serve the broader public interest to the extent that their potential costs in terms of forgone FDI and potential efficiency gains are compensated by broader social and economic benefits. For this reason, they should be constantly re-evaluated to determine whether their original motivation remains valid and their scope remains proportional to their public intent so to ensure that any potential costs are not greater than needed (OECD, 2015a).

Despite significant liberalisation in the past, Indonesia's foreign investment regime remains quite restrictive

Seen from a broad perspective, Indonesia has significantly liberalised restrictions on international investment over time, albeit at a slower pace and with some occasional relapses more recently (Figure 3.6). Yet, Indonesia still remains quite restrictive to FDI according to the OECD FDI Regulatory Restrictiveness Index (Figure 3.7; Box 3.3). Governments all over the world discriminate among investors in one way or another, sometimes deliberately, sometimes unwittingly. But the extent of FDI regulatory restrictiveness observed in Indonesia is by far greater than in most other emerging and developing countries and is even higher than in some of its direct ASEAN peers, such as Thailand, Malaysia and Viet Nam.

Figure 3.6. OECD FDI Regulatory Restrictiveness Index: a historical perspective, 1985-2019

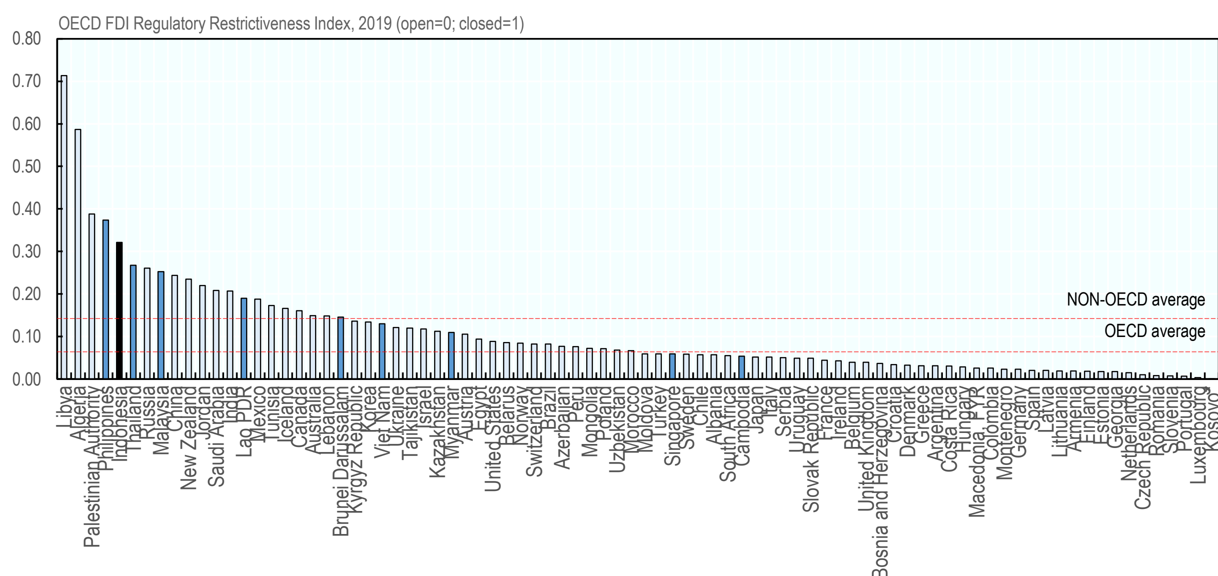


Note: The OECD *FDI Regulatory Restrictiveness Index* covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other important aspects of an investment climate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

The current investment negative list (DNI) of May 2016 has only modestly helped to bring Indonesia's FDI regime closer to international and regional levels of openness, although it has played a key role in restating Indonesia's willingness to attract foreign investment. The list sets out the business fields closed to investment and those open with conditions, including in relation to foreign ownership limitations, location requirements, special licensing requirements, businesses reserved for 100% domestic (Indonesian) ownership and in which higher foreign ownership thresholds apply for ASEAN investors. It came at a critical moment as the previous negative list issued in 2014 revealed a more ambivalent sentiment towards foreign investment by the government.

Despite some liberalisation, the 2014 list overall reversed some past achievements by making foreign investment in some key sectors, such as mining, more restrictive. Meanwhile key regional peers and competitors continued to open their economies to foreign investors, leaving Indonesia relatively less attractive as an investment destination. The 2016 list was, thus, an important breakthrough as it signalled again a more positive attitude towards foreign investment, notably by lifting foreign ownership caps on 45 business lines (*e.g.* toll roads, tourism-related activities and e-commerce) and easing foreign equity restrictions in some other key service sectors (*e.g.* warehousing, distribution and transport).

Figure 3.7. OECD FDI Regulatory Restrictiveness Index, 2019



Note: See note to Figure 3.6 above.
Source: OECD *FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

However, the list still places limits on foreign-equity participation and prohibits foreign investment altogether either in a wide range of activities spanning agriculture, fisheries, mining and quarrying, manufacturing, power generation, construction, distribution, banking, insurance and other financial services, hotels and restaurants, media, telecommunications and transport sectors. Many activities are reserved exclusively for domestically-owned micro, small and medium enterprises (MSMEs) as well.

Box 3.3. Calculating the OECD *FDI Regulatory Restrictiveness Index*

Covering roughly 80 countries, the OECD *FDI Regulatory Restrictiveness Index* seeks to gauge the restrictiveness of a country's FDI rules. It is not a standalone measure of a country's investment climate, as it does not cover many other aspects of the investment regulatory framework which may impinge on the FDI climate, nor does it capture the actual implementation of formal restrictions. Nonetheless, FDI rules are a critical determinant of a country's attractiveness to foreign investors and the Index, used in combination with other indicators measuring various aspects of the FDI climate, contributes to assessing countries' international investment policies and to explaining the varied performance across countries in attracting FDI.

The *FDI Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial and professional services). Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a simple average of individual sectoral scores. For a detailed description of the scoring methodology, please refer to the technical working paper by Kalinova et al. (2010).

For each sector, the scoring is based on the following elements:

- the level of foreign equity ownership permitted,
- the screening/approval procedures applied to inward foreign direct investment;
- restrictions on key foreign personnel; and
- other restrictions, e.g. on land ownership, corporate organisation (branching).

The measures taken into account by the *Index* are limited to statutory restrictions on FDI typically reflected in official OECD instruments on investment or identified in OECD *Investment Policy Reviews* and yearly monitoring reports. The *FDI Index* does not assess actual enforcement and implementation procedures. The discriminatory nature of measures, *i.e.* when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored. Preferential treatment for special-economic zones and export-oriented investors is also not factored into the *FDI Index* score, nor is the more favourable treatment of one group of investors as a result of preferential treatment under international agreements.

The government's expressed intention to massively revise Indonesia's FDI regime in the context of the Omnibus law reform on job creation is, therefore, a timely and welcome step for increasing Indonesia's appeal to international investors. The last significant FDI liberalisation dates back already to the early-1990s and early-2000s, driven, as historically the case in Indonesia, by the difficult economic contexts that marked those eras (Box 3.4). These allowed Indonesia to catch up somewhat in terms of openness to FDI with some of its regional peers during the 2000s, but its relative competitiveness has been eroding since then as others continued to progress with reforms more intensively.

Box 3.4. Historical perspective of FDI reforms in Indonesia

Indonesia's FDI reforms have traditionally been influenced by crisis and external pressures, rather than from political conviction and support for more open investment policies. In the late-1990s and early 2000s, FDI liberalisation, particularly in the banking sector and for acquisitions of local firms, was contemplated in the context of economic recovery from the Asian Financial Crisis, but seen from a longer term perspective the crisis merely served to speed up a process which was already under way. In the mid-1990s, it was the increased competition from China for FDI , together with a significant decline in Japanese FDI in Indonesia, that exerted considerable pressure on the Indonesian government to step up FDI liberalisation efforts that had started nearly a decade earlier, when the need for foreign exchange and capital mounted with declining oil revenues and the appreciation of the yen (a large portion of Indonesia's external debt was denominated in yen) (OECD, 1999; Conklin and Lecraw, 1997).

Unlike some of its regional peers, such as Malaysia and Thailand, it was not until the mid-1980s that Indonesia came to appreciate the potential role of FDI for its economic development and started to adopt a consistently more open policy stance on foreign investment. Previously, an early attempt to create a more favourable environment to FDI had occurred in the late 1960s with the promulgation of the first Foreign Investment Law (1967), following from the deep economic crisis that gulfed Indonesia during that decade. But this was quickly reversed in the 1970s and early 1980s when the government, facilitated by increased oil income, turned again to more inward-looking policies and placed increasingly severe conditions on inward investment.

Then, in the 1980s, when economic conditions deteriorated again, the government began to contemplate more thoroughly the potential role of FDI for Indonesia's economic development and to adopt more friendly policies towards foreign investment. Starting in 1986, limits on foreign ownership for export-oriented investments were first relaxed and investment licensing procedures were made easier in order to attract foreign capital. Various other policy packages opening up the Indonesia economy to FDI were adopted in the following years, culminating in 1994 with the most significant liberalisation package ever implemented.[5] This marked a major change in the government's FDI policy orientation (OECD, 1999; Conklin and Lecraw, 1997).

