Executive Summary

Indonesia has achieved impressive success in overcoming immense political and economic obstacles since the late 1990s. New economic laws and policies, based on an increasingly transparent and accountable political system, are bearing fruit in the form of stable growth and a renewed rise in inflows of foreign direct investment (FDI). At the same time, fixed investment, both domestic and foreign, remains inadequate to meet the country's requirements for basic infrastructure and higher productivity.

Indonesia has been opening to international investment since the mid-1980s, particularly since 1993 and immediately after the 1997-98 Asian financial crisis. Foreign investors have taken notice, although the upward trend in FDI inflows was temporarily reversed in the aftermath of the Asian crisis. Subsequent economic reforms, including a landmark Investment Law in 2007, have allowed FDI to recover to pre-1997 levels. As a demonstration of a new resilience to external shocks, FDI inflows have remain respectably high during the global economic crisis, while falling in absolute terms. Inflows in the first quarter of 2010 were at one of the highest levels achieved in the past decade.

FDI has historically contributed relatively little to fixed capital formation in Indonesia, but it has played a major role in raising employment and productivity and in generating exports. FDI has created nearly half the new jobs in recent years, and exports from foreign multinationals have accounted for an increasing share of Indonesia's exports since 1990. FDI in Indonesia has also generated productivity spillovers to domestic industries. While the sources of FDI in Indonesia have become more diversified, much of the investment comes from only a few countries and is concentrated in Java and Sumatra, particularly in manufacturing.

Economic policy certainty is improving, but some implementing regulations are lagging. Public consultation is becoming more institutionalised and the appeals process strengthened. Red tape remains an obstacle to business, though procedures are being simplified. The government is striving to register land and property and to protect intellectual property rights. Despite recent judicial reforms, enterprises often prefer alternative dispute resolution mechanisms. The 2007 Investment Law gives standard protection to investors against expropriation and enshrines national treatment.

Restrictions persist on foreign equity ownership. The provision of a Negative List of sectors where private investment is not permitted or where foreign investors are subject to restrictions has added to transparency, and the list has been streamlined. Indonesia has signed a number of bilateral and regional investment agreements and has ratified the ICSID Convention. Disputes between the government and foreign investors may be settled through international arbitration.

Indonesia is actively promoting investment and has worked to streamline investment approval procedures through a one-stop integrated service. Administration and promotion of investment is vested in the Indonesian Investment Co-ordination Board, while a National Team on Export and Investment Promotion has been formed to advance reforms. Local investment promotion agencies vary in capacity, and decentralisation of power has led to uneven policy implementation.

FDI incentives, which had been removed in 1984, were reintroduced on a non-discriminatory basis in the 1990s. The government has also pursued zone-based policies to accelerate investment, and a mechanism to evaluate investment incentives is being put in place. Strategies for promoting linkages between foreign and local businesses are evolving.

Other barriers to entry are also coming down, partly as a result of a Competition Law enacted in 1999, but regulations on merger review have not yet been issued. Transparent procedures for enforcement are set in the regulations. The competition regulatory authority enjoys operational independence and wide investigative powers and has a mandate to evaluate the effects of government policies on competition.

In infrastructure, public spending has not filled the gap left by the disappearance of public-private partnerships (PPPs) after the 1997-98 crisis, and, as a result, Indonesia lags behind its regional peers. Increasing infrastructure spending is a national priority: a new legislative framework has been put in place to accommodate PPPs, institutions created to mobilise private investment and share risks, and ambitious targets set for increasing infrastructure provision.

The government has taken steps to improve the performance of the financial sector in recent years. A major restructuring of the banking sector was triggered by the 1997-98 crisis. Banks have become more robust against shocks but have been slow to lend for investment. Indonesia's financial sector has been open to foreign investors for over 20 years. The insurance and pension sectors have not yet developed to channel long-term finance. Indonesia has no registry system for collateral, but a Credit Bureau has been established to facilitate information flows among financial institutions.

Regulatory reform has been limited in scope, although a comprehensive regulatory review is planned and some independent regulatory bodies have a mandate to review government regulations. Decentralisation initially complicated the regulatory environment due to the lack of capacity and awareness at local level and co-ordination between central and local governments, but these constraints have gradually been removed as the central government has further clarified the authority of local governments and provided more guidance. Business sector and civil society groups have been actively participating in these reform efforts.

Fighting corruption has been made a top priority of government, and the Corruption Eradication Commission established in 2003 has actively investigated and prosecuted corrupt public officials at all levels of government. To assist in this process, Indonesian legislation is being harmonised with the UN Convention against Corruption and co-operation with the OECD in fighting bribery is growing.

Trade policies have been liberalised unilaterally and through international agreements. The government has largely resisted protectionist responses in the current crisis, as shown in the OECD-UNCTAD-WTO monitoring reports to the G20. It has also reduced constraints on trade and streamlined border procedures, especially by reforming customs, and has launched an Indonesia National Single Window.

Foreign-owned companies incorporated in Indonesia receive the same tax treatment as domestic ones, but the proliferation of local taxes has added to the burden on investors. Tax administration has become more efficient, which has significantly raised revenues. Indonesia has concluded 59 bilateral tax treaties.

Corporate governance problems were a major contributor to Indonesia's economic collapse in 1997-98. Indonesia has since made progress in establishing a corporate governance framework, notably through the 2007 Company Law and corporate governance guidelines published in 2001.

The Indonesian government is encouraging responsible business conduct in various ways. The legal framework for human rights protection has been strengthened since 1998 and more players are now involved in enforcing human rights, though improvement is still needed, particularly in the judicial system.

This Review assesses the progress made by Indonesia in developing a policy framework for investment, describes remaining challenges and proposes policy options to address them. The OECD's main recommendation is that the Indonesian government persevere with its efforts to increase the transparency and accountability of this framework and continue to share experience of good practice in formulating and implementing investment-related policies.