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The OECD Regulatory Reform Review of Indonesia

MARKET OPENNESS

Molly Lesher

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Abstract

THE OECD REGULATORY REFORM REVIEW OF INDONESIA: MARKET OPENNESS

This paper focuses on the market openness aspects of regulatory reform in Indonesia to devise recommendations for improving the country's regulatory processes. These recommendations involve institutionalising independent and objective evaluations of policies from an economy-wide perspective, as well as instituting a process by which broad public consultations are systematically required. Moreover, the findings in this paper suggest that the Indonesian economy would benefit from streamlining the licensing regime. The paper also identifies a need to ensure that new laws and regulations benefit Indonesia as a whole. Finally, the paper advocates for better co-ordination between the central government and the periphery. The implementation of these recommendations will help Indonesia achieve its goal of becoming one of the world's ten major economies by 2025.

JEL Classification: E6, F10, F13, F14, F15, H7, L5, R1, R5.

***Keywords*:** Indonesia, Regulatory Reform, Trade, Investment, Market Openness, Regulatory Process, NTMs, ASEAN, APEC, INSW, INTR, Regional Autonomy, DNI, Investment Negative List.

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Executive Summary

The OECD conducts reviews of regulatory reform in OECD member countries and strategic non-member partners. The aim of these reviews is to help governments improve the processes by which they make and enforce regulations with a view to supporting the interests of business and citizens, attracting and retaining investment, improving services and other means of raising public welfare. The reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, competition policy and enforcement, market openness, and the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

This paper focuses on the market openness aspects of regulatory reform in Indonesia. It addresses five principal issues. Section 1 sets the stage by providing an overview of the trade and economic environment in Indonesia. Section 2 surveys the trade and investment policymaking process currently in place and is followed in Section 3 by an outline of recent developments in trade and investment policy in Indonesia. Section 4 addresses steps that have been taken, or that could be useful, to better link Indonesia’s internal domestic market, as well as the Indonesian economy as a whole, to world markets. Section 5 offers five key recommendations aimed at improving the regulatory process.

Section I finds that the Indonesian economy is healthy, with GDP, inflation, unemployment and external balances all on solid footing. Investment has also been robust, with inward stocks as a share of GDP reaching their highest point in 2009, the worst year of the global economic crisis. However, foreign direct investment (FDI) is not spread equally across the archipelago. Moreover, the effects of the 1997-98 Asian financial crisis still linger. GDP growth rates and Indonesia’s share of world trade remain below pre-1997 levels, and Indonesia has experienced a steady deterioration in its terms of trade.

Section II shows that Indonesia’s goods trade is concentrated in energy-related products, with no change in this general orientation in the past 5-10 years. However, Indonesia has lost competitiveness in some traditional export sectors, such as textiles and wood. In other sectors, such as motor vehicles, Indonesia is increasing its competitiveness on world markets. Services trade is less developed and concentrated in a few sectors (tourism and transportation make up the bulk of Indonesia’s services trade), but business services are also increasingly important. Trade patterns for both goods and services have shifted markedly toward Asian and developing countries, in part due to the rise of production networks and regional integration, in particular through the Association of Southeast Asian Nations (ASEAN).

The ASEAN commitment to build the ASEAN Economic Community (AEC) by 2015 is pushing the reform effort forward in Indonesia and other countries in the region. As a result, tariff liberalisation has been deep and successful, with falling rates of effective protection. On the services side, liberalisation is less advanced, and recent regulatory changes are causing concern among some foreign providers of services,

especially in the logistics and telecommunications sectors. While some of the changes are welcome, other aspects of the new legislative framework will almost certainly increase Indonesia's trade costs and reduce its competitiveness on world markets. As a result, services reform could boost domestic productivity and improve trade performance. Investment Law 25/2007 and its implementing regulations represent a significant step toward improving the investment environment in Indonesia, but important ambiguities remain.

Non-tariff measures (NTMs) also appear to be on the rise, a worrying development given that these measures are less transparent and more easily influenced by special interests. An increase in NTMs undermines Indonesia's overarching intent to be more open, and creates less predictability. It also reduces the domestic economy's access to imported inputs, which play a critical role in connecting global value chains and driving export performance. It is also unclear that all NTMs have a clear policy objective and are in Indonesia's overall economic interest. Authority for non-tariff measures is also spread across a wide range of ministries and government agencies, which makes a whole-of-government approach to policymaking in this area more challenging.

Section III finds that other aspects of the trade and investment policymaking process in Indonesia are fragmented across many ministries and government agencies, and there is no formal, independent body to evaluate policies from an economy-wide perspective. In addition, mechanisms to ensure public consultations involving a broad base of stakeholders take place are not embedded in the regulatory process. Moreover, while frameworks for regulatory impact assessments (RIAs) have been put in place in some parts of government, RIAs do not appear to be used systematically, and as a result, sub-optimal regulatory outcomes can occur.

Section IV highlights the significant steps Indonesia has taken to better integrate with world markets, in particular via Indonesia's National Single Window (INSW). Indonesia is also pushing to better integrate its domestic market. For example, an ambitious programme to create one-stop-shops for investment licensing is notable. However, more can be done to rationalise licensing requirements. In addition, efforts to ensure that sub-national licenses have clear policy objectives and are not contradictory or duplicative are important.

Section V outlines five key recommendations aimed at improving the regulatory process in Indonesia.

1. ***Institutionalise independent and objective evaluations of policies from an economy-wide perspective.*** Independent and objective evaluations of policies from an economy-wide perspective are not currently institutionalised in Indonesia. An institution within the existing regulatory framework can be empowered to conduct these types of evaluations, with a view to significantly enhancing inter-ministerial co-ordination and improving regulatory outcomes.

2. ***Institute a process in which broad public consultations are systematically required.*** A mechanism is needed to ensure public consultations involving a broad base of stakeholders are held systematically to enhance transparency and avoid unintended trade restrictions. Rules or guidelines that ensure contact and consultations with experts in the relevant policy evaluation teams and interested parties would be useful. An on-line mechanism would ensure the broadest possible reach and facilitate interactions with stakeholders, including other governments.

3. ***Streamline the licensing process.*** While significant steps have been taken to successfully group the many licenses needed to start and operate a business in Indonesia into one-stop shops, more effort is needed to streamline the licenses themselves. In particular, efforts to ensure that sub-national licenses have clear policy objectives and are not contradictory or duplicative are important.

4. ***Ensure that new laws and regulations benefit Indonesia as a whole.*** The fragmentation of the policymaking process has led to an increase in opportunities for special interests to exert influence. As a result, the government should consider embedding regulatory impact assessments systematically into the regulatory framework for all policies that meet a pre-defined threshold test. In addition, the development of well-defined criteria to guide the evaluation of significant regulations would be useful.

5. ***Improve co-ordination between the central government and the periphery.*** Better co-ordination between the central government and the periphery is a critical component of ensuring overall national interest. Toward this end, an objective review of local laws and regulations is important. Mechanisms to ensure that local governments cannot easily ignore national laws are also needed. Further, an essential aspect of improving co-ordination between the central government and the periphery involves increasing human resource capacity.

The OECD Regulatory Reform Review of Indonesia: Market Openness

The OECD conducts reviews of regulatory reform in OECD member countries and strategic non-member partners.[1] The aim of these reviews is to help governments improve the processes by which they make and enforce regulations with the aim of supporting the interests of business and citizens, attracting and retaining investment, improving services and other means of raising public welfare. The reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, competition policy and enforcement, market openness, and the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

This paper focuses on the market openness aspects of regulatory reform in Indonesia. The overall aim is to demonstrate the ways in which regulatory reform can help Indonesia achieve its own economic objectives, namely to transform Indonesia into one of the 10 major economies in the world by 2025 (GOI, 2011). To achieve this, real economic growth must reach 7-9% per year, and improvements are envisaged in education and health outcomes, employment, and poverty reduction. To achieve these goals, policy reforms will be needed to increase competitiveness, improve the business climate, and establish an efficient distribution network.

Regulatory reform is one tool that can help governments enhance market openness through the improvement of existing laws and regulations. It can also ensure that the creation of new laws and regulations are non-discriminatory and efficient. Regulatory reform can help reduce the regulatory burdens faced by firms including in their trading activities, and thereby facilitate the flows of trade and investment. With the help of advanced regulatory reform tools and approaches – such as regulatory impact analysis (RIA), administrative simplification, and consultation procedures – governments can create regulations and regulatory procedures that efficiently meet their policy objectives and at the same time support market access.

This paper addresses five principal issues. Section 1 sets the stage by providing an overview of the current trade and economic environment in Indonesia. Section 2 surveys the trade and investment policymaking process currently in place and is followed in Section 3 by an outline of recent developments in trade and investment policy in Indonesia. Section 4 addresses steps that have been taken, or that could be useful, to better link Indonesia’s internal domestic market, as well as the Indonesian economy as a whole, to world markets. Section 5 offers five key recommendations aimed at improving the regulatory process.

[1] The OECD has assessed regulatory policies in 24 member countries, Brazil, China and the Russian Federation.

I. The current trade and economic environment in Indonesia

Any analysis of Indonesia must be viewed through the lens of its experience during the 1997-98 Asian financial crisis, which inflicted significant damage on the domestic economy. Exchange rate pressures led to a steep devaluation of the Indonesian rupiah, which stood at 15% of its USD value in the last 6 months of 1997 (Blalock and Roy, 2007). In 1998, investment declined by 45%, GDP contracted by 13%, and poverty rose sharply. Economic hardship led to unrest, and President Suharto resigned after three decades as President, ending the New Order regime and paving the way for democracy to take hold.

As part of the transition to democracy, decentralisation was rolled out. This process resulted in a significant transfer of power from central to provincial and local governments. While decentralisation is widely viewed as a necessary condition for keeping the archipelago together during the democratisation process, it has also created unique challenges. In the trade and investment context, issues have become particularly manifest as local governments now have the ability to impose investment and trade taxes that may create internal barriers to trade in the domestic market.

This section assesses various indicators of Indonesia's economic performance with the aim of understanding better how government regulations and processes can be made more efficient and conducive to trade and growth.

Trade has contributed to Indonesia's impressive growth, but trade and growth remain below potential

Indonesia weathered the 2008-09 economic crisis well, in part due to significant and successful structural reforms implemented in the aftermath of the Asian financial crisis. Since peaking in 2005, Indonesia's unemployment rate has been falling and stood at 8.4% in 2010 (Table 1). Concerns about inflation have also diminished, with inflation running at 4.4% year-on-year in October 2011 (ADB, 2011b). Indonesia is running a modest current account surplus as a share of GDP, and growth and investment have been strong.

Table 1. Selected indicators, Indonesia and Southeast Asia, 2010

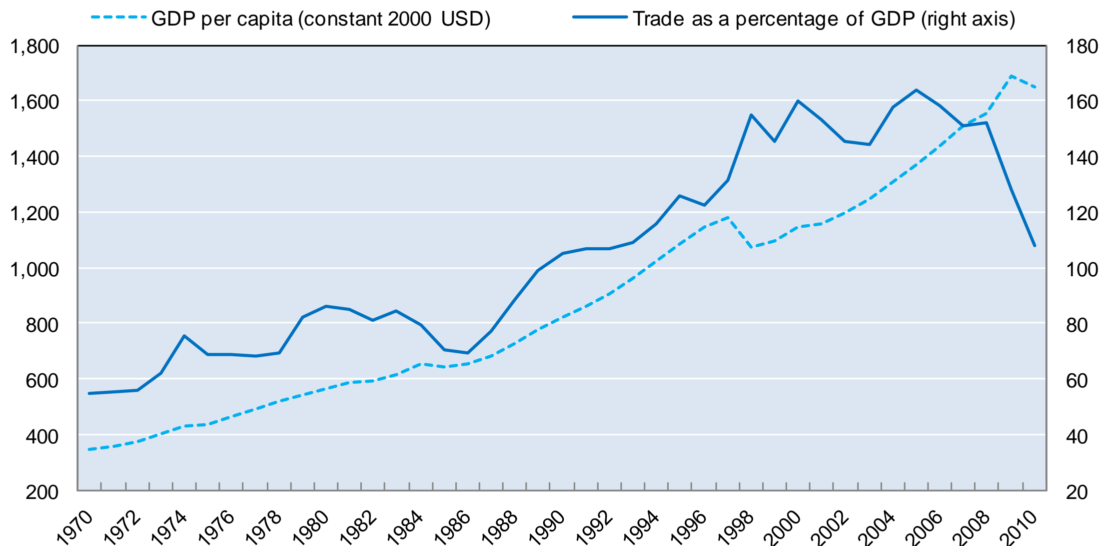
	Indonesia	Southeast Asia
GDP growth (% per year)	6.1	7.9
Inflation (% per year)	5.1	4.0
Unemployment rate (%)	8.4	n/a
Current account balance (share of GDP)	0.9	6.3

Source: ADB Outlook Update 2011.