This time again, although not emerging from the current global crisis, Indonesia's FDI reform will likely be influenced by the challenging global economic context. Time will tell what sort of impact the pandemic will have on industries and firms' FDI strategies and behaviour going forward. Some expect FDI to become scarcer as more and more firms and government policies will turn to re-shoring or near-shoring strategies as a solution for possible value chain disruptions in the future. Others see in further off-shoring and FDI an increased opportunity for diversification and supply chain resilience, by avoiding putting 'all the eggs into one basket'. There is some evidence supporting the latter from past supply chain disruptions arising from natural disasters (Miroudot, 2020). Whichever the case, the global economic slowdown will put considerable strain on firms' abilities to pursue FDI projects in the near term.

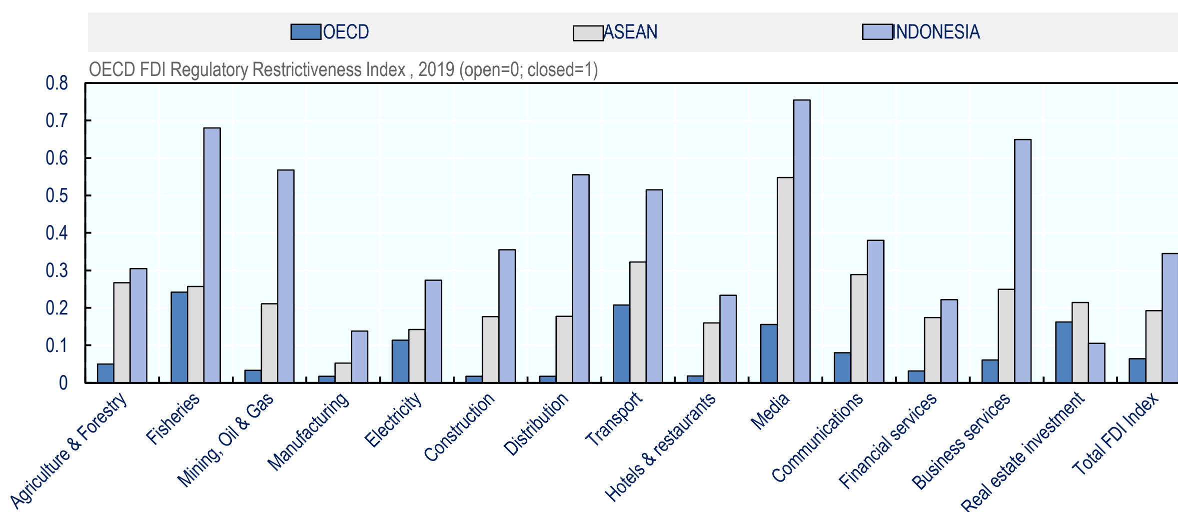
Probably more than ever, FDI reforms will have to be compelling for boosting, or even preserving, Indonesia's attractiveness to FDI in such times. The OECD (2020a) projects a 4.5% contraction of the global economy in 2020 and estimates (2020c) global FDI flows will fall by more than 30% in 2020 even under the most optimistic scenario for the success of the public health and economic support policy measures taken by governments to address the COVID-19 pandemic and the resulting recession (see Chapter 2). In the past, FDI generally responded positively to Indonesia's liberalisation efforts (OECD, 2010). But this may prove particularly difficult this time considering the scale and magnitude of the current crisis. Even holding on to existing FDI might prove a challenge. Without reforms, however, Indonesia

remains at a relative disadvantage and the chances of attracting needed FDI quickly for the recovery following the pandemic could be slight.

Discriminatory measures against foreign investors harm domestic consumers, as well as firms in downstream industries

Manufacturing has been widely liberalised, but many primary and service sectors remain partly off limits to foreign investors, holding back potential economy-wide productivity gains (Figure 3.8). Restrictions in place often exceed considerably the ASEAN average. In the primary sector, the relatively high level of restriction is mostly due to the outright prohibition on foreign investment in commercial capture fishing activities in Indonesian territorial waters and the open sea, and the various equity limitations on foreign investment in oil & gas activities and in mining, where foreign investors additionally face divestment obligations and more or less stringent ownership limitations depending on whether processing or purification activities, or both, are carried out.

Figure 3.8. OECD FDI Regulatory Restrictiveness Index, by sector: Indonesia vs. ASEAN vs. OECD, 2019



Note: See note to Figure 3.6 above.
Source: *OECD FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

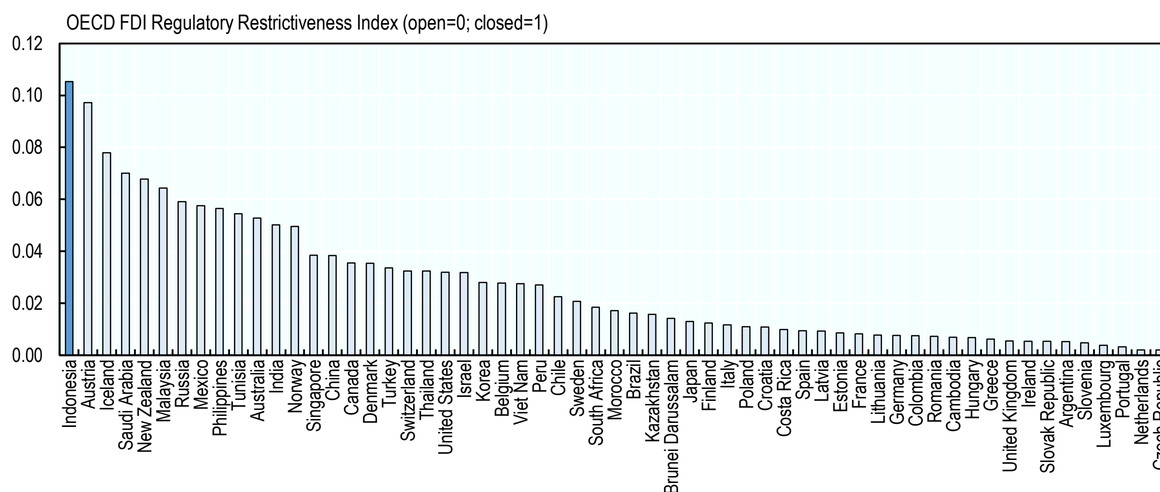
Services liberalisation has typically lagged behind that of manufacturing almost everywhere, including in OECD countries, finding strong resistance in domestic interest groups. But by shielding domestic service providers from foreign competition, Indonesia has implicitly been favouring local service providers over domestic consumers and manufacturing firms relying increasingly on services inputs for their activities. As discussed in the section above, FDI restrictions, even partial ones, impose additional costs on FDI entry and make the services sector overall less efficient by limiting competition and contestability, which translates into higher input prices for downstream activities and end-consumers.

Manufacturing industries in Indonesia are among the most affected worldwide by FDI restrictions in services sectors (Figure 3.9). This is because local manufacturers rely quite extensively on inputs from domestic services sectors relatively more insulated from foreign competition than elsewhere. Maintaining

such a high level of restrictiveness in services sectors imposes a sizeable cost on manufacturing sectors. In line with the evidence available for other countries, Duggan et al. (2013) estimate that about 8% of the observed increase in Indonesian manufacturers' total factor productivity over 1997-2009 can be explained by the relaxation of FDI restrictions in services throughout the period.

This is ever more pressing given the level of ('premature') de-industrialisation, which has steadily shrunk more than 10 percentage points as a share of GDP over the last decade and a half and which may weigh heavily on Indonesia's ambition to become a high-income economy in the medium-term (Rodrik, 2015). The decline in competitiveness is particularly visible in exports markets, which have seen total exports of goods and services halve to 20% of GDP since 2000, largely due to a reduction in manufacturing exports (World Bank, 2018).

Figure 3.9. Services FDI restrictiveness impinging on manufacturing activity, 2019



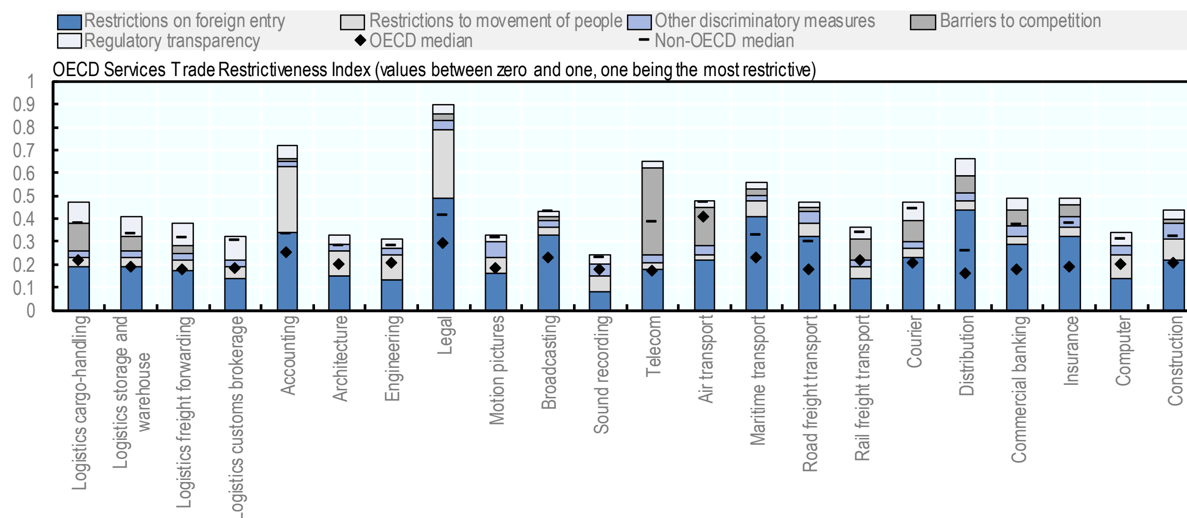
Notes: see Technical Notes.
Source: author's elaboration based on the OECD FDI Regulatory Restrictiveness Index, the OECD Input-Output Tables 8 Edition.

