

## Indonesia's Investment Law

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Indonesia begins 2007 with a new drive to increase domestic and foreign investments during the mid-term of the Yudhoyono's government. The Legislative Assembly approved the Investment Law of 2007 with the sole intention of making the Indonesian economy more attractive to foreign investments. On a broad front, the Investment Coordinating Board (BKPM) wants to reduce the procedures to approve new investments by promoting better coordination between the various government institutions, providing tax incentives to make the returns to investments attractive and by persuading major players to capitalize on the 'large' domestic consumer market.

The Central Bank (Bank Indonesia) and the National Planning Board (Bappenas) estimate that the economy will expand between 5.3% and 6.3% in 2007, given that inflation is stable at 6.5% and the currency at IDR9300 against the US Dollar.<sup>1</sup> This optimism is not commonly shared. The Indonesian economy depends extensively on imported oil for domestic use, making the economy vulnerable to the volatility of global fuel prices.<sup>2</sup> The government targeted that the three dominant sectors contributing to economic expansion are agriculture (14%), trade (15%) and non-oil industries (28%).<sup>3</sup> The major contributor to the 2007 budget remains the energy sector, making up 35% of the GDP and expected to haul in US\$18 billion worth of new investments.<sup>4</sup> First quarter data from BKPM notes a 27.17% increase in

foreign investments, year-on-year, but this sudden surge is attributed to oil-related investments in Batam and commercial properties in Jakarta that are not significant in generating employment in densely-populated Java.<sup>5</sup>

### Parameters for Economic Growth

Despite this optimistic assessment of the main components of the economy, the Indonesian Chambers of Commerce estimates that investments totalling IDR 989 trillion are needed to stimulate the economy to attain the targeted 6.3% growth this year. An increase of 12.3% of new investments is needed in 2007, far greater than the 2.9% attained in the previous year.<sup>6</sup> The Finance Minister noted that 35% of these new investments will come from the state-owned enterprises and a maximum of IDR100 trillion of borrowing by the banking sector.<sup>7</sup>

<sup>1</sup>Asumsi Dasar Ekonomi Makro 2007, <http://www.hukmas.depkeu.go.id>

<sup>2</sup>Pertumbuhan Ekonomi 2007 Tergantung Minyak Dunia, <http://www.kompas.com>

<sup>3</sup>Tiga Sektor Ekonomi Tunjang Pertumbuhan Ekonomi 2007, <http://www.tempointeraktif.com>

<sup>4</sup>Target Investasi Sektor ESDM 2007 Sebesar US\$18 Milyar, <http://www.indonesia.go.id>

<sup>5</sup>Investasi Mulai Bangkit, <http://www.bisnis.com>

<sup>6</sup>Butuh 989 Trillion untuk Target Pertumbuhan 6.3%, <http://www.tempointeraktif.com>

<sup>7</sup>Pertumbuhan Investasi 2007 harus 12.3%, <http://www.antara.co.id>

The largest stimulant for economic growth will be the public spending of the central government, and more importantly, the provincial and regency administrations that will amount to IDR 763.57 trillion (US\$ 82.1 billion). Aside from incessant corruption, the next daunting challenge is to get the government and local administrations to spend on constructive developmental programs instead of investing the funds in bonds. In 2006, 40% of the SBIs (government-guaranteed short-term Bank Indonesia Certificates) were owned by the provincial and regency banks, amounting to IDR 212 trillion; these are funds that would otherwise have stimulated the rural economy.<sup>8</sup>

First quarter figures show that public spending at the provincial and regency levels reached only 13.73%, down by 1.61%.<sup>9</sup> Given the inherent weak management in the regencies and conflicting political interests, can the new Investment Law salvage this sluggish economic growth? While there are adequate incentives, the law has come under immediate criticism from a protective domestic economy and political parties that plan to sell a social-oriented agenda to compete against the incumbent government in the 2009 elections.