In the first half 2011, GDP growth averaged 6.5% due to robust investment, a pick-up in private consumption and strong export performance (ADB, 2011a). Looking ahead, short-term projections suggest growth rates of around 6% for 2011 and 2012 (OECD, 2010b). However, Indonesia has yet to fully recover to growth rates pre-Asian financial crisis, and its 2010 growth rate was a full two percentage points below the ASEAN average, suggesting that scope remains to further enhance growth. Moreover, growth is not evenly spread across regions, with Java contributing almost 60% of Indonesia's total growth in 2010 (BPS Statistics).

Indonesia's GDP per capita has risen almost five-fold in the past forty years (Figure 1). Trade has played an important role in this remarkable achievement. In the past 25 years, trade as a share of GDP increased significantly in Indonesia, in part due to the country's outward-oriented development strategy. And while the deep global trade contraction in 2009 is apparent, more recent data suggest that trade has increased to levels closer to trend.

Figure 1. Evolution of GDP per capita and trade as a share of GDP in Indonesia



Source: World Bank's World Development Indicators.

Openness has been an important driver of structural change. The rise of intra-industry trade in Asia coupled with deep and successful reforms aimed at improving economic performance has contributed to changes in trade patterns as well as underlying structural adjustments (Plummer and Chia, 2009). Imports – particularly of services – play an important role in boosting domestic productivity via technology spillovers, lower costs and access to a greater variety of inputs (Lesher and Nordås, 2006).

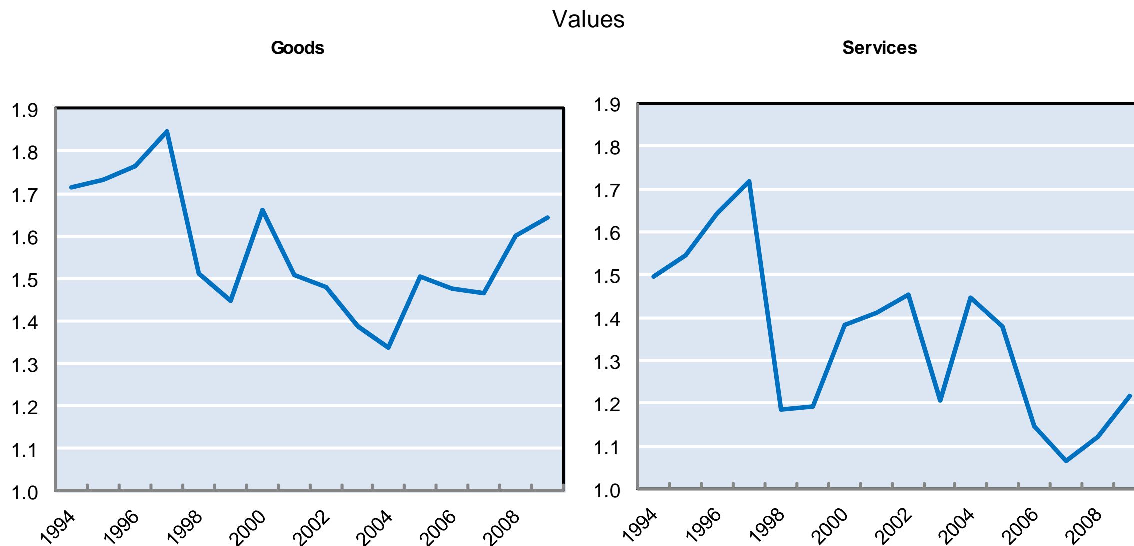
However, the positive role that trade in general and imports in particular play in the domestic economy is often overlooked by policymakers. Indeed, in the wake of the global economic crisis of 2008-09, policymakers across Southeast Asia are taking stock and revisiting openness as a tool for economic development. Such is the case in Indonesia, where there appears to be a serious reconsideration among some policymakers of the benefits of openness for sustained, balanced growth (see, for example, Yulisman, 2011 and Silalahi, 2011).

This development has emerged despite the fact that Indonesia's share in world trade in both goods and services has not recovered to levels prior to the Asian financial crisis (Figure 2), underscoring the severity of the crisis on the Indonesian economy. The difference between the peak and current levels is particularly marked in the services sector, and investment demand dropped precipitously. This is in part because Indonesia's average annual rate of growth of trade has been below that of other Asian economies, such as China, India, Singapore and Vietnam. It also partly explained by the relatively high regulatory burdens faced by service providers in Indonesia. Thus, there remains

much potential in the Indonesian economy to boost trade, and thus growth, going forward.

Figure 2. Share of Indonesia in world trade, 1994-2009

Values

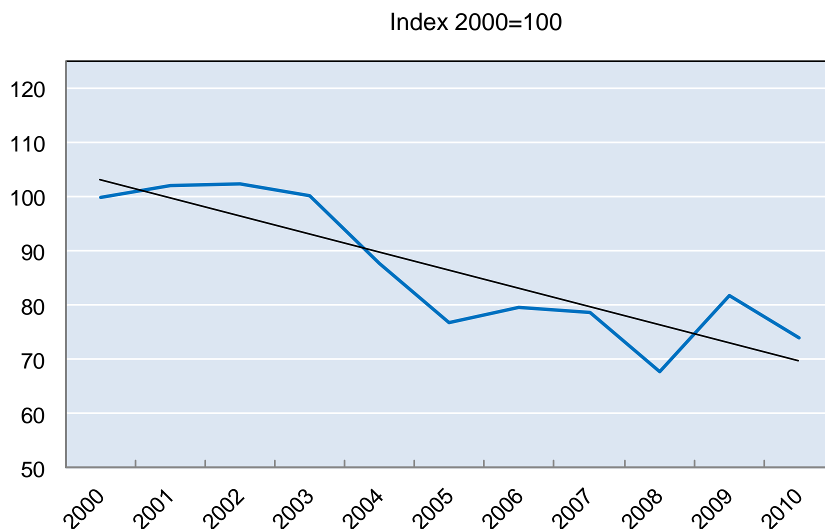


Source: IMF Balance of Payments Statistics.

Important shifts in prices have affected Indonesia's trade performance. Data suggest a downward trend in Indonesia's terms of trade since 2000, despite the relatively high world prices of commodities that have a positive effect on the terms of trade (Figure 3).

Figure 3. Trends in Indonesia's terms of trade

Index 2000=100



Note: The terms of trade is calculated as follows: (export price index base 2000/imports price index base 2000)*100.

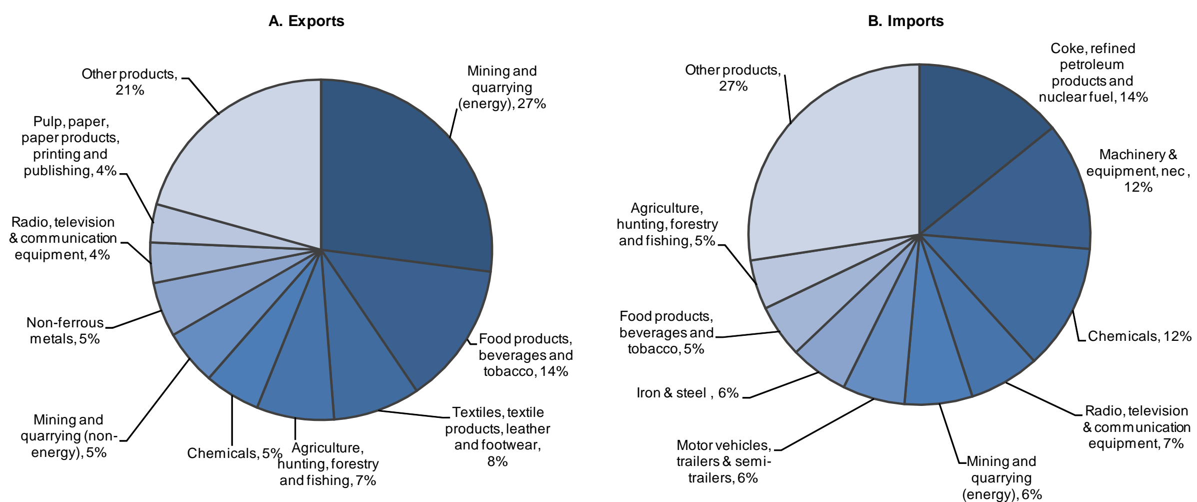
Source: World Bank's World Development Indicators.

The deterioration may be at least partly due to the rise of oil prices in the past few years. Indeed, government subsidies for fuel and electricity are projected to amount to around 15% of total government outlays, leading to artificially low consumer prices (ADB, 2011a). Fossil fuel subsidies have been pernicious, and contributed to the premature emergence of Indonesia as a net oil importer (in 1980, not only was Indonesia an oil exporter but oil exports constituted around three-quarters of total exports). High prices for machinery and equipment may also have contributed to downward pressures on the terms of trade.

Goods trade is concentrated in energy products…

Indonesia trades more energy-related products[2] than any other product category, on both the export and the import side (Figure 4). In 2010, energy-related products accounted for the largest share (30%) of Indonesia's exports, up slightly from 29% five years ago. Other natural resource-based products, including agriculture-based commodities, non-energy mining and quarrying, and non-ferrous metals, are also represented strongly in total exports. The food and beverage sector's contribution to total exports increased to 14% from 10% in the past five years. The textile sector's share in overall exports has been declining (down 4 percentage points over the past five years), but still accounts for 8% of the total.

Figure 4. Indonesia's trade is dominated by energy, 2010



Source: UN Comtrade Database.

On the import side, energy accounted for 20% of Indonesia's overall imports, down from 35% only five years ago. Imports of machinery and equipment (12%) and chemicals (12%) are also prominent in Indonesia's total imports. Other significant import sectors include radio, television and communication equipment (7%) and motor vehicles, trailers and semi-trailers (6%).

2 ISIC Rev. 3 codes 10-12 and 23.

Moving from broad sectors to a more detailed level of disaggregation, shifts in Indonesia's trade in particular products can be seen over the 15-year period 1995-2010 (Table 2). Overall, there has been no change in the general orientation of Indonesia's top ten export products. In 1995, nine of the top ten export products were natural resource-based. In 2010, all top ten products were in this category.

Table 2. Top 10 products exported at the 6-digit level of the HS classification, 1995 and 2010

Value in million USD and ranking

HS 6 digits code		1995	Ranking in 2010	HS 6 digits code		2010	Ranking in 1995
Total	**Total Trade**	**45 418**		**Total**	**Total Trade**	**157 779**	
270900	Petroleum oils and oils obtained from bituminous minerals	5 146	3	270112	Bituminous coal, not agglomerated	11 976	8
271111	Natural gas, liquefied	3 614	2	271111	Natural gas, liquefied	10 572	2
441211	Plywood with >=1 outer ply of tropical woods	2 684	28	270900	Petroleum oils and oils obtained from bituminous minerals	10 403	1
400122	Technically specified natural rubber	1 821	5	151110	Crude palm oil	7 650	10
260300	Copper ores and concentrates	1 537	6	400122	Technically specified natural rubber	7 103	4
640319	Sports footwear, with rubber, plastics	1 001	21	260300	Copper ores and concentrates	6 882	5
030613	Frozen shrimps and prawns	875	30	270119	Other coal, not agglomerated, nes	6 155	61
270112	Bituminous coal, not agglomerated	867	1	151190	Palm oil (excl. crude) and liquid fractions	5 819	37
090111	Coffee, not roasted or decaffeinated	596	29	271121	Natural gas in gaseous state	2 887	..
151110	Crude palm oil	590	4	271000	Petroleum oils, etc, (excl. crude);	2 191	..