Barriers to entry are only one part of the story in services sectors. The development of efficient services depends as much as on policies that eliminate discrimination and barriers to entry and allow for greater competition and contestability pressures, as on policies that promote an efficient regulatory environment behind the borders for all firms in the sector. A more granular analysis of the domestic regulatory regime in services is beyond the scope of this review, as services sectors are quite diverse and would require a more industry-specific approach. But it is worth noting that Indonesia maintains a fairly stringent regulatory regime in services sectors overall, including beyond market access barriers (Figure 3.10). In almost all 22 services sectors assessed by the OECD Services Trade Restrictiveness Index, Indonesia appears as more restrictive than the average of OECD and non-OECD economies covered. And while restrictions on foreign entry are particularly dominant, the level of restrictiveness observed in other behind-the-border policy dimensions important for services development, such as measures related to the movement of people, barriers to competition, regulatory transparency and other discriminatory measures that affect the ease of doing business, is also considerable.

Furthermore, with services being increasingly traded online, a trend that is likely to accentuate in the post covid-19 context, regulatory barriers in sectors like telecoms risk derailing the potential gains from digitalisation going forward. As portrayed in the new OECD Digital Services Trade Restrictiveness Index, regulatory barriers to digitally enabled services have been trending upwards in many countries in the past years and, while this is not the case for Indonesia, it maintains one of the most restrictive frameworks for

digital services trade among the countries covered in the index (Ferencz, 2019). Such barriers may hold back innovation and create obstacles for possible spillover effects to other services, like business or audio-visual services. Information, communication and technology backbone infrastructure is also a core input to modern logistics management and GVCs (e.g. the ability to track and trace shipments is critical for just-in-time production), much like other infrastructure such as transport and warehousing. As such, accompanying reforms to behind-the-border services regulations should go hand in hand with FDI liberalisation for these to fully bring about their potential benefits.

Figure 3.10. OECD Services Trade Restrictiveness Index, by sector and policy area, 2019

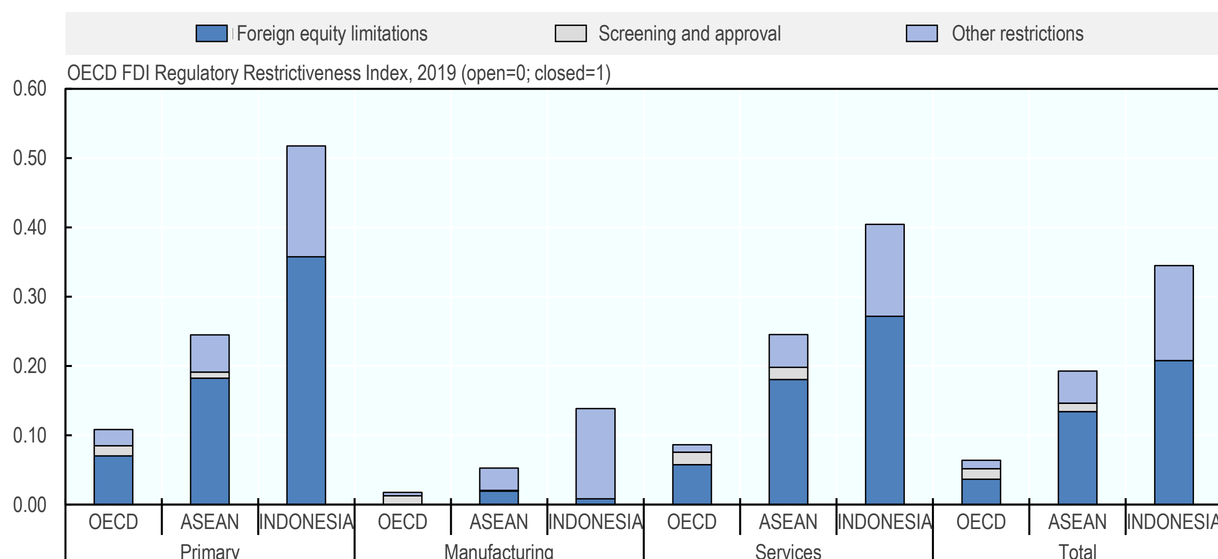


Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 37 OECD Members, Brazil, China, Costa Rica, India, Indonesia, Malaysia, Russia, South Africa and Thailand. The STRI database records measures on a Most Favoured Nation basis. Preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people).
Source: OECD Services Trade Restrictiveness Index, http://oe.cd/stri.

Foreign equity restrictions are the most prevalent type of barrier to FDI, but other operational measures are unusually pervasive in Indonesia

As for most countries, foreign equity restrictions are the most prevalent type of barrier to FDI in Indonesia (Figure 3.11), reflecting both a relatively extensive incidence of such measures across sectors and their stringency in terms of the level of foreign participation permitted.[6] This is particularly the case in primary sectors and in services where foreign shareholding limitations are far more prevalent than elsewhere. In manufacturing, foreign equity restrictions are limited and lower overall than in the average ASEAN economy. Indonesia also does not impose horizontal or sector-specific discriminatory investment screening and approvals for the admission of foreign investors, as is sometimes the case in ASEAN and a few OECD economies.[7]

Figure 3.11. OECD FDI Regulatory Restrictiveness Index, by type of restriction, 2019



Note: See note to Figure 3.6 above. Other restrictions groups together restrictions on key foreign personnel and other operational measures.
Source: OECD *FDI Regulatory Restrictiveness Index* database, http://www.oecd.org/investment/fdiindex.htm; See also the ASEAN FDI Regulatory Restrictions Database for information on the underlying measures captured in the Index, https://qdd.oecd.org/subject.aspx?Subject=ASEAN_INDEX.

Another salient feature of Indonesia's FDI regime is its discriminatory policy on minimum capital requirements for foreign-invested companies (PT PMA, Perusahaan Terbatas Penanaman Modal Asing). Except for investments in banking and oil & gas, Indonesia does not permit the establishment of local branches by foreign investors. All investments must be conducted through a locally incorporated company in the forms of a limited-liability company (PT) with foreign shareholding (PMA). Unless otherwise provided by specific legislation, an Indonesian-owned PT company shall have a minimum authorised capital of IDR 50 million, at least 25% of which must be issued and paid-up in full in accordance with Indonesia's Company Law 40/2007. A PT PMA, in turn, must invest at least IDR 10 billion, excluding land and buildings, of which IDR 2.5 billion (25%) must be issued and paid-up in full by the shareholders in order to start the business, according to BKPM's Regulation 1/2020 regarding guidelines and procedures for investment licensing and facilities.

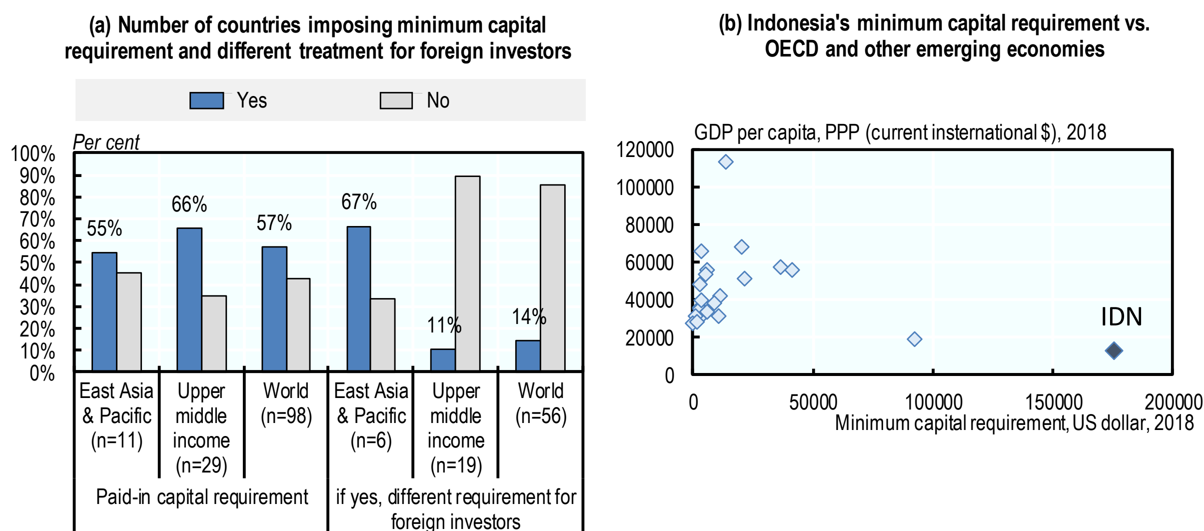
This is 200 times the minimum amount of paid-up capital required from domestic investors, and applies on top of any applicable foreign equity limitation, further restricting foreign participation to even larger undertakings in these sectors. It also precludes foreign participation in business fields reserved for MSMEs as the maximum legal threshold for being considered a medium-sized enterprise under the Law No. 20 of 2008 on MSMEs is IDR 10 billion, also excluding land and buildings used by the business, or having up to IDR 50 billion in revenues annually.