#### **Features of the amended Investment Law**

The key feature of the Undang-undang Penanaman Modal (Investment Law) is the tax incentives granted to business ventures.<sup>10</sup> The quantum has yet to be defined and will be finalized in the Tax Laws to be debated later in 2007. The parameters of these tax incentives have been defined. New investments, as well as ongoing investments that are partners with local business entities, will be entitled to get tax incentives. Similar

tax facilities will also be granted to companies that venture in rural and border areas to develop innovative industries that have the capacity to absorb large scale manpower into the workforce. The law, in broad terms, allows greater mobility of foreign professionals if such skills are not found among the local employees and it opens up almost all sectors of the economy with the guarantee that the government will not enforce nationalization.

The law is also permissive in land acquisition matters with lease for an initial 60 years with an option to extend for another 35 years. Lease of buildings will be permitted for an initial 50 years with an option for renewal of up to 30 years. To facilitate the success of the investment, the government can direct investors to Special Economic Zone (Kawasan Ekonomi Khusus) that has been fitted with optimal legislation and facilities to accelerate the economic growth of a particular region.

Only the defence-related industries are closed to foreign investors conclusively. The rest of the potential areas of investments are defined by loose parameters as long as the proposed industry does not jeopardize the cultural, economic and environmental balance of the nation. Within these broad parameters, investors are guaranteed income tax incentives, reduction in import duties on capital machinery and raw materials and reductions in land and building-related taxes.

Investors will also be granted multiple entry visa for 24 months with an option for temporal residency during the stay. For dispute settlement between the government and the foreign investor, the matter can be sent for international arbitration as agreed by both parties. The tax incentives are scheduled to be debated and tabled by the government three months after the passing of this Investment Law.

<sup>8</sup>Mengikis Ketergantungan Utang - Optimilisasi Dana Daerah, <http://perpustakaan.bappenas.go.id>

<sup>9</sup>Belanja Public Masih Seret, <http://www.bisnis.com>

<sup>10</sup>While this law has been passed in the Legislative Assembly in late March 2007, the government has not yet assigned the formal title and reference to the law at the time of this paper.

### Public reaction to the Investment Law

The government, in particular the Coordinating Minister for Economic Development, Boediono, noted that the law provides the assurance that all forms of investments are protected by Indonesia's legal and legislative instruments.<sup>11</sup> The Chambers of Commerce came out strongly in support of the legislation and noted that it should be incorporated in bilateral trade agreements.<sup>12</sup> The optimism ends there.

Two political parties, PDIP [Nationalist] and PKB [Islamic], rejected the law on the basis that it provided inadequate protection to local entrepreneurs who could not compete on the basis of capital and expertise.<sup>13</sup> The equal status granted to foreign and domestic investments are regarded as being historically apathetic to the colonial past of Indonesia and representative of a government leaning towards foreign interests.<sup>14</sup> Scholars from leading state universities felt that the new law strengthened the position of large multi-national industries that represent the cultural and economic domination of Indonesia and constituted a violation of the constitution.<sup>15</sup>

Islamic political movements have also felt that the new law shows that the democratic system and its legislature has clear leaning towards a capitalist mindset that disregards Islamic interests.<sup>16</sup> Opponents to the legislation regard the welcoming gestures to foreign capital as a move to place "Indonesia for Sale".<sup>17</sup> This is especially when the

land lease clause allows a total of 95 years of managing vast expanses of potentially arable or mineral-rich lands.

### Premature Optimism

While the Legislative Assembly has approved the new Investment Law, many of the government institutions have yet finalized internally the micro aspects of the proposed incentives. Since the time when the President has issued Inpres no 3/2006 with 85 actions assigned to the government bodies, little has been done to make the country more conducive for foreign investments. Many of these policy reforms will need to take place in the Department of Finance, Trade, Manpower, and Small and Medium Enterprises.