Source: UN Comtrade Database.

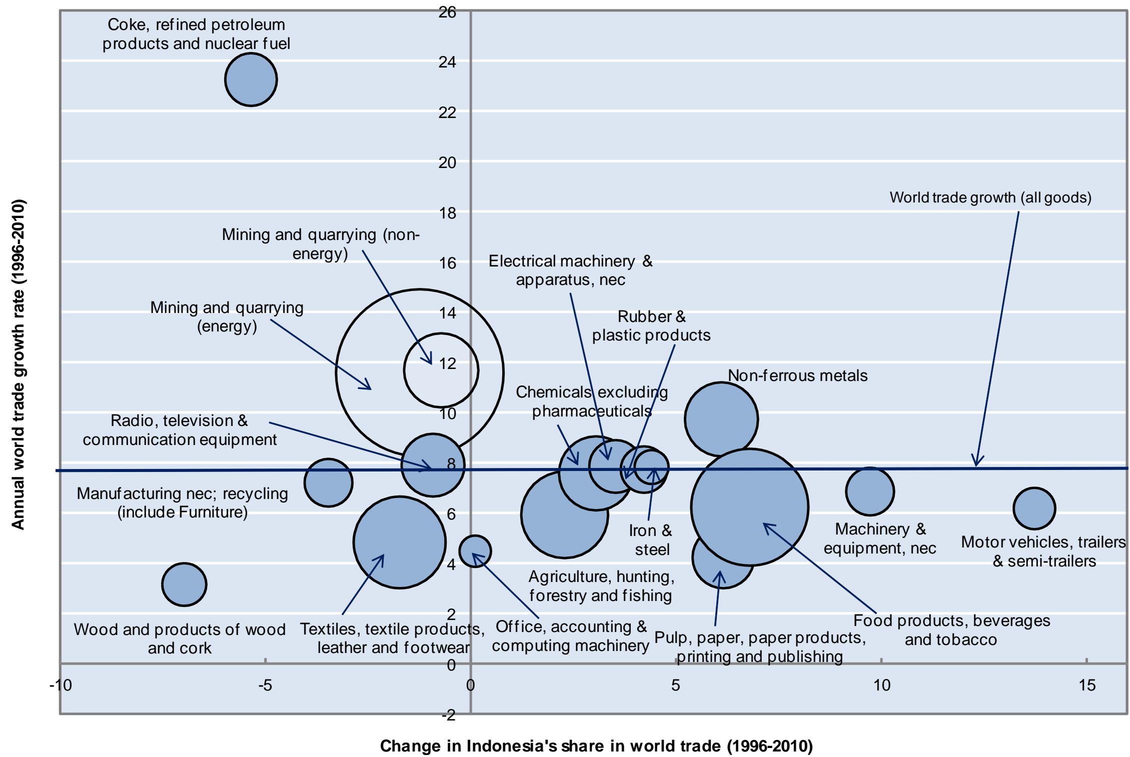
Within this group coal and palm oil have become more important export products, while natural gas continues to be the second most important export. Timber-related exports (primarily plywood) decreased during the 15-year period, from Indonesia's 3rd most important export product in 1995 to 28th in 2010. Coffee and shrimp exports have also fallen in terms of export ranking. Copper and rubber have retained their importance as Indonesia's 4th and 6th most important export products.

Dynamic analysis of export performance for goods using a quadrant approach[3] shows that non-ferrous metal products is the only product category firmly in the champions corner, underscoring Indonesia's competitiveness in this sector in world markets over 1996-2010 (Figure 5). Other sectors, such as iron and steel, chemicals (excluding pharmaceuticals), rubber and plastic products, and electrical machinery also demonstrate global competitiveness during this period, although world trade growth in these sectors is declining somewhat.

[3] In this approach, the horizontal axis represents the change in Indonesia's world market share for a particular product, and the vertical axis represents world trade growth of that product. Using this methodology, the top right-hand quadrant represents products in which Indonesia is increasing its market share as world trade growth is rising ("champions"). The top left-hand quadrant shows growth products in which Indonesia is losing market share ("underachievers"), while the bottom left-hand quadrant characterises products in which world trade growth is declining in tandem with Indonesia's share in world trade ("losers"). Finally, the bottom right-hand quadrant represents products in which Indonesia's market share is increasing even while world trade growth is declining ("achievers in adversity").

Natural resource-based sectors, such as mining and quarrying, coke and refined petroleum products, in addition to radio, television and communication equipment, rest in the underachiever's area. This is particularly disappointing as the "bubble" is relatively large for the energy-related mining sector, showing that trade in mining products in particular represents an important share of Indonesia's overall exports. This is in part reflective of Indonesia's infrastructure deficiencies in these energy-related sectors (IEA, 2008).

Figure 5. Indonesia's export performance: Goods trade, 1996-2010



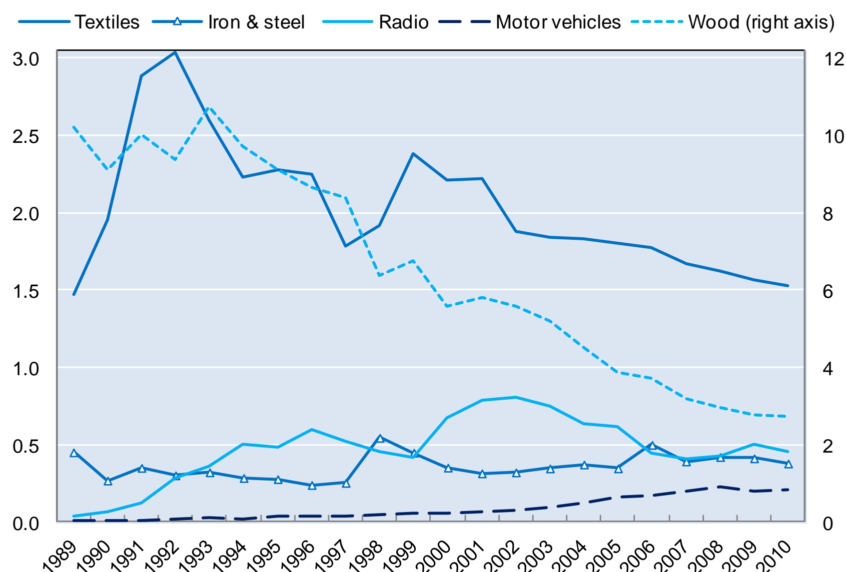
Source: UN Comtrade Database.

Several of the high-technology sectors, including chemicals, cluster on the right-hand side of the figure very near the average world growth rate of all traded goods. Food, beverage and tobacco products, which represent one of the top export sectors, are found on the bottom right-hand side of the figure, suggesting that this is one sector that has gained world market share even as world trade in these products has declined. The paper and publishing, machinery and equipment, and primary sectors also fall into this area.

The most undesirable corner of the figure is the bottom left-hand side, which presents sectors that are losing market share in declining sectors. Textiles, leather and footwear as well as wood products can be found here, suggesting that Indonesia may need to increase competitiveness in niche markets in these sectors to improve export performance. The loss of competitiveness in these sectors is mirrored in analysis of revealed comparative advantage (RCA) (Figure 6).[4]

4 A RCA index is used as a proxy for revealed comparative advantage (and thus export potential). This paper follows Balassa (1965), whose approach is to use normalised export shares to evaluate export performance of individual industries. This normalisation is calculated by dividing Indonesia's

Figure 6. Revealed Comparative Advantage indices for Indonesia, selected sectors



Source: Author's calculations based on UN Comtrade Database.

Indonesia's motor vehicles industry represents one of the industries that has benefited from liberalisation (Molnar and Lesher, 2008). With a long record of policy failures related to so-called infant industry protection, the sector is now showing increasing signs of competitiveness (Figure 6). It is still small, but nonetheless a fast-growing export sector. Effective protection of the industry has fallen substantially, and an increasing share of inputs is sourced domestically, resulting in a relatively high share of domestic value-added (Molnar and Lesher, 2008). It is also one of the few industries that have regained pre-Asian financial crisis shares of exports in production.

…amid a marked shift of increased trade with developing countries, primarily in Asia

The rise of production networks in Asia has also impacted Indonesia's trade pattern. Indonesia and other Asian economies have become suppliers of intermediate inputs, often with China as a hub for final assembly, in the electronics and other industries. Indeed, in 2008 intra-Asian trade in parts and components accounted for 55% of total trade (ADB, 2010).

The shift toward more integrated production networks in Asia is borne out in the data. In 1995, Indonesia exported predominately to developed countries, four of which are located outside of Asia (Table 3, Panel A). China was the only developing country in the top ten export destinations for Indonesia's goods in 1995. In 2010, however, more developing countries make it into the top 10 (India, Malaysia, Thailand), and the destination shifts markedly to Asia. In 2010, only one country is non-Asian (the United States).

export share in the world exports of an individual commodity by Indonesia's share in the combined world exports of manufactured goods. A RCA index of 1 or above indicates comparative advantage in that sector.

Table 3. Indonesia's top 10 trading partners, goods trade

1995 and 2010, Value in billion USD

Panel A. Destination of exports

	1995	Ranking in 2010		2010	Ranking in 1995
Japan	12 288	1	Japan	25 782	1
United States	6 322	3	China	15 693	6
Singapore	3 767	4	United States	14 302	2
Korea, Rep.	2 917	5	Singapore	13 723	3
Other Asia, nes	1 766	8	Korea, Rep.	12 575	4
China	1 742	2	India	9 915	21
Hong Kong, China	1 657	14	Malaysia	9 362	11
Netherlands	1 452	11	Other Asia, nes	4 838	5
Germany	1 382	13	Thailand	4 567	14
United Kingdom	1 129	18	Australia	4 244	12

Panel B. Origin of imports

	1995	Ranking in 2010		2010	Ranking in 1995
Japan	9 217	3	China	20 424	8
United States	4 756	4	Singapore	20 241	2
Germany	2 819	12	Japan	16 966	3
Korea, Rep.	2 451	6	United States	9 416	4
Singapore	2 367	2	Malaysia	8 649	5
Australia	2 015	9	Korea, Rep.	7 703	6
Other Asia, nes	1 828	11	Thailand	7 471	7
China	1 495	1	Saudi Arabia	4 361	8
France	1 064	16	Australia	4 099	9
Saudi Arabia	943	8	India	3 295	10

Note: The "Other Asia" category encompasses all Asian economies not otherwise specified in the Comtrade Database, such as Chinese Taipei.

Source: UN Comtrade Database.

A similar pattern emerges on the import side (Table 3, Panel B). In 1995, Indonesia imported more from higher-income economies, four of which are non-Asian (United States, France, Germany and Saudi Arabia). China is the only developing economy in the top 10 list in 1995. In 2010, the United States and Saudi Arabia are the only non-Asian country of origin, and more developing, Asian countries are included (Malaysia, Thailand, and India again become important trading partners).

While the rise of production networks in Asia partly explains the changes in Indonesia's main trading partners, other factors are also at play. Indonesia's regional integration, in particular through the Association of Southeast Asian Nations (ASEAN) framework, can also partly explain these shifts. The ASEAN Free Trade Area (AFTA), the process to build the ASEAN Economic Community (AEC), the ASEAN–China Free Trade Area (ACFTA), among other regional integration efforts, have all pushed Indonesia to trade more with its Asian neighbours.