The use of discriminatory minimum capital requirements is somewhat more prevalent in East Asia but far less so in other parts of the world. According to the World Bank's Investing across Borders database (last available year is 2012), only eight countries (out of the 98) discriminated then between foreign and domestic investors in this regard, four of which are in the East Asia and Pacific region (Figure 3.12, panel a). The use of minimum capital requirements for general business activities[8], whether or not discriminatory, has declined considerably over the past decade. According to the World Bank (2014), 39 economies eliminated capital requirements in the preceding seven years, and many others never had them in the first place. Despite this, non-discriminatory minimum capital requirements remain a reality in many countries.

Out of 190 economies included in the World Bank's Doing Business 2020, 56 economies still required a minimum amount of capital to be paid-in by investors to register a business (World Bank, 2020b).

Where minimum capital requirements still exist, the amount required is typically much lower than what is required for foreign investors in Indonesia. This is the case even across economies with a level of income per capita much greater than that of Indonesia (Figure 3.12, panel b). The minimum paid-up capital requirement of not less than Rp 2.5 billion for a foreigner to be allowed to establish operations makes Indonesia an outlier in this respect.

Figure 3.12. Indonesia's minimum capital requirement policy in international comparison



Note: Data in Figure 3.12, panel b refer to minimum capital requirement for limited liability companies and was converted at the 2018 yearly average exchange rate. In addition to Indonesia, the figure covers another 25 OECD and large emerging economies applying minimum capital requirements for the establishment of limited liability companies as reported in the OECD *Services Trade Restrictiveness* database.
Source: World Bank's Investing Across Borders database (Panel a); OECD *Services Trade Restrictiveness* database, IMF International Financial Statistics and World Bank's World Development Indicators (Panel b).

Another restriction contributing to Indonesia's relatively higher scores across sectors as observed in Figure 3.11 is the relatively stringent system for employing foreigners in key management positions. It is worth noting that the measures captured in the OECD *FDI Regulatory Restrictiveness Index* do not encompass general foreign employment quotas and other restrictions not specifically affecting foreign investors' capacity to place foreigners in top executive-level positions. Measures taken into account in this respect also do not need to be discriminatory, *i.e.* they might apply equally to foreign and domestically-owned companies, but they are considered to be more burdensome to foreign investors and, thus, treated as a restriction under the *FDI Index*.

In spite of being relatively unimportant in the *FDI Index*, such restrictions are relatively more prominent in Indonesia's overall score because of the economy-wide scope of application of Indonesia's measures. While it is not uncommon for countries to impose general limitations on foreign employment that apply across sectors, these typically do not affect foreign investors' capacity to nominate foreigners to top executive level positions. The general legal framework in Indonesia requires a company to obtain prior government approval for engaging a foreign employee to whichever position, including that of a Director or Commissioner, unless the nominated person is also a shareholder of the company. In this case, the company is exempted from having to submit for approval an expatriate placement (known as RPTKA, Rencana Penempatan Tenaga Kerja Asing) plan for such purposes.[9][10] Additionally, foreigners are not allowed to hold certain top executive positions, including that of Human Resources Director and 'Chief

Executive Officer', which despite the term does not refer to the President-Director, but to the Head of the Office in the field of personnel and administration. While measures like these are unlikely to be a 'deal-breaker', they add to the overall cumbersomeness of business-related bureaucracy observed in Indonesia to date.

Public procurement legislation also discriminates against foreign investors. Indonesia accords preferential treatment to majority-owned Indonesian services suppliers in public procurement and the rule on public procurement of goods favours those companies partnering with Indonesian MSMEs, applying work, health & environmental safety standards and possessing management quality certificates in addition to meeting domestic component threshold levels in terms of goods and services inputs.[11] According preferential treatment to resident enterprises in public procurement is widely observed across countries, but discriminating against foreign-owned established firms in this respect is rather exceptional. As for other nationality-based discriminatory measures, these might hinder competition and contestability in the affected markets and may drive up costs of goods and services procured by the government.

Stringent local content requirements in some sectors add to the hurdles of carrying foreign investments in Indonesia

Data from the Global Trade Alert database suggest that Indonesia is the 7th country in the world with the highest number of local sourcing requirements imposed since November 2008 and in force as of end-2018. These apply on top of foreign equity restrictions discussed above and span various product groups (Table 3.2) in quite prohibitive manner in some cases. A brief description of selected measures in force can be found in Annex Table 3.B.1.[12] While local content requirements tend not to discriminate against foreign-owned firms established in the country, and in which case they are not considered a FDI restriction under the *OECD FDI Regulatory Restrictiveness Index*, they may still discourage FDI by establishing hard to achieve local requirements that restrain competition from imports, which might contribute to higher production costs and ultimately higher prices to downstream industries and consumers. Potential short-term gains in the targeted industry can, therefore, act as a drain on the rest of the economy. The costs in terms of forgone investments might also not necessarily be compensated by improved local development outcomes if any, such as increased employment, investment and technology transfer.

The literature on the potential effects of local content requirements is extensive, and while there may be situations where these policies could potentially increase domestic welfare depending on market characteristics (e.g. potential learning and technological spillovers, economies of scale etc.), the overall evidence suggest that they tend to lead to suboptimal allocation of resources (Stone et al., 2015; OECD, 2019b; Deringer et al., 2018). There is some evidence indicating that this may be the case in Indonesia. Local content policies seem to be negatively affecting not only foreign investments in Indonesia but also domestic investments (World Bank, 2017). Besides indicating that investors face difficulties in meeting some of the requirements, it suggests that such measures have had a limited crowd-in effect and have potentially failed to spur further technology spillover to domestic parties. Negara (2016) also finds that local content policies in Indonesia may adversely affect industrial performance and thus competitiveness.

In pursuing such objectives, horizontal policies addressing deficiencies of the business and regulatory environment, trade and investment barriers, innovation policy, and infrastructure development, can offer an alternative to local content policies and have less negative economy-wide effects on output, exporting industries and jobs (OECD, 2019b).

Table 3.2. Product groups affected by local sourcing requirements in Indonesia

UN Central Product Classification v2.1: 3-digit product groups
Computing machinery and parts and accessories thereof
Parts for the goods of classes 4721 to 4733 [TV, radio and telephone equipment] and 4822 [radar and radio apparatus]
Motor vehicles, trailers and semi-trailers; parts and accessories thereof
Other transport equipment and parts thereof
Agricultural or forestry machinery and parts thereof
Machinery for mining, quarrying and construction, and parts thereof
Television and radio transmitters; television, video and digital cameras; telephone sets
Pharmaceutical products
Specialised store retail trade services
Accommodation services for visitors
Other accommodation services for visitors and others
Weapons and ammunition and parts thereof
Food serving services
Beverage serving services
Internet telecommunications services
Medical and surgical equipment and orthopaedic appliances
Non-specialised store retail trade services

Note: The list of sectors reflect local sourcing requirements introduced since November 2018 and still in force as of end-2018. Product classes 4721 to 4733 belong the following product groups: 472 - Television and radio transmitters; television, video and digital cameras; telephone sets; 473 - Radio broadcast and television receivers; apparatus for sound and video recording and reproducing; microphones, loudspeakers, amplifiers, etc. Product class 4822 refers to: Radar apparatus, radio navigational aid apparatus and radio remote control apparatus.
Source: Global Trade Alert, https://www.globaltradealert.org/.

The Omnibus Law on Job Creation: market access issues for consideration

Indonesia has been active in improving the business environment for both foreign and domestic investors since the early 1990s. Since then, numerous economic reform packages have sought to make the private sector the engine of growth and sustainable development. Economic and FDI liberalisation played an important role in the early days. In the 2000s, efforts focused predominantly on legislative changes improving the overall regulatory and institutional environment across all economic areas. In the field of investment, the 2007 Investment Law was an important landmark. It unified the previously distinct foreign and domestic investment laws and increased the transparency of Indonesia's policy framework for investment, including by clarifying which sectors were closed or partly open to foreign and domestic investors (OECD, 2010).

Since the current administration first took office, there has been a further push for business climate improvements, particularly in terms of reducing red tape. Recognising that high administrative costs reduce productivity and are an avenue for corruption and informality, the government initiated business licensing and investment facilitation reforms to ease the process of starting and operating a firm. For this, successive measures intending to improve transparency, streamline licences and facilitate the process to start a company were implemented.

At the beginning of 2020, the government submitted to Parliament two draft omnibus laws on taxation and on job creation, which could become key new milestones in the business environment reform process. The Omnibus Law on Job Creation brings back to the centre of investment climate reforms the issue of economic and FDI liberalisation, including key measures to lift restrictions and conditions placed on FDI, while continuing to press ahead with reforms to centralise and streamline business licensing and land acquisition procedures and significantly reform Indonesia's labour market.

Despite strong opposition by labour unions, regional administrations and civil society, who expressed concerns over the bill's proposed amendments to the 2003 Labour Law, the recentralisation of administrative power in the hands of the executive, the lack of public hearings and on environmental protection regulations, the Omnibus Law on Job Creation was eventually enacted in October 2020. Implementing such an 'all-in-one' law reform package will be a challenge but there are compelling arguments for revising the current FDI regulatory regime once the pandemic is controlled. While this section focuses on the implications of the Omnibus Law for foreign investment restrictions in Indonesia, other, more contentious areas of the new law are considered elsewhere in the review.

Beyond the more fundamental reasons, tapping into a larger pool of FDI than previously the case might be ever more critical for the economic recovery following the pandemic, which is projected to significantly weaken Indonesia's real GDP growth from the above 5% observed in recent years to -3.3% in 2020 as projected by the OECD (2020a). Typically larger and more geographically diversified and productive, foreign-owned firms are overall more resilient to crisis (Alfaro and Chen, 2012; Desai et al., 2008). Therefore, they could potentially be an asset to reignite recovery earlier or faster. In addition, at a time of record-high portfolio capital outflows from emerging markets (OECD, 2020b), FDI could help to ease any possible financing pressure on Indonesia's current account deficit, which is projected to widen once again on the back of sluggish tourism exports and commodity markets (World Bank, 2020a).