Reforms include deciding which imported equipment will be given tax and customs facilities to expedite the setting up of new industries. Tax incentives have also been promised for small and medium enterprises that deploy innovative energy-saving industrial equipment. The Department of Trade is also looking into the permits and licenses for the setting up of large scale retailers in the city centres that would potentially compete with the local small scale retailers. And the largest task by far is the review of the UU No 13/2003 on Labour Issues that should have been reviewed by the Legislative Assembly by 2006 as it is regarded to favour the labour unions and is a burden for labour-intensive industries.

The large segment of the oil-dependent economy is also facing uncertainty with foreign investments with the upcoming review of the Energy Law in 2007 (proposed as RUU Energi). This proposed law may replace the long term work contracts with renewable mining licenses which would affect the continuity and profitability of large investments. The shorter term

<sup>11</sup>UU Penanaman Modal Memberi Kepastian Modal, <http://www.tempointeraktif.com>

<sup>12</sup>Kadin Sambut Baik Penyesahan UU Penanaman Modal, <http://perpustakaan.bappenas.go.id>

<sup>13</sup>Dua Partai Tolak Undang-undang Penanaman Modal, <http://www.tempointeraktif.com>

<sup>14</sup>Sesat Pikir UU Penanaman Modal, <http://www.republika.co.id>

<sup>15</sup>UU Penanaman Model Perjuat Kelembagaan Neokolonialisme, <http://www.antara.co.id>

<sup>16</sup>Read views expressed in [www.hizbut-tahrir.or.id](http://www.hizbut-tahrir.or.id)

<sup>17</sup>Saling Tuding di Balik Investasi, <http://www.media-indonesia.com>

proposed by the licenses will also leave the renewal procedures open to much political lobbying and corruption at the various levels providing approval.

Timing is everything in deciding whether these vital reforms can be pushed through to capitalise on the rapid economic growth of the region. The government of Yudhoyono is in its mid term and the public evaluation has not been optimistic. Polls done by LSI at the end of March 2007 show that both the President and his deputy had lost ground with their popularity sliding below the 50% level.<sup>18</sup> Much of the decline is attributed to the loss of faith in the management of the economic policies and the failure to curb corruption in the bureaucracy.

The survey also shows increasing popularity of the PDIP with its iconic Megawati as a potential contender in the 2009 Presidential Elections.<sup>19</sup> Given such political dynamics, both the incumbent as well as aspirants to the palace will not want public support to waver by reforming the 2003 Labour Laws and by reducing the compensation rights of retrenched workers for the long term prospect of being investor-friendly. Though the law passed with opposition only from two political parties in Legislative Assembly, it is likely that the increased 'freebies' to investors and the equal status granted to both foreign and domestic capital will become key issues among the Islam-oriented as well as Nationalist political parties in the 2009 General Elections.

### Finding Continuity and Consistency

Despite the equal status to foreign and domestic investors, the Indonesian government seems to have reneged on its promise by granting the state-owned oil and gas company, Pertamina, a preferential right to own 15% of any new exploration license. This is in addition to a 10% participation right for the locally-

formed regency-owned enterprises.<sup>20</sup> This mandatory participation is necessary to facilitate the target of producing 1.3 million barrels/day by 2009 as well as to compensate for the increased subsidies in 2007 for electricity. Approximately IDR60 trillion (US\$6.45 billion) has been allocated to fuel subsidies and IDR28 trillion (US\$3 billion) to electricity subsidies.<sup>21</sup> State-owned enterprises that were formed as the spine of the national economy and managing vital resources have become a burden with Garuda, the national airlines, requiring a cash injection of IDR500 billion (US\$53.7 million). Garuda is one of the twelve non-performing state-owned enterprises due to receive financial assistance in 2007.<sup>22</sup>

While the newly-approved Investment Law was conceived to make Indonesia competitive with Cambodia, Malaysia, Vietnam, India and China, the government has set about protecting local companies to straddle domestic political concerns. Selling the ownership of state-owned enterprises has proven to be lucrative and productive in reforming the management but as in the case of Indosat, such a move gets continued public criticism, especially nearing elections.<sup>23</sup>