Trade in services is less developed and concentrated in relatively few sectors

Trade in services as a share of GDP in Indonesia was about 6% in 2010, down from a little over 12.5% in 2000. On balance, Indonesia shows a net services trade deficit. On the export side, travel services dominate with almost half of Indonesia's services exports (Table 4, Panel A). Travel services broadly represent the tourism sector, one of the three priority services sectors in ASEAN co-operation. Economy-wide spillovers from tourism, which tend to increase demand in other sectors, may be one reason to encourage further liberalisation in that sector (Geloso-Grosso *et al*, 2007). Transportation services account for the second largest services export sector (18%) followed by other business services (14%) and communication services (7%).

Table 4. Indonesia's trade in services, 2008

Panel A. Exports (% of total services exports)

	Indonesia	ASEAN Average
Transportation	18%	22%
Travel	48%	51%
Communications services	7%	3%
Construction services	4%	2%
Insurance services	0%	1%
Financial services	2%	2%
Computer and information services	1%	1%
Royalties and license fees	0%	5%
Other business services	14%	10%
Personal, cultural, and recreational services	1%	0%
Government services, n.i.e.	3%	2%
Services not allocated	0%	1%

Panel B. Imports (% of total services imports)

	Indonesia	ASEAN Average
Transportation	49%	46%
Travel	20%	20%
Communications services	3%	3%
Construction services	3%	4%
Insurance services	2%	4%
Financial services	1%	1%
Computer and information services	3%	1%
Royalties and license fees	5%	4%
Other business services	14%	12%
Personal, cultural, and recreational services	0%	0%
Government services, n.i.e.	1%	1%
Services not allocated	0%	5%

Note: Myanmar and Brunei Darussalam are not included in the ASEAN average because of data limitations.
Source: UN Service Trade Statistics Database.

On the import side, transportation services accounts for almost half of all of Indonesia's services imports, followed by travel services (20%) and other business services (14%). Services have generally been more regulated than the manufacturing sector, leading to less competitive outcomes (Aldaba and Pasadilla, 2010). And while Indonesia does not currently import a lot of network services (e.g. electricity), network industries have important spillover effects in the overall economy.[5] Increasing competition is thus an important component of ensuring sustained, balanced future growth. Imported inputs also help boost domestic productivity via technology spillovers, lower costs and access to a greater variety of inputs.

Most of Indonesia's exports of services are destined for the Asian market (Table 5, Panel A). The other important export destination is Europe, the region in which the other countries in the top 10 are located. Imports are sourced from Asia although to a lesser extent; Europe and the United States also represent significant origins of imports (Table 5, Panel B). It is not surprising that Singapore and Hong Kong, China are important sources of imports, given their highly developed services bases; nor is it surprising that Indonesia's services trade is concentrated among more developed economies for the same reason.

Table 5. Indonesia's top 10 trading partners, services trade

2008, Value in USD

Panel A: Destination of exports

Japan	1 779 287 716
Korea	1 260 900 000
Singapore	967 867 252
Australia	818 270 727
Hong Kong, China	344 000 000
Netherlands	305 138 776
France	259 177 115
United Kingdom	236 716 290
Denmark	134 698 407
Italy	125 038 232

Panel B: Origin of imports

Singapore	3 093 338 335
Japan	2 058 599 573
United States	1 589 214 695
Korea	951 600 000
Australia	869 031 693
Sweden	526 861 062
Hong Kong, China	518 000 000
Germany	504 375 276
Netherlands	489 338 642
United Kingdom	474 134 809

Note: Data are constructed using mirror data; Indonesia does not independently report services trade by partner country.

Source: UN Service Trade Statistics Database.

The largest single flow of services exports among sectors involve other business services (Japan and Korea), transportation, especially in freight and sea transportation (Europe), travel services (Europe, Japan and Australia), and construction services (Japan). On the import side, other business services and computer services (Europe), transportation services, particularly in freight and sea (Europe and Korea), royalties and license fees (Japan), and travel services (Australia) are among the largest single flows of services.

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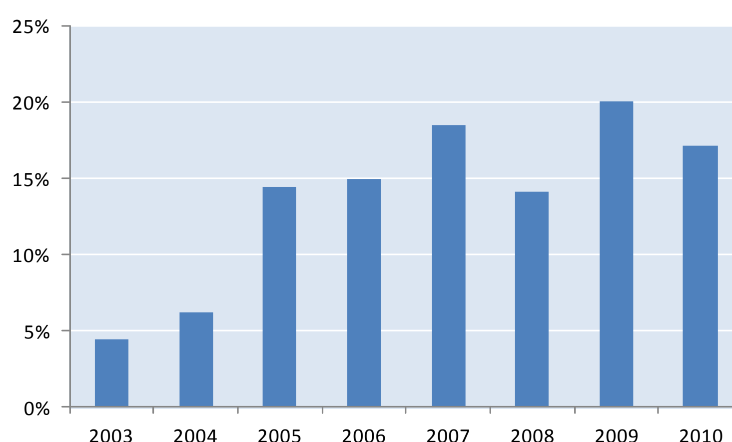
5 Transportation and telecommunications represent other network sectors with spillover potential.

FDI has benefited Indonesia, but it is not widely spread across the archipelago

Inward stocks of foreign direct investment (FDI) in Indonesia have been increasing steadily since 2003 and stood at 17% of GDP in 2010 (Figure 7). This upward trend persisted in spite of the global economic crisis of 2008-09; in fact, inward FDI stocks as a share of GDP reached their highest point (20%) in the last seven years in 2009, the worst year of the global economic crisis. This reflects Indonesia's attractiveness as an investment destination both in terms of its large domestic market as well as its location as a production platform to serve other Asian markets. However, Indonesia's FDI performance lags most of the other ASEAN economies, suggesting that there is significant scope to further boost investment (Annex Table 1).

Figure 7. Inward stock of FDI as a share of GDP



Source: World Bank's World Development Indicators and UnctadStat.

Data from Indonesia's Investment Co-ordinating Board (BKPM) suggest that foreign investment is concentrated in Java (60%) and Sumatra (21%), particularly in the Jakarta metropolitan area, Batam, Bintan and Karimun (OECD, 2010a). Since 2004, FDI concentration has shifted from manufacturing toward the mining and quarrying and certain services sectors (OECD, 2010a). Foreign investors tend to come from other Asian countries, with Japan, Korea, Malaysia and Singapore as important investors (OECD, 2010a). However, other countries, such as the United States (particularly in the mining sector) and the United Kingdom are also important sources of FDI in Indonesia.

To sum up the current trade and economic environment in Indonesia, the Indonesian economy is healthy, with GDP, inflation, unemployment and external balances all on solid footing. Investment has also been robust, with inward stocks as a share of GDP reaching their highest point in 2009, the worst year of the global economic crisis. However, FDI is not spread equally across the archipelago, and is concentrated largely in Java and Sumatra. Moreover, the effects of the 1997-98 Asian financial crisis still linger. GDP growth rates and Indonesia's share of world trade remain below pre-1997 levels, and Indonesia has experienced a steady deterioration in its terms of trade.

Indonesia's goods trade is concentrated in energy-related products, and there has been no change in this general orientation in the past 5-10 years. However, Indonesia has lost competitiveness in some traditional export sectors, such as textiles and wood. In other sectors, such as motor vehicles, Indonesia is increasing its competitiveness on world

markets. Services trade is less developed and concentrated in a few sectors (tourism and transportation make up the bulk of Indonesia's services trade), but business services are also increasingly important. Trade patterns for both goods and services have shifted markedly toward Asian and developing countries, in part due to the rise of production networks in the region as well as regional integration, particularly through the ASEAN framework.

II. Recent developments in trade and investment policy

Tariff liberalisation has been deep and successful in Indonesia, and today it represents a relatively low-tariff country by developing-country standards. The effective rate of protection has also fallen over the past decade, although effective rates remain above nominal rates of protection. And as tariffs have fallen, non-tariff measures, which are less transparent and more easily manipulated, appear to have risen in number and scope. A new trade law is also currently being formulated.

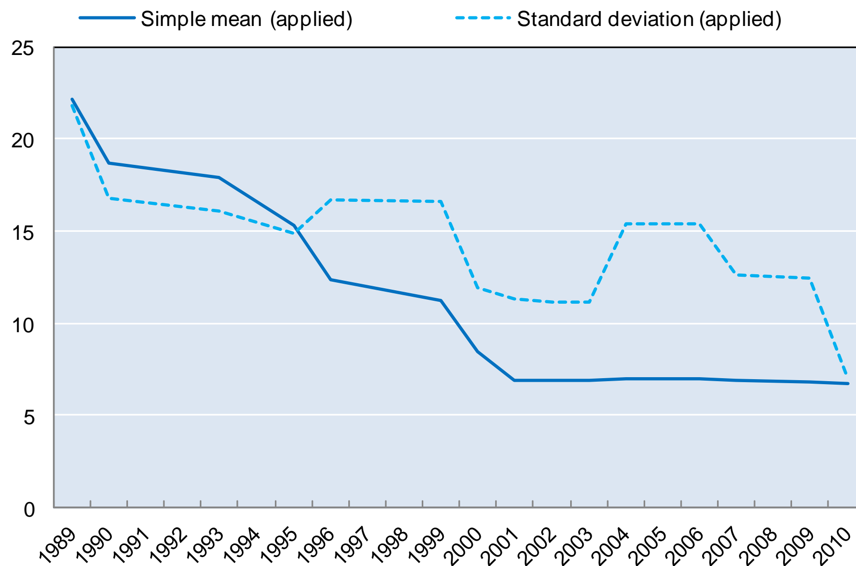
Attracting additional investment, particularly in the infrastructure sector, is an important component of the government's plan to achieve its growth objectives in its new Masterplan for the Acceleration of Indonesia's Economic Development for the period 2011-2025 (GOI, 2011).[6] Important developments have also taken place on the investment policy front, including the enactment of new laws and regulations governing FDI and the recent passage of a new land law (see Box 3), which will be important for future investors in infrastructure projects.

Tariffs have fallen sharply in recent years

Indonesia's MFN applied tariffs have fallen by two-thirds since the early 1990s to about 6.7% in 2010, a relatively low figure by developing country standards (Figure 8). Moreover, after a widening between the simple mean and the standard deviation – indicating increased tariff dispersion and thus lower economic efficiency – this gap has decreased significantly in recent years. This suggests that the overall number of tariff peaks have fallen, particularly in the past two years.

6 The Masterplan identifies 22 priority areas that will be promoted in six economic corridors.

Figure 8. Indonesia's tariff structure



Source: UN Trains Database.

Overall, MFN tariffs are higher for finished goods than they are for intermediate inputs, implying a cascading tariff structure (Table 6). As a result, the impact of tariffs on production depends not only on the tariff applied on final goods in a particular sector, but also on the tariffs applied on the intermediate inputs used in production. This is particularly important given the shift toward production networks.

Table 6. Indonesia's MFN tariffs

	Applied MFN Rates			
	Capital goods	Consumer goods	Intermediate goods	Raw materials
1989	14.67	35.10	17.92	15.38
1990	14.12	29.05	14.17	14.91
1993	13.06	28.25	13.55	13.75
1995	10.78	24.39	11.85	10.96
1996	6.27	20.20	9.86	9.93
1999	5.90	18.58	8.72	8.72
2000	4.45	13.81	7.32	4.38
2001	3.67	10.99	6.02	4.24
2002	3.71	10.98	5.97	4.23
2003	3.70	10.96	5.98	4.23
2004	3.79	10.93	6.10	4.17
2005	3.79	10.93	6.10	4.17
2006	3.79	10.93	6.10	4.17
2007	3.72	11.07	5.85	4.51
2009	3.63	10.85	5.79	4.50
2010	5.46	9.16	6.03	4.48

Note: Preferential tariff rates are excluded.

Source: UN Trains Database.

The importance and the inherent distortions in this cascading tariff structure are evident in an analysis of nominal and effective rates of protection (Table 7). In almost all sectors analysed, effective rates of protection were higher than nominal rates in 2005, the most recent year for which data is available.