The announced global economic downturn scenario – the OECD (2020a) projects a 4.5% contraction of the global economy in 2020 – might perhaps work in favour of pushing reforms forward. The pace of Indonesia's FDI reforms have historically been largely shaped by crises, rather than being driven by strong political leadership with support from domestic constituents for more open investment policies.[13] This time is different as the Omnibus Law on Job Creation does not seem to be originally stemming from a severe economic crisis or external factor. Yet, as the current global downturn spreads and overwhelms Indonesia's economy, the reform process might end up being largely influenced by the crisis situation, as on past reform occasions.

If it was not for the current unique situation, past perspectives about FDI liberalisation reforms would be comforting in suggesting a pick-up in FDI activity. In the past, FDI generally responded positively to enhanced market opportunities and conditions resulting from Indonesia's liberalisation efforts (OECD, 2010). But this may prove particularly difficult this time. It might actually be challenging even to hold on to existing FDI. The impact of the pandemic on FDI flows globally, and particularly for emerging economies, is projected to be severe, with global FDI flows projected to fall by more than 30% in 2020 even under the most optimistic scenario (see Chapter 2).[14] ASEAN as a region is likely to remain well positioned to compete for investments looking for further diversification following the pandemic, which could also benefit Indonesia. Without reforms, however, Indonesia remains at a relative disadvantage and the chances of attracting needed FDI in the immediate aftermath of the pandemic may be slim.

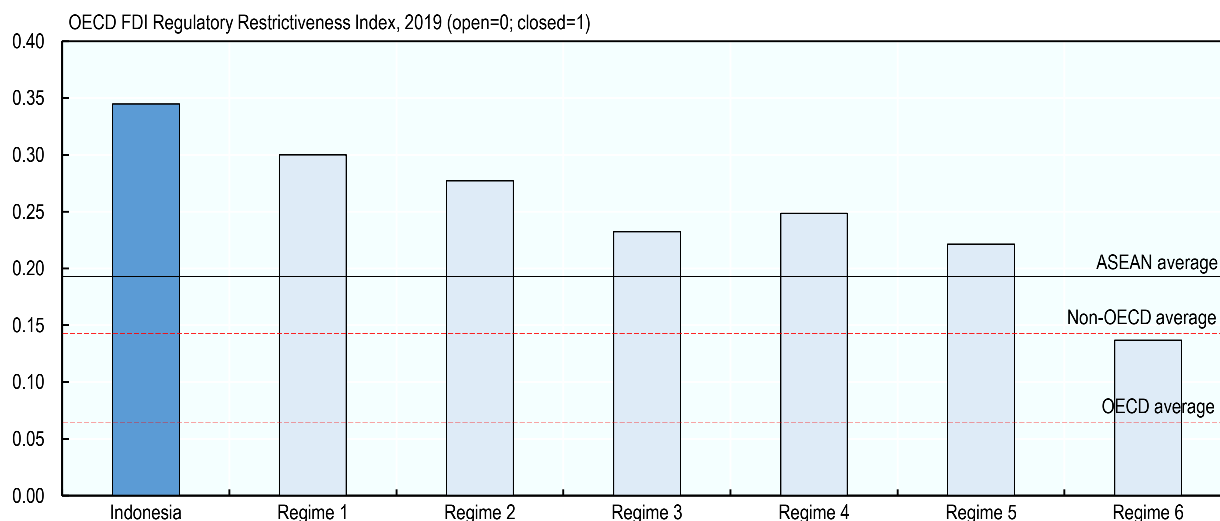
Ambitious reforms are needed to bring Indonesia closer to ASEAN levels of FDI openness

A comprehensive overhaul of Indonesia's FDI regime may not be easy to achieve, but only such a bold and comprehensive reform package would allow Indonesia to significantly reduce barriers to FDI and increase its relative attractiveness as an investment destination. Stringent barriers to FDI also make other doing business impediments, and reforms less effective. Figure 3.13 below synthesises the results of how Indonesia's FDI regime would compare to peers if some hypothetical reforms scenarios were to be achieved with the on-going Omnibus Law on Job Creation. Six different reform regimes are contemplated in the exercise, which draws on the OECD *FDI Regulatory Restrictiveness Index*:

- *Regime 1* – abolishment of the discriminatory treatment against foreign investors in terms of minimum capital requirements for doing business in Indonesia

- *Regime 2* – easing of foreign shareholding restrictions by (1) allowing foreign investors to hold minority stakes in business activities closed to foreign investment; and (2) allowing foreign investors to hold majority-ownership stakes in business activities where they are only allowed to hold minority stakes
- *Regime 3* – the combination of *regimes 1* and *2* above
- *Regime 4* – easing of foreign shareholding restrictions by reducing equity restrictions to the ASEAN average level in those sectors where Indonesia is more restrictive, all else held constant
- *Regime 5* – easing of foreign shareholding restrictions by reducing equity restrictions to the non-OECD average level in those sectors where Indonesia is more restrictive, all else held constant.
- *Regime 6* – eliminating all foreign shareholding restrictions, all else held constant

Figure 3.13. Omnibus Law on Job Creation: reform simulations on Indonesia's FDI regime



Note: See note to Figure 3.6 above.
Source: author's elaboration based on the *OECD FDI Regulatory Restrictiveness Index*, http://www.oecd.org/investment/fdiindex.htm.

As can be seen in Figure 3.13 above, only some substantial reforms to sector-specific foreign shareholding policies and/or horizontal policies, as exemplified in the hypothetical reform scenarios, would bring Indonesia closer to average international levels of openness. Of all simulated scenarios, only the full removal of foreign shareholding limitations (regime 6) in line with a more optimistic reading of the Omnibus Law on Job Creation would lead to a FDI regime that is more open than in the average non-OECD economy included in the *OECD FDI Regulatory Restrictiveness Index*.[15]

This requires the Omnibus Law on Job Creation to break with Indonesia's rather timid track record in reforming its FDI regime in recent years. As demonstrated earlier, despite other improvements to the business environment, there has been only limited progress in terms of FDI liberalisation since the 2000s. Economic and resource nationalism still resonate in public opinion and political forces favouring the protection of certain segments of the local economy from foreign competition have been effective in countering those supporting more in-depth FDI reforms.

Overall, Indonesia has yet to demonstrate a clear intention to place FDI at the centre of Indonesia's economic, social and environmental development ambitions. At the outset, the Omnibus Law on Job Creation has the ambition to do just that, but the extent of success will depend greatly on how much it will be able to achieve in the end. The challenge is not small.

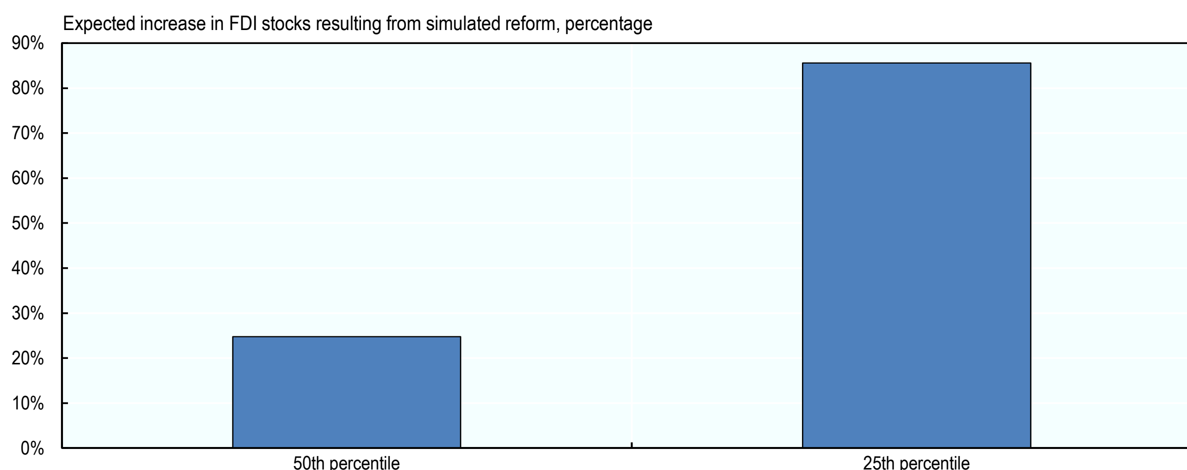
The impact of substantial FDI reforms can be sizeable

The right of governments to favour some investors over others in order to achieve social, economic or environmental goals is widely accepted, but any policy that discriminates against one group of investors involves a cost. Discriminatory measures can thus only serve the broader public interest to the extent that their potential costs are compensated by broader social and economic benefits. For this reason, they need to be constantly re-evaluated to determine whether their original motivation remains valid, supported by an evaluation of the costs and benefits, including an assessment of the proportionality of the measure to ensure they are not greater than needed to address specific concerns (OECD, 2015a).