The Investment Law of 2007 fails to guarantee consistency between the legislature in the central government and the provincial and regency administrations. These Governors and Regents usually have a mind and agenda of their own. The case of the ban on sand exports to Singapore in the early part of 2007 showed inconsistency in the management of the situation by the Riau Provincial administration, NGOs, the Department of Trade and the Department of Environment. The fast pace of changes in legislation in Jakarta does not guarantee

<sup>18</sup>Kinerja Presiden dan Wakil Presiden, <http://www.lsi.or.id/>

<sup>19</sup>Kinergi Partai Politik, <http://www.lsi.or.id/>

<sup>20</sup>Pertamina Diberi Privelege, <http://www.bumn-ri.com>

<sup>21</sup>These subsidies are spelled out in the Peraturan Menteri Keuangan NOMOR 25/PMK.02/2007, <http://www.sjdih.depkeu.go.id>

<sup>22</sup>Tak Ada Lagi Tambahan PNM buat BUMN, <http://web.bisnis.com>

<sup>23</sup>Mochtar Pabottingi luncurkan buku Risiko Politik Divestasi Indosat, <http://web.bisnis.com>

efficiency on the ground. Officials in the provinces who are keen to facilitate the needs of the investors also have to balance the political interests of legislators and Regents.

The missing link is the development of an efficient bureaucracy and system that manages data and financial transactions. The vast bureaucracy is still managed by an extensive network of favourites who bear loyalty to kin and political patrons. This abyss requires extensive financial resources to penetrate. Even the new Investment Law and its legal paraphernalia cannot penetrate this extensive web of business and political connections that cut across all levels of society. The Judicial system that will eventually manage contractual disputes is as opaque as the bureaucracy. Given that the next General Election is less than 30 months away and that the governing coalition is unlikely to remain intact for the next term of government, we can expect that little progress can be achieved in reforming and augmenting the efficiency of the bureaucracy.

The other stark reality is that the national transportation infrastructure is fragile. The government hopes that the new law will bring keen investors to develop the ageing roads and rail. Existing business parks are also scarce except for those in the pricey island of Batam. The trans-Kalimantan and trans-Sumatra roads are in derelict condition. The rail, sea and air modes of transportation have seen several high profile accidents in the last four months with little hope of immediate improvements. Without adequate government spending to improve these basic modes of moving people and products, it is unlikely that the new Investment Law can actually persuade foreign industries to relocate to areas which do not have a ready supply of water and electricity. Furthermore, the supposedly large consumer market in Indonesia remains glum. Poverty is estimated to be at 17.75%

of the 222 million population.<sup>24</sup> Unemployment stands at a staggering 10.4% of the employable population.<sup>25</sup>

Leadership is also a rare but necessary commodity to get investors back into Indonesia. If Yudhoyono can assemble a team of professionals in his Cabinet in the reshuffle scheduled in early May 2007, then perhaps new zest and determination can push through the vital reforms.<sup>26</sup> If the pace of policy implementation is not accelerated by the end of 2007, then the momentum is lost.

By early 2008, it is likely that political aspirants for legislative and executive posts in the next General Election will harness their energies to mass support and funding for their respective political parties. While the economy may seem stimulated in 2008 and 2009 with higher spending on campaign-related events, paraphernalia and transportation, eventually the growth is not sustainable and is unevenly distributed among the increasing population of Indonesia.

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<sup>24</sup>Angka Kemiskinan 2007 Berpotensi Naik, <http://www.liputan6.com>

<sup>25</sup>Angka Kemiskinan 2009 Sulit Ditekan, <http://www.tempointeraktif.com>

<sup>26</sup>Reshuffle Kabinet diumumkan Awal Mei, <http://www.antara.co.id>

<sup>27</sup>THE INFORMATION contained in this article is intended solely to provide general guidance on matters of interest for the personal use of the reader, who accepts full responsibility for its use. The information is provided with the understanding that the authors and publishers are not herein engaged in rendering legal, accounting, tax, or other professional advice or services. As such, it should not be used as a substitute for consultation.

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