Table 7. Nominal and effective rate of protection in Indonesia, 2005

	Nominal rate	Effective rate
Food products, beverages and tobacco	10.2	12.1
Textiles, textile products, leather and footwear	9.6	10.8
Wood and products of wood and cork	6.3	8.3
Pulp, paper, paper products, printing and publishing	4.4	4.7
Coke, refined petroleum products and nuclear fuel	3.7	3.8
Chemicals excluding pharmaceuticals	4.2	4.6
Pharmaceuticals	5.3	6.3
Rubber & plastics products	12.4	13.9
Other non-metallic mineral products	5.9	6.5
Iron & steel	8.4	9.8
Non-ferrous metals	5.0	5.1
Fabricated metal products, except machinery & equipment	10.0	10.6
Machinery & equipment, nec	2.8	2.8
Office, accounting & computing machinery	1.7	2.3
Electrical machinery & apparatus, nec	6.6	6.9
Radio, television & communication equipment	5.7	5.8
Medical, precision & optical instruments	4.8	5.2
Motor vehicles, trailers & semi-trailers	21.1	21.9
Building & repairing of ships & boats	1.5	1.4
Aircraft & spacecraft	0.0	-0.1
Railroad equipment & transport equip n.e.c.	0.3	0.3
Manufacturing nec; recycling (include Furniture)	11.0	11.9

Source: Authors calculations based on the 2007 edition of the *OECD Input-Output Database*.

Effective rates are notable in the textiles and wood products sectors, two sectors in which Indonesia has been losing competitiveness. The food, beverages and tobacco as well as the rubber products sectors also have larger effective rates of protection than other sectors. Given that effective rates are generally higher than nominal rates of protection, the reduction in tariff dispersion over time has been very important, even though more can still be done.

Regional integration has been a driver of tariff reduction in Indonesia

Low tariffs are common among the ASEAN countries, and Indonesia is no exception. In fact, Indonesia's applied MFN tariffs across broad sectors are relatively low even among fellow ASEAN countries and are characterised by fewer tariff peaks, apart from a relatively high levy of about 52% on beverages and tobacco (Table 8). Indeed, Thailand, Vietnam, Lao PDR and Cambodia all post a higher average tariff with more tariff peaks than Indonesia.

Table 8. Average MFN applied tariffs in ASEAN countries

Latest year, percentages

	Brunei Darussalam	Cambodia	Indonesia	Lao PDR	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam
	2008	2008	2009	2008	2009	2008	2009	2009	2009	2009
Animal products	0	27.8	4.4	24.9	3.9	10.7	21	0	28.7	14.6
Dairy products	0	25.8	5.5	8.5	2.3	3.4	3.9	0	24.8	12.8
Fruit, vegetables, plants	0	14	5.9	30.3	3.6	11.5	9.8	0	30.5	24.4
Coffee, tea	2.1	26.7	8.3	24.2	5.7	14	15.7	0	28.3	29.8
Cereals & preparations	0.2	19.8	5.8	9.2	4.5	8.7	10.9	0	18.1	21.6
Oilseeds, fats & oils	0	9.1	3.9	12	1.8	1.7	5.6	0	10	8.6
Sugars and confectionery	0	7	8	12.5	2.5	5.4	16	0	22.3	15.8
Beverages & tobacco	0	33.1	51.8	31.3	155.2	23.2	8.2	2.5	41.9	50
Cotton	0	7	4	8	0	0.8	2.6	0	0	6
Other agricultural products	0	15.5	4.3	9.8	0.6	3.1	3.4	0	9.4	6.8
Fish & fish products	0	18.9	5.8	12.7	1.2	8.2	8.1	0	11.7	25.7
Minerals & metals	0.2	11	6.4	5.8	11.2	3.4	4.9	0	6	8.6
Petroleum	0.6	14.8	0.3	14.9	0.7	1.8	2.9	0	6	13.5
Chemicals	0.5	9.6	5.2	6.8	2.9	2.3	3.8	0	3.1	4.2
Wood, paper, etc.	4.4	11.8	5	14.1	10.1	6.5	6.6	0	6.9	13.5
Textiles	0.9	9.6	9.3	8.9	10.3	8.4	9.1	0	8	10
Clothing	0	28.5	14.4	10	15.9	17.2	14.9	0	29.8	19.7
Leather, footwear, etc.	3.4	18	9	11	13.9	5.3	6.6	0	12.4	15.4
Non-electrical machinery	7.1	14.6	2.3	6	3.6	1.7	2.3	0	4.1	4
Electrical machinery	14.3	24.3	5.8	6.8	4.3	4.3	4	0	7.5	10.9
Transport equipment	4	16.1	10.6	13.5	11.6	4.2	9.1	0	20.3	18.9
Manufactures, n.e.s.	5.1	14.9	6.9	10.3	4.8	6.5	4.9	0	10.2	12.1

Source: WTO Statistics.

Regional economic integration has played a pivotal role in driving economic liberalism in Indonesia (Plummer and Chia, 2009; Feridhanusetyawan and Pangestu, 2003). While ASEAN's initial foundations were based more on political rather than economic union, the ASEAN Common Effective Preferential Tariff (CEPT) scheme in 1992 started the momentum toward freer trade within the ASEAN region. The CEPT scheme reduced tariffs to 0-5% on goods traded among the ASEAN countries that meet a 40% ASEAN content requirement. Indonesia has implemented its CEPT obligations, with 80% of all tariff lines at zero, including the priority integration sectors, and the transformation of the CEPT package into the ASEAN Harmonised Tariff Nomenclature (Molnar and Lesher, 2008).[7] The tariff reductions are significant, with the spread particularly evident at a disaggregated level (Table 9). Overall, greater differences exist for manufacturing goods than for agricultural commodities.

Table 9. CEPT rates are substantially lower than Indonesia's MFN tariffs, 2006

	MFN	CEPT
By sector		
Agriculture and fisheries	4.2	0.5
Manufacturing	9.8	2.8
By stage of processing		
Initial processing stage	4.7	0.7
Semi-processed goods	7.0	2.0
Final goods	11.1	3.1

Source: WTO, 2007.

7 See Legislation 12 129/PMK.011/2007 and 125/PMK.010/2006.

The CEPT served as the framework for the ASEAN Free Trade Area (AFTA), which began implementation in 1993. In 1997, ASEAN leaders adopted Vision 2020, which aspires to create a region characterised by stability and prosperity; where there is free flow of goods, services, and investment; the freer flow of capital; and less poverty and income inequality. To realise this goal, in 2003 ASEAN leaders pledged to create the ASEAN Economic Community (AEC) by 2020, noting that the AEC is the ultimate goal of regional integration (Bali Concord II). In 2006, ASEAN countries decided to develop a region-wide blueprint to realise the AEC and adopt a more ambitious target date of 2015 for its completion. In 2007, ASEAN leaders signed the Cebu Declaration on the Acceleration of the Establishment of an ASEAN Community by 2015; the AEC Blueprint was formally adopted later that year.

The AEC Blueprint represents a significant step in ASEAN economic integration insofar as it makes the integration process more measurable and concrete. Under the AEC Blueprint, Ministers are required to report periodically on progress made to achieve the AEC targets. The AEC Blueprint contains four objectives: (i) to create a single market and production base; (ii) to achieve a highly competitive region-wide economy; (iii) to more equitably spread economic development; and (iv) to fully integrate with the global economy. The AEC Blueprint is comprehensive, and covers 17 "core elements" together with 176 priority actions to be completed within four broad implementation periods (Soeastro, 2007).

The AEC Blueprint builds upon major ASEAN economic initiatives, such as the ASEAN Free Trade Area (AFTA), the ASEAN Investment Area (AIA)[8] and the ASEAN Framework Agreement on Services (AFAS) (Soeastro, 2007). Among other issues, the AEC Blueprint seeks to move beyond these existing agreements to tackle issues such as non-tariff measures, deeper liberalisation of the services sector, more meaningful investment liberalisation, trade facilitating measures (i.e. national single windows), strengthening the ASEAN Dispute Settlement mechanism, and issues stemming from the proliferation of free trade agreements (FTAs). Indonesia has identified infrastructure development, customs modernisation, and standards and conformity assessment as the most significant challenges for Indonesia to implement the AEC Blueprint (Soeastro, 2007).

To respond to challenges posed by the emergence of competitors, including China and India, ASEAN countries have embarked on an accelerated integration path. Integration has deepened in the areas of trade and investment. ASEAN currently has agreements with Australia and New Zealand, China, Korea, India, and Japan.

The "early harvest" packages on goods between ASEAN and China were implemented in 2005, and include tariff reductions on 40% of tariff lines, although a substantial number of sensitive products are omitted. The agreements with Korea and India also follow the early harvest programme format. An agreement was signed with Japan in spring 2008, and it went into effect later in the year. It covers almost 90% of ASEAN-Japanese trade which will be tariff free in ten years' time. The ASEAN-

8 Indonesia signed the ASEAN Investment Area (AIA) arrangement in 1998, which represents an important mechanism for reducing barriers to intra-regional investment, with the goal of enhancing the region's competitiveness. The AIA covers both the primary and manufacturing sectors, as well as the services incidental to these sectors. The AIA has been superseded by the ASEAN Comprehensive Investment Agreement (ACIA), which was enacted in 2009, but is not yet in force. The goal of the ACIA is to realise the related AEC goals.

Australia-New Zealand Free Trade Area (AANZFTA) was signed in 2010, and entered into force for Indonesia in January 2012. It represents a comprehensive FTA covering issues such as services and investment, in addition to goods liberalisation.

ASEAN is currently in discussions with China, Japan and Korea as to whether it might be beneficial to form an East Asian Free Trade Area (EAFTA).[9] ASEAN is also considering whether it might be useful to consolidate all of the region's FTAs with its six dialogue partners (Australia, China, India, Japan, Korea, and New Zealand) into one overarching agreement.

Indonesia is also active in the Asia-Pacific Economic Co-operation Forum (APEC), and will host the annual APEC Summit next year. Indeed, Indonesia was a founding member of APEC in 1989, whose 21 members account for about half of all global trade. APEC's "Bogor Goals," adopted in 1994, involve commitments to create a region of "open trade and investment" by 2010 (2020 for developing country members). Liberalisation through APEC occurs primarily through individual action plans (IAPs), which are peer reviewed periodically with a view to meeting the Bogor targets. In November 2010, APEC underscored its commitment to free trade across APEC economies by 2020, approving of various approaches (e.g. Asian and Trans-Pacific tracks) to create a Free Trade Area of the Asia-Pacific. APEC has been particularly effective in encouraging trade facilitating measures in Indonesia, which have diminished somewhat Indonesia's high trade costs.

More recently, Indonesia has engaged in FTA negotiations with partners outside of the ASEAN framework. One of the most important bilateral agreements for Indonesia is the Economic Partnership Agreement (EPA) with Japan, which entered into force on 1 July 2008, the same year as the ASEAN-Japan accord. The EPA is a comprehensive economic agreement involving co-operation in several economic sectors. As a result of the agreement, over 93% of Indonesian products enter the Japanese market duty free and over 90% of Japanese products enter Indonesia duty free. According to the Indonesian Ministry of Industry, the automotive, electronics and construction sectors will receive an immediate boost from the tariff cuts, as many Japanese investment commitments are in these sectors. A distinct feature of the EPA is the inclusion of labour mobility (mode 4) under which qualified Indonesian nurses and caretakers will have access to the Japanese labour market.

Indonesia is also currently negotiating FTAs with several trading partners, including Australia, the European Free Trade Association (EFTA),[10] and Pakistan. Indonesia is also studying whether it might be beneficial to start FTA negotiations with Chile, India, Korea, and the United States. Yet regionalism is also posing challenges for Indonesia. Negotiations on a possible Trans-Pacific Partnership, which Indonesia has not chosen to join, could result in trade diversion, for example.

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9 While ASEAN had started negotiating a FTA with the European Union, talks have been suspended since 2009.