As already alluded to in the beginning of this chapter, a number of potential costs have been associated with discriminatory policies against FDI in the empirical literature, most notably in terms of forgone investments and potential efficiency gains. In terms of investments, recent OECD research estimated that the introduction of FDI reforms leading to a 10% reduction in the level of FDI restrictiveness, as measured by the OECD *FDI Regulatory Restrictiveness Index*, could increase bilateral FDI inward stocks by around 2.1% on average across countries (Mistura and Roulet, 2019). While it is evident that when foreign investment is prohibited an economy will receive no such investment, the evidence suggests that even partial restrictions, such as foreign equity limitations and discriminatory screening and approval mechanisms, can have a significant impact on FDI (Mistura and Roulet, 2019; Fournier, 2015; Nicoletti et al., 2003).

For Indonesia, an illustrative simulation exercise using the average partial direct elasticity obtained in Mistura and Roulet (2019) suggests that if Indonesia were to reduce restrictions to the 50th and 25th percentile levels of the *FDI Index*, inward FDI stocks could be 25% to 85% higher, respectively (Figure 3.14).

Figure 3.14. Simulated Effects of FDI Liberalisation: reducing Indonesia's restrictions to the 50th and 25th percentile levels of OECD FDI Regulatory Restrictiveness Index



Note: The simulation is based on the average partial direct elasticity of FDI to regulatory restrictions estimated through an augmented gravity model of bilateral inward FDI positions using a poisson pseudo-maximum likelihood estimator. Typical gravity variables and a series of other policy and non-policy factors are included (distance, contiguity, the existence of a common language, colonial ties, market size, real GDP growth rates, real exchange rates, similarity in size and factor resource endowments, trade openness, natural resource endowments, institutional maturity, FDI restrictions, participation in free trade areas, corporate tax), as well as host and home country and time-fixed effects. The regressions cover bilateral FDI relationships between 60 countries over the 1997-2012 period.
Source*:* author's elaboration based on Mistura and Roulet's (2019) baseline estimation.

The effect is found to be larger for FDI in services sectors, reflecting greater incidence of restrictions in these sectors. But even FDI into manufacturing sectors, which are mostly open to FDI, is also negatively affected by restrictions in services activities (Mistura and Roulet, 2019). As discussed earlier, this can have economy-wide productivity implications given the increasing importance of services inputs for other economic sectors as well as end-consumers.

Keeping the 'achievements' of the 2007 Investment Law

While revisiting the FDI regime is certainly warranted, the Omnibus Law on Job Creation should ensure that past achievements are preserved. Economic policy certainty in Indonesia improved substantially in the field of investment with the passing of the Investment Law in 2007 (OECD, 2010). This landmark law covered both domestic and foreign investment and stipulated national treatment for foreign investment, charting a future of a more level playing field for all investors (see Chapter 4 on investment protection and dispute resolution).

It also increased the transparency of Indonesia's policy framework for investment, in particular by adopting a 'negative list' approach for clarifying which sectors were closed or open with certain conditions to foreign or domestic investors. To date, there have been four Presidential Regulations specifying the list of business activities facing investment restrictions, most recently Presidential Regulation 44/2016. These lists have overall added to transparency, including by adopting a standard industrial classification system for the listing of activities, e.g. Standard Classification of Indonesian Business Fields (KBLI) or International Standard for Industrial Classifications (ISIC). These are all key achievements that deserve being preserved in the ongoing reform introduced by the Omnibus Law on Job Creation.

As of August 2020, there was still uncertainty as to whether the previous 'negative list' approach would continue to be used for regulating market access conditions for foreign investors following the current Omnibus reform. According to consultations with the Office of Cabinet Secretary, the government intends to re-conceptualise the negative investment list into a 'positive' Investment Priority List (DPI), through the revision of Presidential Regulation Number 44 Year 2016 with business fields covering: (1) closed business fields; (2) business fields reserved to government activity; and (3) open business fields, including: priority business fields; business fields in which investors are required to partner with medium, small and micro enterprises (MSMEs); business fields in which investment is allowed subject to requirements; business fields reserved for MSMEs, and other open business fields.

It was not clear, however, in what ways such a 'positive' DPI would depart from a 'negative list' in technical terms if it was to follow the above-mentioned structure. A shift to a 'positive list' would technically imply that only those sectors and/or activities contemplated in the list would be open to investment under the stipulated conditions, all else would be potentially off-limits to investors. Foreign investors have at times expressed discontent with the current pace of liberalisation and questioned the capacity of the 'negative list' revisions process to encourage liberalisation. But one can easily understand the challenge in implementing an open business environment under this setting as it would require listing all the activities open for investment, which requires a massive undertaking not to leave aside any activity unintentionally and to avoid uncertainty associated with broad scope definitions. The 'negative list' approach is more efficient and predictable in this respect, as all activities are deemed opened without conditions, except for those few identified and listed in the regulation.

The authorities, however, have confirmed during this review that the 'negative list' approach will continue to be used for the regulation of market access. Improvements could thus be considered on the institutional setting and procedures for the formulation of such list going forward. The Co-ordinating Ministry of Maritime Affairs and Investment is since 2019 the responsible authority for monitoring, evaluating, and settling problems arising out of the implementation of investment activities in the business fields listed.[16] Presidential Regulation 76/2007 on the criteria and requirements for formulation of closed and conditionally opened business lines in the investment sectors provides some guidance on the procedures for formulating

such lists. They are to be evaluated and improved periodically in accordance with developments of economy and national interests on the basis of studies, findings and recommendations of investors. Ministers or leaders of institutions concerned are to recommend closed and conditionally opened business lines along with supporting reasons to the Co-ordinating Minister of Maritime Affairs and Investment. Recommendations draw on the criteria and considerations stipulated in the presidential regulation for placing conditions or determining certain activities closed to foreign or domestic investors. The Co-ordinating Ministry of Maritime Affairs and Investment shall then set up a team to judge, formulate, evaluate and finalise these lists.

The process of assessing and formulating the lists of sectors to be opened up or restricted could likely benefit from greater transparency and technical support. The current procedure is silent on rules for the composition of the team in charge of assessing and formulating the policies. Considering the potential implications of restrictions for other sectors beyond their sectors of application, an inter-agency composition would likely be warranted, as would the involvement of representatives from foreign and domestic chambers of commerce, trade unions, civil society and consumers. A more balanced representation could help to broaden the information-base supporting discussions and deliberations.

Recommendations by concerned ministries could also be complemented by more technical assessments of the implications of proposed measures by qualified independent institutions, such as academia and research institutes, private sector consultants and international organisations, or at least by a qualified technical unit within the government. It is not clear the extent to which in practice technical assessments are prepared to support deliberations by the responsible ministry, but if there have been any, these have not been publicly disclosed. To date, there has also been limited public stakeholder consultations on related matters. More transparency on the formulation of the 'negative list' would facilitate dialogue with interested stakeholders and help to contribute to improved policy-making.

Presidential Instruction No. 7 of 2017[17] and the Cabinet Secretary Regulation No. 1 of 2018[18] provide guidance to ministries and government agencies for formulating policies that are strategic, have a broad impact on the community, and are of a national scale. The adoption of such guidance in the formulation of FDI policies would already be a step towards implementing a proper regulatory impact assessment of existing restrictions on FDI, including assessments of potential substitutive non-discriminatory policies where relevant. They contemplate issues such as the need to conduct public consultations, risk mitigation, and other matters such as considering alternatives other than establishing regulations. According to the authorities, the implementation of policy formulation based on the Presidential Instruction and the Cabinet Secretary Regulation still faces obstacles: some perceive it to excessively extend the policy formulation cycle and there is still room to simplify the policy formulation procedures. Nevertheless, the guidance is an important initial step for improving the policy making process in Indonesia and its implementation in the context of FDI reforms is certainly warranted.

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Annex 3.A. Technical Notes

Shift-share decomposition of Indonesia's FDI inward stock growth, 2010-18

The above decomposition is based on the traditional shift-share analysis (see WTO (2009) for description) as follows: $\Delta I_j = rI_j' + \sum_i (ri - r)I_j' + \sum_i (ri_j - ri)I_j'$, where for each country or grouping *j*, ΔIj is the difference in inward FDI stocks between 2010 and 2018; *Ij'* is the inward FDI stock in 2010; *r* is the growth rate of world inward FDI stock in the 2010-18 period; *ri* is the growth rate of world inward FDI stock of industry *i* in the same period and *rij* is the growth rate of country or grouping *j*'s inward FDI stock of industry *i* in the period.

Due to the limited availability of disaggregated and comparable data on FDI stocks per sector across countries or groupings, the analysis was limited to the following industries: agriculture, forestry and fishing; mining and quarrying; manufacturing; construction; and others (residual). Sectoral FDI stocks were estimated as per the following:

- China: FDI stocks per industry were estimated using the total International Investment Position reported by the State Administration of Foreign Exchange, adjusted by the share of FDI inflows per sector over 2005-10 (for 2010) and 2005-18 (for 2018) as reported by the National Statistics Bureau;
- OECD: FDI stocks per industry are based on total FDI positions in OECD economies reported in the OECD's FDI statistics database, adjusted by the share of FDI positions per sector based on available data;
- Indonesia: industry FDI estimates are based on total IIP data by Central Bank of Indonesia, adjusted by the share of cumulated inflows per sector over 2004-2010 (for 2010) and 1990-2018 (for 2018) as reported by the Central Bank of Indonesia. Similar trends, albeit of greater magnitudes, are obtained using cumulated inflows per sector over 1990-2010 (for 2010) and 1990-2018 (for 2018) as reported by BKPM [not reported];
- ASEAN9 (excluding Indonesia): estimates are based on total FDI stocks in ASEAN9 as reported in UNCTAD's FDI statistics database, adjusted by the share of cumulated inflows per sector over 2005-10 (for 2010) and 2012-18 (for 2018) as reported in the ASEAN's Secretariat FDI Statistics database;
- World: estimates are based on the total world FDI position reported by the OECD, adjusted by the share of FDI positions per sector in OECD, Indonesia, China and ASEAN9 altogether;
- Rest of the World: estimated as the residual of World estimates minus OECD, Indonesia, China and ASEAN9.