10 EFTA members include: Iceland, Liechtenstein, Norway and Switzerland.

Services regulations appear minimal at first blush…

While further reducing border barriers to agriculture and manufactures, particularly in the relatively small product categories in which tariff peaks exist, can be useful in reducing distortions in the domestic economy, it is in the services sectors that the most significant reforms are needed. Services play an important role in the production of goods and facilitate trade of both primary products and manufactures (e.g. logistics, communications and transport services). The services sector also employs about 40% of the workforce. But productivity in services can be low, variety is often limited, and markets are in some cases highly protected.

Barriers to services are difficult to quantify, and reliable data across a large sample of countries (especially developing countries) covering most services sectors are currently unavailable. Nonetheless, some researchers have made important strides in cataloguing restrictions in ASEAN economies in particular sectors (Table 10). Overall, these analyses tend to identify those regulations that restrict market access (for foreign and domestic suppliers), or reduce competition and efficiency. At their core, these types of regulatory barriers increase trade costs.

Table 10. ASEAN services restrictiveness scores in select sectors, 2009-10

(Frequency measures, as a share of total possible barriers)

	Brunei Darussalam	Cambodia	Indonesia	Laos	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam	Average
Air transport	40	44	32	55	51	38	22	6	19	61	37
Maritime transport	*n/a*	22	31	*n/a*	19	42	32	18	27	41	29
Telecommunications	21	35	19	87	25	85	26	8	19	21	35

Note: The restrictiveness scores represent the number of restrictive barriers in a particular country as a share of the total possible barriers; as such, a lower score indicates fewer restrictions. The underlying data come from questionnaires completed for each ASEAN economy over the period September 2010 to March 2011.

Source: Dee (2010).

According to Dee (2010)'s analysis, Indonesia scores relatively well among the other ASEAN economies in the air transport and telecommunications sectors, being less restrictive than the ASEAN average. In fact, only Singapore and Thailand have more open services regulatory regimes in these sectors. In maritime transport, Indonesia scores slightly above the ASEAN average, behind all other ASEAN economies surveyed except for Myanmar, the Philippines and Vietnam. The most variation among the ASEAN economies occurs in the telecommunications sector. In this sector, only Singapore posts a more open regulatory regime than Indonesia. However, the most recent restrictions on foreign investment in telecommunication towers may not be reflected in the index.

Box 1. The policy environment for logistics services in Indonesia

The regulatory environment in the logistics sector has evolved rapidly in the past few years. In October 2009, the Indonesian government passed a new law that overhauls its regulations of the postal services sector (Law 36/2009). The changes were made to address the impacts that technological advances have had on the postal services industry.

Significantly, the postal law dissolved the monopoly on the provision of postal services by *Pos Indonesia Persero* (*Posindo*). Under the new regulatory framework, other providers may enter the postal services market, including co-operatives, regional government-owned companies and private firms.

However, the postal law defines postal services broadly to include logistics services, financial transaction services, and express delivery services, among others. Importantly, the new law allows foreign firms to provide delivery services only up to Indonesia's international gateway, thus prohibiting foreign providers from providing end-to-end logistics services. All services firms that fall under the postal services definition must also contribute to the Universal Service Obligation to provide postal services to all, even services firms like express delivery, which are normally not included in such an obligation.

These aspects of the postal law have raised concerns among foreign services providers, particularly as it means that they are prohibited from providing logistics services within Indonesia and are limited to 49% equity ownership in a firm that provides the international services component. This structure increases logistics costs, discourages investment, and reduces Indonesia's competitiveness internationally. The picture is further complicated by the licensing structure. Each firm may only acquire an operating license for one slice of the logistics chain, thus limiting the efficiency gains domestic firms may reap from economies of scale and scope.

More recently, Indonesia issued Government Regulation 8/2011 on Multimodal Transport. While this regulation indicates that foreign-owned companies registered under Indonesian law are to be regarded as national legal entities, the Ministry of Transport has not yet confirmed this interpretation. Moreover, this regulation allows national service providers to conduct domestic transport, but foreign entities are only allowed to perform these services up to the international gateway, after which a domestic agent must be appointed to conduct the domestic leg. The unclear implementation and interpretation of this regulation is causing considerable concern in the foreign freight forwarding community.

In the World Trade Organisation (WTO), Indonesia has made significantly more commitments in services than the average lower middle-income country on GDP-weighted average terms, suggesting a more liberal services trade regime.[11] This suggests significant engagement with the WTO *vis-à-vis* services trade policy.

However, Indonesia appears most active in pursuing services trade liberalisation within the ASEAN region. In particular, the AFAS provides the outline for liberalising services among the ASEAN economies. Since the agreement was signed in 1995, several "packages" of commitments have been negotiated on a sectoral basis. Some of the more important services sectors included in the AFAS framework include financial services, construction, air transport, telecommunications and tourism services. In practice, however, progress has been modest, and achieving all of the AFAS targets associated with realising the AEC by 2015, that is, free flow of services trade throughout the ASEAN region, appears challenging.

11 Data come from the World Bank's World Trade Indicators 2009/10 Database. The World Bank's GATS Restrictiveness Index shows Indonesia's posting an index score of 9.52 compared to 24.11 for the average lower middle-income country in GDP-weighted terms. In this index, a score of 0 indicates complete liberalisation.

…but important barriers to commercial presence (mode 3) remain

Trade via commercial presence (mode 3 trade in services) is important for Indonesia.[12] This type of investment is a critical component of the government's growth strategy; as such, Indonesian policymakers have been putting significant effort into trying to improve the investment environment.

Indonesia has been actively trying to improve the investment policy environment, but challenges persist

In March 2007, Indonesia's parliament passed a new law on investment (Law 25/2007).[13] This law opens all business sectors to foreign investment unless specified in a presidential regulation containing Indonesia's Investment Negative List. The presidential regulations implementing the Investment Law consist of two sections. The first is the set of clauses that guide implementation of the investment restrictions in the Investment Negative List. The second is the actual list of investment restrictions.

The Investment Law narrows the disparities between domestic and foreign investors by providing national treatment and increases in the length of work permits available to foreigners. The new law is a major piece of legislation with several important features that:

- Replaces separate laws on foreign and domestic investment from the 1960s, and thus merges legislation of the two types of investment into a single framework;
- Affords National Treatment to foreign investors;[14]
- Opens all business sectors to investment unless restrictions are noted in Indonesia's Investment Negative List;
- Mandates the development of one-stop-shops for investment licenses in Indonesia;
- Contains a national interest clause that implies that restrictions should only be introduced if they are in Indonesia's national interest; and
- Offers dispute settlement via international arbitration.

But the law and its implementing regulations also promulgate distinctions between domestic and foreign investors. For instance, foreign investment must take the form of a limited liability company, foreigners cannot invest in sectors limited to small and medium-sized enterprises, and several restrictions in the amended Negative Investment

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12 There are four modes of supplying services: Mode 1, or cross-border supply (e.g. services provided electronically); Mode 2, or consumption abroad (e.g. tourism services); Mode 3, or commercial presence (e.g. establishment of a business in the host country); and Mode 4, or movement of natural persons (e.g. doctors or teachers who physically move to the host country).

13 The new investment policy package includes: Law 25/2007 (investment law); Government Regulations 1/2007 (taxes on investments), 38/2007 (division of government authority), 46-48/2007 (free trade zones), 77/2007 (Investment Negative List) and its amendment, 111/2007, which have been subsequently replaced by Presidential Regulation 36/2010 and Presidential Instruction 5/2008.

14 National Treatment in this instance appears to mean "post establishment."

List apply only to foreigners. Divesture requirements are also not mentioned in the new law.[15]

Box 2. The regulatory framework for the mining sector has been unpredictable

The Mineral and Coal Mining Law (Law 4/2009) created a new regulatory framework for the mining sector. Importantly, the law introduced a new mining licensing system that replaced mining authorisations available to wholly-owned Indonesian companies (*kuasa pertambangan*, or KPs) and contracts of work (CoWs) and coal contracts of work (CCoWs) available to foreign firms. However, the law did not address the issue of how the new law applies to existing KPs, CoWs, and CCoWs as well as how auctions for new mining business licenses (*izin usaha pertembangan*, or IUPs) would operate in practice.

The Indonesian government subsequently issued two implementing regulations – Government Regulation 22/2010 on mining areas and Government Regulation 23/2010 on the conduct of coal and mineral mining business activities. These regulations addressed some of the uncertainties stemming from Law 4/2009. In particular, these regulations clarified that KPs, CoWs and CCoWs that were awarded under the previous regulatory regime would be honored until their expiration. In addition, existing KPs must be converted to IUPs within three months of the publication of the new regulations (i.e. 1 May 2010). Further, Government Regulation 22/2010 provided some technical guidelines regarding how mining areas would be designated.

Government Regulation 23/2010 also provided clarity regarding divestment requirements via the imposition of a 20% local ownership requirement within 5 years. Moreover, divested shares must be offered first to the central government, then to provincial/local governments and state/region-owned enterprises, and lastly to private interests. Some foreign mining firms were thus surprised when Indonesia then issued Government Regulation 24/2012, which requires foreign mining firms to divest at least 51% of their shares to Indonesian control over a ten-year period. Moreover, the government has made contradictory statements as to whether the new regulations will apply retroactively to existing investments or only to new investments.

As a result, some foreign investors now worry that the new regulation will be used to pressure holders of existing CoWs and CCoWs to renegotiate terms and conditions. In this area in particular, how the price of divested shares will be determined looms large for foreign investors (i.e. will the share price be based on the cost of project development or the value of the underlying resource). Furthermore, there is neither a reference to a minimum price in relation to auctions nor a provision for sales to Indonesians through a public listing, which is more transparent and spreads ownership more widely.

A presidential regulation with Indonesia's new Investment Negative List was issued in 2007 soon after the after passage of the Investment Law.[16] The new list was compiled by an inter-departmental team responsible for gathering all regulations impacting investment, including those in lower-order government decrees and any unofficial regulations that may have existed. Although the 2007 list covers far more sectors and thus appears more restrictive than previously, it is not clear whether the inter-departmental team added to the list of restrictions, or whether the new list simply includes restrictions that already existed in sectoral regulations (Annex Table 2).

15 Government regulation 20/1994, which was amended via regulation 83/2001 and decree 15/1994, requires all wholly foreign-owned companies to divest partial ownership to an Indonesian partner after 15 years of commercial operation. The percentage to be divested is not specified, but guidance from BKPM indicates a range of 1-5%. How this regulation will interact with the new investment law has contributed to uncertainty for foreign investors, although the government has stated that Regulation 20/1994 will not be revoked.

16 There were actually two regulations. The second regulation (Perpres 111/2007) was issued in 2007 soon after the first in order to correct for several ambiguities. Until the latest update in 2010, Perpres 111/2007 was commonly called the "Investment Negative List."

The legal requirement that all restrictions on investment, whether foreign or domestic, be listed in the Investment Negative List is intended to improve investor certainty. Previous negative lists lacked detail and did not include all restrictions. As a result, investors often needed to visit line ministries and BKPM to determine the actual regulations concerning a proposed investment.[17, 18]

In 2010, a new Negative Investment List was issued under Presidential Regulation 36/2010. According to BKPM, 40 sub-sectors, largely in the construction services sector, have been liberalised for investment, while 10 sub-sectors have become more closed. The more open sectors include health, creative industries, construction services, and multilevel marketing. The more closed sectors include telecommunications, security services and inspection services. Although the sub-sector count makes it appear like the new list is more open, this is difficult to determine because the sub-sectors vary in size and importance. For example, investment in telecommunication towers is now entirely closed to foreign investors and represents a large sector from an investment perspective, and foreign ownership was reduced in several capital- and technological-intensive sectors (e.g. transport, pharmaceutical manufacturing and distribution).

In addition, despite some important revisions to the Investment Negative List, restrictions on foreign investment in key sectors such as pharmaceuticals, distribution, telecommunications and transport services remain. Moreover, although meant to address many of implementation issues identified by the government and other stakeholders, the new regulation left a number of ambiguities that require further clarification (Magiera, 2011a). Major issues are outlined below.

- ***The grandfather principle***. New restrictions do not apply to investments that have already been approved, but it is not always clear what is being grandfathered. In some cases (e.g. security services and telecommunication towers), foreign investors have been required to divest.
- ***Publicly-listed companies***. It is not clear whether all publicly-listed companies are excluded from the investment restrictions. For example, whether a foreign entity that has a controlling interest in a publicly-listed company is subject to the law continues to be ambiguous.
- ***The coding and descriptions of sectors***. The Investment Negative List is based on Indonesia's version of Standard Business Classification. Businesses do not always fall neatly into this classification system.
- ***Divestment***. Indonesia's Investment Law no longer requires divestment. However, the implementing regulations from previous laws are still in effect and require divestment in certain cases. Moreover, new regulations in the horticulture and mining industries have imposed divesture requirements.
- ***The hierarchy of laws and regulations***. Although the presidential regulation implementing Indonesia's Investment Law takes precedent over ministerial decrees and

[17] BKPM attempted to document the regulations for every sector in a single document called technical directives (*petunjuk teknis*), but this document lacked a legal basis and defeated the purpose of having presidential decrees that list investment restrictions. Furthermore, *petunjuk teknis* was itself not always up-to-date and sometimes appeared to contradict the Investment Negative List (Magiera, 2011a).

[18] For example, see the hospital services entry in Annex Table 2.

other lower-order regulations, some line ministries have introduced their own restrictions on investment (e.g. shipping, mining, postal services, and horticulture).[19] In addition, several recent sector laws conflict with the Investment Law and its implementing regulations. As a result, investors can no longer be certain that the Investment Negative List takes precedent, a situation that negatively impacts the investment climate for the benefit of a small segment of Indonesian society.

- ***Equity restrictions***. Uncertainty remains regarding the implications of equity restrictions when there are mergers, acquisitions and consolidations.

One additional problem is that the types of restrictions on the Investment Negative List are fairly limited in scope, pertaining mostly to foreign equity ceilings, reservations for small and medium-sized enterprises (SMEs), partnership requirements and regional restrictions. Other types of restrictions that might impact investment are not included. For instance, the number of telecommunication licenses for fixed lines, international gateways, and VoIP are limited, and are subject to approval by the Minister. These are restrictions on investment and are included in Indonesia's schedule of WTO commitments. Yet, the restrictions on the number of licenses and conditions for issuing new license are not contained in the Investment Negative List (Magiera, 2011a).

Box 3. Indonesia's new land law

Importantly, the new law sets a 436-working day limit for all legal proceedings related to the acquisition of land for a government infrastructure project in addition to a 60-day period for public consultations prior to the transfer of land rights (Jakarta Post, 2011). If all stakeholders agree with the ruling, then all necessary legal and business proceedings must be finalised within 260 days. If stakeholders are unhappy with the ruling, then they may also appeal a decision to transfer land for infrastructure projects to the state administrative court (PTUN) with recourse to the Supreme Court, the proceedings of which all have required time limits (Jakarta Post, 2011).

The next step in the process involves the National Land Agency (BPN), whose role it is to find an independent appraisal team that includes independent experts who are certified by BPN to determine the value of the land and the compensation due to private owners. This process must not take longer than 30 days. Landowners who are dissatisfied with the valuation or the method of payment – which may include cash, land swaps, resettlement, or stock ownership in the infrastructure project – may file a legal complaint with recourse to the Supreme Court (Jakarta Post, 2011).

While the new land law is an important step toward Indonesia's goal to improve its infrastructure, issues remain that will need to be resolved in the implementing regulations. For one, there are cases in which individuals, particularly indigenous Indonesians, hold a land certificate but are not registered; in this case, they do not fulfill the definition of a "rightful land owner" as specified in the new law. It is thus critical that Indonesia put in place an efficient land registration system and effective land-use planning. Unless these enabling conditions manifest themselves, implementation may be challenging.

Across sectors, Indonesia was most open in the banking, mining, oil and gas, and electricity sectors in 2010 (Table 11). For these sectors, Indonesia's foreign equity ceilings were higher than the Asian and world averages.

[19] For a discussion of the horticulture law (Law 13/2010), see OECD 2012a.

Table 11. Comparison of Foreign Equity Ceilings in Indonesia and the World, 2010

Average Foreign Equity Ceiling in %

	Indonesia	Asia regional average	World average
Banking	99.0	76.1	91.0
Mining, Oil and Gas	97.5	75.7	92.0
Electricity	95.0	75.8	87.6
Construction, tourism, retail	85.0	91.6	98.1
Health care, waste management	82.5	84.1	96.0
Insurance	80.0	80.9	91.2
Agriculture and Forestry	72.0	82.9	95.9
Light Manufacturing	68.8	86.8	96.6
Telecommunications	57.0	64.9	88.0
Transportation	49.0	63.7	78.5
Media	5.0	36.1	68.0

Source: World Bank, Investing Across Borders (2010).

For all other sectors, Indonesia's foreign equity ceilings are lower than the regional or world averages. This includes labour-sensitive industries in agriculture, forestry and light manufacturing. It also includes several sectors – telecommunications and transport – that are critical to connectivity and reducing logistics costs in Indonesia. For example, foreign equity ceilings in transport average 49% compared to a regional average of 63.7% and a world average of 78.5%. However, more recent developments in the mining and multi-modal transport sectors have ushered in much lower foreign equity ceilings and other restrictions on foreign operators (Boxes 1 and 2).

The OECD FDI Regulatory Restrictiveness Index provides a sense of relative restrictiveness across countries and sectors (Table 12). It includes four primary components: restrictions on foreign key personnel, equity restrictions, screening and approval requirements, and other operational restrictions (e.g. land use restrictions) (Kalinova *et al.,* 2010). While both burdensome non-discriminatory measures and discriminatory measures are included in the index, the discriminatory nature of measures is the primary criterion for inclusion in the index. Overall, Indonesia is less restrictive on average across all sectors compared with India and China, but more restrictive than Korea, Japan and with respect to the OECD average.

Table 12. OECD FDI Regulatory Restrictiveness Index, 2010

	Business services	Telecoms	Construc-tion	Distribu-tion	Financial Services	Hotels & Restaurant	Transport	Electricity	Media services	Real Estate Services	Manufac-turing	Total
China	0.14	0.80	0.27	0.24	0.61	0.25	0.67	0.61	1.00	0.28	0.25	0.46
India	0.30	0.30	0.30	0.30	0.32	0.30	0.32	1.00	0.30	1.00	0.30	0.43
Indonesia	**0.56**	**0.41**	**0.31**	**0.69**	**0.14**	**0.25**	**0.42**	**0.11**	**0.75**	**1.00**	**0.08**	**0.33**
Japan	0.00	0.30	0.00	0.00	0.00	0.00	0.55	0.00	0.00	0.10	0.07	0.24
Korea	0.00	0.50	0.00	0.00	0.02	0.00	0.50	0.42	0.40	0.00	0.00	0.14
OECD average	0.10	0.12	0.06	0.06	0.15	0.05	0.25	0.12	0.23	0.28	0.04	0.12

Note: Scores on a 0-1 scale, with 1 indicating the highest level of restrictiveness. The index does not take into account actual enforcement of laws and regulations, but rather reflects the regulatory situation as noted on the books. The data do not appear to have taken into account Perpres 36/2010.

Source: Kalinova *et al.* (2010).

The regulatory environment for FDI is important given that economies with more liberal FDI regimes tend to attract more investment (Kalinova *et al*., 2010). No multilateral agreement on investment exists, although provisions in the General Agreement on Trade in Services (GATS) and the WTO Agreement on Trade-Related Investment Measures (TRIMs) relate to cross border investment. In addition, many bilateral and plurilateral free trade agreements include rules on investment.[20] In the 1990s, Indonesia was active in signing BITs, and this trend continued to a lesser degree in the 2000s. As of 1 June 2011, Indonesia had signed 62 BITs with countries across the globe, with 45 actively in force (Annex Table 3).

Non-tariff measures touch upon many segments of the economy

Indonesia maintains a number of different types of non-tariff measures (NTMs) at its borders. The measures are listed in Indonesia's NTM database, LARTAS (*Larangan Terbatas*). This database is used by Customs for the clearance of goods and will be publicly available on the portal of Indonesia's National Single Window (INSW). The portal will be further developed and in the future will house Indonesia's National Trade Repository (Box 4).

20 As of 2011, over 6 000 bilateral investment treaties (BITs) existed worldwide (UNCTAD, 2011). BITs commonly include commitments on treatment of investment, expropriation, free transfers of investment-related capital, and access to investor-state arbitration, among other obligations.

Box 4. The Indonesian National Trade Repository (INTR)

Under ASEAN's Agreement on Trade in Goods, the ASEAN Secretariat will establish the ASEAN Trade Repository (ATR) containing the regulations of each member State related to trade. The trade repositories should include:

1. Tariff nomenclature;
2. MFN tariffs;
3. ASEAN CEPT tariffs and tariffs under ASEAN Free Trade Agreements (FTAs);
4. Non-tariff measures;
5. National trade and customs legislation and rules;
6. Procedures and documentary requirements;
7. Administrative rulings;
8. Best practices in trade facilitation applied by the individual countries; and
9. A list of Authorised Traders.

Indonesia is already well-along in establishing a national trade repository. Indonesia's National Trade Repository (INTR) will be made available on Indonesia's National Single Window portal and will be based on the LARTAS System. A presidential instruction has been drafted that envisages the INTR as the legal reference for trade regulations in Indonesia.

A work plan for the IT system has been developed and work on assembling decrees for the system is in process. Regulations are currently available in both English (unofficial) and Bahasa Indonesia (official). Finally, automated links will be established between the INSW and other government agencies so that the INTR is automatically notified of new regulations as they are issued by other government agencies. This will also facilitate meeting Indonesia's WTO and ASEAN notification requirements, and bring greater transparency to Indonesian trade policy.

More than 13 government agencies have authority over some type of NTM in Indonesia. The Ministry of Trade has the authority over the largest number (58.4%), followed by the quarantine agencies (18.5%), the National Agency for Food and Drug Control (BPOM) (15.1%) and the Ministry of Health (3.8%). The remaining agencies issue NTMs related to product standards, public safety and environmental protection, and have less than 1% of the total each (Preparation Team INSW, 2009). The large number of government agencies that have the ability to impose NTMs poses challenges to the regulatory process. The absence of a process to ensure co-ordination among agencies creates ample scope for contradictory and overlapping measures that can negatively impact the economy.

Indonesia's NTMs are of four general types: (i) licenses, (ii) sanitary and phytosanitary requirements (SPS) and technical barriers to trade, (iii) export restrictions, and (iv) other restrictions (e.g. local content requirements).

Licenses

The Ministry of Trade and BPOM both require certain licenses and registration requirements. Many product categories are subject to two or more licensing requirements, and the licensing system has also been used to restrict imports of certain commodities, such as salt, rice, refined sugar and meats. The different types of licenses are discussed below.

- ***Automatic import licenses (API)***. All importers must reside in Indonesia and register with the Ministry of Trade.[21]

- ***Producer Importer License (IP).*** IP licenses are granted to companies that import goods for use in their own production, and not for sale on the domestic market. Products subject to IP include: rice, sugar, textile and textile products, salt, iron and steel, certain petrochemical and chemical products, non-dangerous waste, pharmaceutical precursors, lubricants and most recently, horticultural products (fruit, vegetables, and ornamental plants). The stated government purpose of the IP for many of these products, such as rice, sugar and salt, is to protect domestic producers.

- ***Registered Importer License (IT).*** Importers of certain products must register with the Ministry of Trade. IT licenses are required for imports of the following products: alcoholic beverages, iron and steel, salt, dibromide, explosive materials, compact discs, rough diamonds, multifunction colour printing machines, hand tools, perfume, cyclamate, saccharine, pharmaceutical precursors and most recently horticultural products (fruit, vegetables, and ornamental plants).