Trends in horizontal and vertical FDI in Indonesia: 1997-2017

The estimation of horizontal and vertical FDI follows Alfaro's (2007) methodology with some adjustments:

- Horizontal FDI: a cross-border M&A transaction is classified as horizontal FDI whenever both the target's and the acquirer's Primary SIC Code are the same. Depending on the industry's variety of sub-activities, 2 or 3-digit level groupings were used.
- Vertical FDI: a cross-border M&A transaction is classified as vertical FDI whenever the target's and the acquirer's Primary SIC Code (4-digit) are identified as vertically associated as per Alfaro's (2007) methodology with some adjustments. Using the United States BEA Industry-by-Industry

Total Requirements Table (2012, the latest), a vertical industry relationship (upstream and downstream respectively) is identified whenever the acquirer or the target industry share of the total direct and indirect industrial output associated with the production of one dollar of output of the reference industry (acquirer or target firm's industry) is equal to or higher than 1,6%.Alfaro (2007) relies on a static 0.05 threshold level.

  - The relative threshold level used is slightly more encompassing than Alfaro's static level: it captures roughly the same number of one-way (upstream or downstream) relationships per industry (maximum observed is 14 against 13 using Alfaro's threshold level), but expands the total number of vertical industries pairs identified from 1638 to 2286. For the estimation, BEA industry codes were corresponded to target and acquirer 4-digit Primary SIC Codes using correspondence matrixes available at BEA's website. The use of the US Input-Output structure instead of each countries' respective I-O tables is because of the unparalleled level of disaggregation of BEA's data, and the likelihood of US industry relationships being relatively more encompassing given the size and sophistication of the US economy.

- Other/diversification FDI: deals not qualifying as horizontal nor vertical FDI (respectively, 50% and 18% of total deal value in Indonesia in 1997-2017) are denoted 'other/diversification FDI' (not reported for presentational purposes).
- The dataset used in the exercise comprise 32 846 completed cross-border M&A deals from 1997 to 2017, which resulted in the ownership by the ultimate acquirer company of at least 10% of the shares of the acquired company after the transaction, as reported in the Dealogic's Merger & Acquisitions database.

Services FDI restrictiveness impinging on manufacturing activity

The exposure of manufacturing sectors to service sector FDI restrictions is estimated by calculating the weighted average the *OECD FDI Regulatory Restrictiveness Index* in nine services sectors (construction, transport, telecommunications, electricity, wholesale and retail distribution, financial and business services), where the weights are given by the sectors' respective shares in the total input costs of manufacturing sectors. It is constructed as: $rest_{s,c} = \sum_{j}^{J}(w_{s,c,j} * Index_{j,c})$, where *rest* is the weighted-average FDI restrictiveness index faced by manufacturing sector *s* in country *c*; *w* is the share of domestic service sector *j* in total inputs of manufacturing sector *s* in country *c* based on the 2015 OECD Input-Output Tables data (latest available); and *Index* is the *OECD FDI Regulatory Restrictiveness Index* of service sector *j* in country *c.*

Annex 3.B. Selected sample of local content requirements in Indonesia

Annex Table 3.B.1. Selected sample of local content requirements in Indonesia

Date announced	Scope	Description	Legal authority	Date of entry into force
2019-08-08	2019 presidential regulation to promote local EV industry	Minimum local content requirement for being eligible to access fiscal and non-fiscal incentives for the production of electric vehicles in Indonesia: at least 35% for vehicles with four or more wheels and of at least 40% for vehicles with two or three wheels. The local content level will be raised until it reaches 80% in 2030 and 2026, respectively.	Presidential Regulation 55/2019 promoting the local electric vehicle industry	12-08-2019
2018-08-15	Local bio-component requirement in diesel	PR 66/2018 introduces a requirement for locally-sold diesel to contain a minimum bio-component of 20% (so-called "B20 biodiesel mix"). As stated in the preamble of the regulation, it is meant to foster the growth of the local palm oil industry.	Presidential Regulation 66/2018 introducing a local bio-component requirement for diesel sales	01-09-2018
2017-02-27	Action plan to push local pharmaceutical and medical equipment industries	The regulation includes the provision that the pharmaceutical and medical equipment industries shall prioritise the use of local raw materials. The regulation also stipulates that the provision of pharmaceutical goods and medical equipment by the government or by private entities for the needs of the community shall prioritise those goods that use local raw materials. There are no clear rules on what percentage the local content requirements shall be set. However, there are some indications in the appendix of the regulation: for instance, during the research and development stage, the content shall be at least 25%. In the production process, the content shall be at least 35%. Furthermore, the regulation mentions reducing the current import market share from 94% to 45% by 2035.	Ministry of Health Regulation 17/2017 introducing an action plan to push the local pharmaceutical and medical equipment industries	28-02-2017
2017-02-07	Restricted investment opportunities for Internet Protocol Television	IPTV providers shall provide Internet Protocol Set-Top-Boxes with a minimum local content requirement of 20%, with the amount rising to 50% within 5 years of starting operations in Indonesia. Furthermore, the IPTV operator shall provide at least 10% of domestic content during its broadcasting services, 30% during its multimedia services, and "the number of domestic Independent Content Providers contributing to the implementation of IPTV services shall be at least 10% (ten per cent) of the number of Content providers in the Content Library of the Organizer and gradually increase to 50% (fifty Percent) within 5 (five) years."	Ministry of Communications and Information Technology Regulation No. 6/2017 on Internet Protocol Television	07-02-2017
2016-07-27	Updated localisation requirements for smartphones & tablets	Ministry of Communication and Information announced a regulation requiring 4G telecommunication devices (on smartphones and tablets) to fulfill a local content requirement of 30%. Meanwhile, "base stations", e.g. wireless modems using 4G LTE networks will be required to have a local content requirement of 40%. The local	Ministry of Industry Regulation 65/2016 introducing further schemes related to the localisation requirement	01-01-2017

Date announced	Scope	Description	Legal authority	Date of entry into force
		content requirement holds for both hardware and software, such as phone applications. The producer has the option to localise the software rather than the hardware components of the devices. For instance under one scheme, creating a number of popular applications and games could reduce the hardware localisation required to 10% and the design and firmware localisation to 20%. The regulation also offers the reduction of the localisation restrictions depending on the size of foreign investment. In the case of investments worth at least 1 trillion IDR (ca. USD 77 million), the localisation requirement would be scrapped altogether.		
2015-09-30	Local content promotion scheme via import tariffs on goods, machinery, and materials used in construction	In order to support the Indonesian construction industry, the government expanded import tariff exemptions to the contruction industry. The exemptions do not cover any services and require each company to use at least 30% locally sourced machinery and materials.	Ministry of Finance Regulation 188/PMK.010/2015 expanding the import tariff exemptions to the construction industry	30-09-2015
2015-03-23	Extended localisation requirements for the automotive industry	The regulation introduces further localisation requirement in the automotive industry. Whereas previously car manufacturers were required to perform four stages of the assembly in Indonesia, the new provisions require de facto the entire assembly process to take place locally.	Ministry of Industry Regulation 34/M-IND/PER/3/2015 on the automobile industry.	23-09-2016
2013-12-12	Local content requirements for traditional markets, modern stores & shopping centers	Shopping centers are required to offer a "counter image" in designated floors strictly reserved for domestic products. Traditional markets, shopping centers and modern stores are required to supply 80% of their products with domestic ones. Exemptions are granted to the following retail categories: (1) Requiring uniformity of production and sourcing from a global supply chain; (2) Having a brand that is world famous (premium products) and have yet to have a production base in Indonesia; or (3) Products from certain countries being sold to meet the needs of their citizens living in Indonesia.' Exempted stores are expected to gradually increase the sales of similar goods that are domestically produced and report its implementation to the Minister through the Director General of Domestic Trade'.	Ministry of Trade Regulation 70/M-DAG/PER/12/2013 concerning traditional markets, shopping centers and modern stores.	12-06-2014/17-09-2016
2013-02-11	Local content requirement in food & beverage franchises	Among other restrictions such as a maximum of 250 franchise stores, the regulation included a minimum 80%-local content requirement on raw materials and business equipment used by the franchisor as well as the franchisee. According to art. 7(2), the Ministry of Trade may give exemptions to this LCR 'after considering the recommendation from the Assessment Team'.	Ministry of Trade Regulation 07/M-DAG/2/2013 concerning the franchise business in the food & beverage industry.	11-02-2013
2009-01-19	Localisation restrictions in the telecommunications sector	The regulation requires tools and equipment used for wireless broadband service which uses radio frequency band of 2.3 GHz and 3.3 GHz to meet the Domestic Component Level of at least 30% for the subscriber station and 40% for the base station. This localisation requirement was to be raised to 50% within five years.	Ministry of Communication and Information Regulation 07/PER/M.KOMINFO/01/2009 introducing localisation restrictions in the telecommunications sector	19-01-2009

Source*:* Global Trade Alert, https://www.globaltradealert.org/.

Notes

[1] This scenario does not consider any fundamental changes in firms' behaviour regarding FDI strategies going forward. In the long-run, some expect worldwide FDI to become scarcer as they expect firms and government policies to turn to re-shoring or near-shoring strategies as a solution for value chain disruptions in the future. On the other hand, increased diversification and off-shoring might turn out to be an even more reliable source of supply chain resilience, as it avoids putting 'all the eggs into one basket'.

[2] Investment climate conditions also play a role in horizontal FDI decisions, albeit likely to a relatively lesser extent. Horizontal FDI (seeking to serve the host market) is typically associated with firm-level economies of scale and, therefore, production can be more easily duplicated in the host market because the benefits of market access and the increasing returns on scale at the firm-level assets are higher than the forgone economies of scale at the plant level. Investment climate conditions play a role particularly in relation to horizontal FDI that seeks to serve regional markets. In these cases, similarly to efficiency-seeking FDI, investors are inclined to look for the most efficient locations for serving the regional market, taking advantage of a combination of factors allowing the rationalisation of their operations, including factor endowments, cultural and institutional arrangements, market structures, and economic policies that certain locations offer.

[3] In response, according to the authorities, the government has plans to form a special inter-ministerial task force to handle investment reallocation, in accordance with Presidential Instruction (Inpres) No. 7 of 2019 concerning Acceleration of Ease of Doing Business. BKPM has already started to give priority to the investment reallocation plan of 40 foreign companies (with future potential projections of 300 companies) in China originating from the United States (US) and Japan. As reported by the authorities, the task force's work would include (1) detecting companies that will be relocating in the near term; (2) checking the facilities provided by competing jurisdictions, and (3) entering into and making decisions in negotiations.

[4] The more recent deterioration of Indonesia's is mostly due to lower commodity exports and higher infrastructure-related imports (IMF, 2019). In addition, the services and income account have long been in deficit notably due to recurrent deficits in the transport and insurance sectors, respectively associated with increasing payments to foreign transport companies used in import-export activities and foreign reinsurance activities, and due to increasing FDI-related income deficits, which is partly offset by reinvested earnings.

[5] Among other things, FDI up to 100% was allowed in permitted sectors without previous conditions (e.g. minimum 5% Indonesian shareholding at the time of investment and divestment to minority foreign-shareholding within 20 years; export-oriented and/or labour-intensive, located in Batam Economic Zone or

in Eastern Indonesia, above USD50 million), allowed partial foreign shareholding in various previously closed sectors, such as telecoms, transport, media and electricity (Conklin and Lecraw, 1997).

[6] Foreign shareholding restrictions are considered a more important barrier to FDI in the OECD *FDI Regulatory Restrictiveness Index* than are other restrictions covered by the indicator, such as foreign investment approval mechanisms, restrictions on the employment of key foreign personnel and other operational restrictions. As such, they are given a higher weight in the *Index* methodology, which partly explains why foreign equity restrictions tend to dominate in terms of barriers to FDI in Indonesia and elsewhere (see Kalinova *et al*., 2010 for further information on the methodology). However, the extent to which this is the case in the aggregate is largely driven by their scope of application, both across and within sectors. In the former case, this is determined by how prevalent foreign equity restrictions are in the 22 sectors covered in the *Index;* in the latter, by how stringent these restrictions are. The *Index* methodology distinguishes three thresholds in this respect: if foreign investors are fully prohibited from investing in the sector, if they are allowed to hold only a minority participation in companies operating in the sector, or if they are only restricted from establishing a wholly-owned operation.

[7] Foreign investment screening and approvals and other policies exclusively based on national security grounds are not considered taken into account in the *OECD FDI Regulatory Restrictiveness Index*.

[8] "What is a minimum capital requirement? It is the share capital that must be deposited by shareholders before starting business operations. For the Doing Business starting a business indicator the paid-in minimum capital is usually the amount that an entrepreneur needs to deposit in a commercial bank or with a notary when, or shortly after, incorporating a business, even if the deposited amount can be withdrawn soon after a company is created" (World Bank, 2014).

[9] As per the Presidential Regulation 20/2018 on Foreign Workers Utilization and Regulation 10/2018 from the Ministry of the Minister of Manpower on Foreign Workers Utilisation Procedures.

[10] According to BKPM's Regulation 5/2019 amending BKPM's Regulation 6/2018 concerning Guidelines and Procedures for Licensing and Investment Facilities, Directors and Commissioners with terms of ownership in a company equivalent to at least Rp 1 billion or the equivalent in US dollar may also benefit from immigration facilities in the field of investment. These includes BKPM's recommendation for being granted a limited stay visa, for transferring a stay permit status to be a limited stay permit, for transforming a limited stay permit to a permanent stay permit.

[11] In order to be considered as a Domestic Service Company, the majority of shares have to belong to an Indonesian citizen and two thirds of the board members have to be locals. If no domestic service suppliers are participating in the procurement, national service suppliers (with at least 10% of shares belonging to Indonesians) will be taken into consideration. When these are unavailable, foreign services suppliers are allowed in the procurement process. Domestic Service Companies are allowed to co-operate with foreign service companies in the form of a consortium or joint venture or subcontract part of the work to foreign service companies, but such a consortium must be led by the Domestic Service Company in the case of on-shore construction services and at least 50% of the implementation work by contract value needs to be carried out the domestic service company. In the case of off-shore construction services, the Domestic Service Company is obliged to perform at least 30% of the work in value terms. For more information, see Ministry of Industry No. 02/M-IND/PER/1/2014 concerning guidelines for improving the use of domestic products in the procurement of government goods and services.

[12] Stakeholders consulted during the review reported some additional local content requirements to those featuring in Annex 3.B based on the Global Trade Alert database, notably in: (A) distribution services, where foreign investors in wholesale distribution of food, beverages, and tobacco, and textile, clothing and

footwear with minimum space above 5,000 meter square are subject to an obligation to cooperate with at least 100 Indonesian SMEs suppliers and/or retailers yearly, along with training and development. Wholesalers in the form of modern stores are also required to offer a minimum of 80% of domestic goods in terms of the total quantity and types of good offered (as reported in the Annex 3.B); (B) Construction and related engineering services: in addition to meeting foreign equity limitations and project size threshold, foreign investors are subject to an obligation to perform domestically at least 50% of the value of construction work and at least 30% (thirty percent) of the construction value is conducted by a partner domestic Construction Services Business Enterprise (BUJK). There are also additional obligations to transfer of knowledge and/or technology and to use domestic products, technology and/or materials; (c) Architectural Services, Engineering Services, Integrated Engineering Services, Urban Planning Services: foreign investors are required to have all the technical planning work done domestically and have at least 50% of the value of the construction planning work undertaken by a domestic partner. Similarly to construction services, there are also obligations to transfer of knowledge and/or technology and to use domestic products, technology and/or materials.

[13] An early attempt to create a more favourable environment to FDI came in the late 1960s, following the deep economic crisis that engulfed Indonesia during the decade, with the promulgation of the 1967 Foreign Investment Law. But unlike some of its regional peers, such as Malaysia and Thailand, Indonesia only came to appreciate the potential role of FDI for its economic development at a later stage. It was not until the mid-1980s, when the need for foreign exchange and capital mounted with declining oil revenues and the appreciation of the yen (a large portion of Indonesia's external debt was denominated in yen), that Indonesia began to adopt a more open policy stance on foreign investment (OECD, 1999; Lecraw, 1997). The policies implemented starting in 1986 marked then an important shift from the preceding inward-looking policy orientation of the 1970s, which had placed increasingly severe conditions on inward investment. Limits on foreign ownership for export-oriented investments were first relaxed and investment licensing procedures were made easier in order to attract foreign capital. This wave of FDI liberalisation intensified in the early 1990s and then again as a consequence of the Asian Financial Crisis in 1997.

[14] See end note 2.

[15] Article 84(2) proposes to amend article 12 of the 2007 Law on Investment, which would read as follows as per the text submitted to Parliament: "*Article 12 (1) All business fields are open to investment activities, except those declared closed for investment or activities that can only be carried out by the Central Government. (2) Business fields closed to investment as referred to in paragraph (1) include: […] [list of 6 activities provided]. (3) Further provisions regarding the investment requirements as referred to in paragraph (1) and paragraph (2) shall be regulated in a Presidential Regulation*." The precedent text provided for an exception "for business sectors or business types that are declared to be closed and open with requirements", which were established and revised by successive Presidential Regulations. The latest of such regulation was Presidential Regulation No. 44 of 2016. As it stands, the Omnibus draft language already incorporates in the law the list of business fields closed for investment, both foreign and domestic, and no longer provides for business sectors or business types that are open with requirements, and as such can be interpreted as not allowing anymore for a discriminatory treatment towards foreign investors in relation to market access conditions. Additionally, Article 84(3) also proposes to remove the previous obligation for the government to establish business sectors that are reserved for micro, small and medium enterprises and cooperatives, as well as business sectors that are open to large businesses on condition that they cooperate with micro, small and medium enterprises, and cooperatives (Article 13(1) of the 2007 Law on Investment).

[16] Pursuant to the Presidential Regulations No. 92 of 2019, the roles and function of co-ordinating, synchronization and controlling investment affairs have been shifted from the Co-ordinating Ministry of

Economic Affairs (CMEA) to the Co-ordinating Ministry of Maritime Affairs and Investment. The latter also assumed the responsibility for overseeing BKPM in 2019.

[17] Presidential Instruction No. 7 of 2017 concerning Taking, Supervising, and Controlling Policy Implementation at the State Ministry and Government Institution Levels.

[18] Cabinet Secretary Regulation No. 1 of 2018 concerning Guidelines for the Preparation, Implementation and Follow-up of the Results of the Cabinet Session.

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