- ***Specific Importer Identification Code Number (NPIK).*** Since 2002, imports of certain types of products require a NPIK from the Ministry of Trade. This permit can only be granted to companies that hold either a Producer Importer (IP) or a Registered Importer License (IT). NPIK permits apply to corn, rice, soybeans, sugar, textile and related products, shoes, electronics, and toys. Without the permit, goods can be detained at port. The NPIK was introduced to stop smuggling and represents about 21% of all NTMs in Indonesia (WTO, 2007).

- ***Import Approval Document (SPI).*** In addition to Producer Importer License (IP), Registered Importer License (IT) and Specific Importer Identification Code Number (NPIK), each shipment of some commodities requires an Import Approval Document from the responsible government agency. The SPI is used to protect public health and intellectual property rights, as well as for managing trade in the case of salt, sugar, cloves, rice, and hand tools.

Sanitary and phytosanitary measures (SPS) and technical barriers to trade

Indonesia's three quarantine agencies – animal, fish, and plant – apply select sanitary and phytosanitary requirements; the principal types are outlined below. Certification requirements and technical standards are sometimes mandated by Indonesia's National Standard (SNI) agency, as well as other agencies such as the Ministry of Communication and Information Technology.

- ***Sanitary and phytosanitary measures***. Indonesia maintains SPS measures for animal, fish and plant products. Products falling under the measures must obtain an approval of disembarkation from ships for testing and a certificate of release by the relevant quarantine agency after testing.

- ***Import Notification Document (Surat Keterangan Impor).*** Imports of food supplements, processed foods, traditional medicines, drugs, and materials for the production of cosmetics must be approved by BPOM before entering Indonesia. These products must meet Indonesian quality standards and can only be distributed in Indonesia by companies approved by BPOM.

[21] The Ministry of Trade is in the process of revising regulations for the API license.

- ***Technical barriers to trade (TBT).*** Indonesia's TBTs include mandatory standards, certification and commodity registration requirements issued by a number of agencies.[22] The most important are those under Indonesia's national standard certification (*Standar Nasional Indonesia/SNI*). Certified commodities (SPPT-SNI) must be registered (*Surat Pendaftaran Barang/SPB*) with the related Ministries. The mandated standards apply to both imported and domestically produced goods. Certification is made by the National Accreditation Komite (*Komite Akreditasi Nasional/KAN*). Some goods may be subject to more than one certification.[23]

Export restrictions

Governments may impose export restrictions for a variety of reasons, such as to stabilise domestic prices of a particular good (e.g. rice), as a means to promote downstream industries or as retaliation for trade or other policy stances taken by foreign governments. But export restrictions represent another type of NTM, as they limit the quantity domestic producers are permitted to export.

- ***Mining***. The Mineral and Coal Mining Law 4/2009 requires that minerals and coal be processed before exporting. Implementing regulations were published in 2010 and 2012, but the export restriction on raw materials remains in place.

- ***Palm oil***. In 2007, Indonesia introduced an export tax on palm oil with tax rates linked to the world market price. The objective is to secure domestic supplies, boost the local refining industry, and reduce price volatility for cooking oil. Recently, the Ministry of Finance issued a decree that raises the minimum price used to set the tax rate on crude palm oil from USD 700 per ton to USD 750 per ton, and lowers the maximum tax rate for crude oil from 25% to 22.5% whenever the price of crude palm oil exceeds USD 1 250 per metric ton on Malaysia's futures market. The export tax for downstream products (e.g. refined bleached deodorised palm oil) was also reduced from a maximum of 25% to a maximum of 10% (Christie, 2011).

- ***Rattan***. In November of 2011, the Minister of Trade signed a decree banning the export of raw rattan as of 1 January 2012.[24] According to the government, the decree is part of a series of measures aimed at reviving industries that use rattan as an input (e.g. furniture). The Minister of Forestry is expected to issue regulations limiting rattan harvesting to maintain sustainability. Other regulations involve the inter-island distribution of rattan and a warehouse receipt system for the storage of excess rattan that cannot be absorbed by local processors.

22 TBTs apply to fertiliser, refined sugar, flour, flat-rolled iron or steel and products of iron or steel plated with zinc, tires, safety glass for motor vehicles, various types of electrical devices such as ballast lighting, lamp holders, automatic circuit breakers, AC switches, tubes, pipes, vulcanised rubber hoses, cement, and vacuum compressors.

23 For example, a regulation issued by the Ministry of Communication and Information Technology requires that telecommunication tools and equipment produced, assembled and imported for sale or domestic use must comply with technical requirements and national standards.

24 Previously, the government maintained export quotas that expired in August of 2011.

Other types of non-tariff measures

Other restrictions, such as local content requirements, limitations concerning state-owned enterprises, pre-shipment inspections and port limitations for imports of certain products, are also applied. Local content requirements in government procurement and restrictions on ports of entry appear to have particularly increased in the past few years. Examples are noted below.

- ***Local content requirements***. In 2009, the Ministry of Communication and Information Technology issued regulations requiring that all telecommunication companies spend 35% of their capital expenditure on local equipment. In addition, at least 40% of inputs must be sourced locally, rising to 50% in five years. Companies must regularly report their use of local components to the Ministry and can lose their operators' permits for non-compliance (Rosender, 2009). Since 2009, Indonesia has also required bidders for energy service contracts to fulfil a 35% local content requirement. Other local content requirements implemented recently involve the maritime and shipping sector, electric power generation, oil and gas sector, mining industry and sugar producers.
- ***Bulog and State Agencies***. According to the WTO, Bulog is Indonesia's only state trading enterprise (STE). As an STE, Bulog has responsibility for managing Indonesia's rice stabilisation programme and maintaining rice stocks for distribution to the military and to low-income families (WTO, 2007).
- ***Pre-shipment Inspection (PSI).*** Many commodities that are subject to the Producer Importer License (IP), Registered Importer License (IT), Specific Importer Identification Code Number (NPIK), and Import Approval Document (SPI) must also undergo pre-shipment inspection in the exporting country. The commodities requiring PSI include cereals, sugar, foods, rubber, wood, textiles, footwear, mineral products such as salt, plastics, stone and glass, metals, pharmaceutical precursor, and machinery. The inspection is undertaken by PT Surveyor, a state-owned inspection company.
- ***Limitations on the port of entry.*** The Ministry of Trade limits the port of entry for certain commodities. Many of the commodities[25] covered by PSI can only be imported through five Indonesian seaports (Belawan in Medan, Tanjung Priok in Jakarta, Tanjung Emus in Semarang, Tanguy Perak in Surabaya, Soekarno-Hatta in Makassar, Dumai in Dumai) and all international airports. In February 2012, the Minister of Agriculture also announced that he would limit the entry point for horticulture imports to just four entry points, excluding the main seaport of Tanjung Priok in Jakarta.

In summing up recent developments in trade and investment policy in Indonesia, regional integration has been an important driver of economic liberalism, particularly in the ASEAN framework. The ASEAN commitment to build the AEC by 2015 is pushing the reform effort forward in Indonesia and other countries in the region. As a result, tariff liberalisation has been deep and successful in Indonesia, with effective rates of protection following a downward trajectory.

On the services side, liberalisation is less advanced. In particular, recent regulatory changes are causing concern among foreign providers of logistics services. While some of

[25] Examples include: fertilizers, automatic ballast lighting, tires, flat-rolled products of iron or steel plated with zinc, refined sugar and flour, flat-rolled iron or steel, safety glass for motor vehicles, automatic circuit breakers, electronic AC Switches, air or vacuum pump compressors, electrical lamp holders, cement, and tubes, pipes, and hoses of vulcanised rubber.

the changes are welcome, other aspects of the new legislative framework will almost certainly increase Indonesia's trade costs and reduce its competitiveness on world markets. The Investment Law and its implementing regulations represent an important step toward improving the investment environment in Indonesia, but important ambiguities remain. In particular, conflicts between the Investment Law and lower-order regulations have created confusion in the regulatory environment (e.g. telecommunication towers and horticulture).

The use of NTMs appears to be increasing, a worrying development given that these measures are less transparent and more easily influenced by special interests. An increase in NTMs undermines Indonesia's overarching intent to be more open, and creates less predictability for all economic actors. It also reduces the domestic economy's access to imported inputs, which play a critical role in connecting global value chains and driving export performance. Authority for NTMs is also spread across a wide range of ministries and government agencies, which makes a whole-of-government approach to policymaking in this area more challenging. In addition, it is not clear that all NTMs have a clear policy objective. For example, some NTMs implemented at the local level appear to be aimed at supplementing local budgets or have rent-seeking objectives.

III. The trade and investment policymaking process in Indonesia

Historically, the President and Cabinet were responsible for the formulation of trade and investment policies in Indonesia. Under former President Suharto, the process was highly centralised. In contrast, the process is now more fragmented and Parliament is more actively involved. Recently, for example, Parliament passed several sectoral laws with economic policy content that normally resides with the Executive Branch.[26]

Indonesia is governed by its Constitution, which was drafted in 1945. The Constitution provides for several constitutional bodies, including the People's House of Representatives (*Dewan Perwakilan Rakyat*, or DPR), Regional Representative Council (*Dewan Perwakilan Daerah,* or DPD) and the People's Consultative Assembly (*Majelis Permusyawaratan Rakyat*, or MPR). The People's House of Representatives consists of 560 elected members, and its main function is to make legislation and provide oversight of the President and government Ministers.

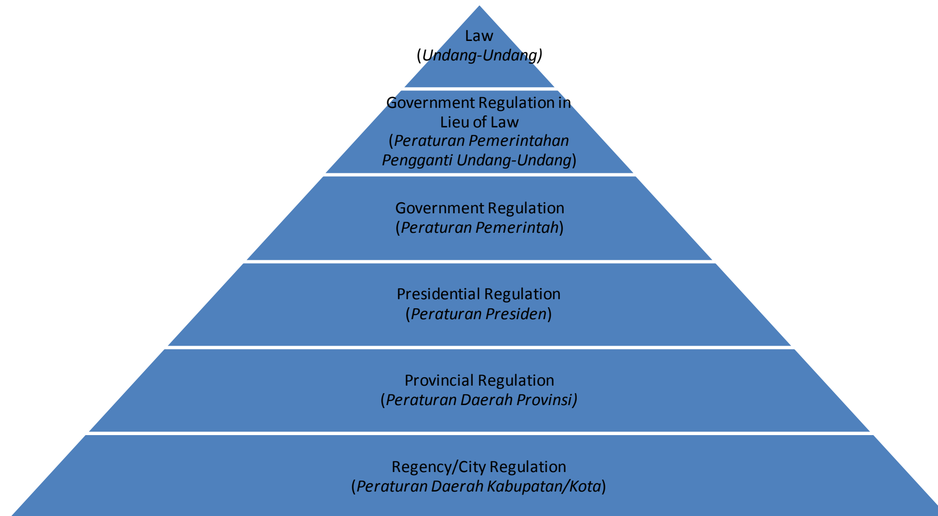
The Regional Representative Council, created in 2001, is comprised of 132 elected officials. Its main function is make legislation on local autonomy; the relationship between central and local government; formation, expansion and merger of local governments; management of natural resources and other economic resources; and bills related to the financial balance between the centre and the regions. The People's Consultative Assembly is made up of both the People's House of Representatives and the Regional Representative Council.

Since 2004, there have been a number of reforms to clarify the legal hierarchy into a number of specific instruments (OECD, 2012b). At the national level, its hierarchy of domestic laws and regulations involve six levels (Figure 9).[27]

26 Examples include the laws on shipping, mining, postal services, and horticulture. All of these laws contain provisions that directly affect foreign investment, even though under the current regulatory framework this should be handled by a presidential decree.

27 Law 12/2011.

Figure 9. Hierarchy of Indonesia's domestic regulation as provided for at the national level



After the Constitution, laws occupy the highest level of the legislative system. The Indonesian Parliament and the President collaborate in the preparation of laws, but the President has no power to veto laws passed by the Parliament. The next level in the hierarchy includes government regulations in lieu of law. This type of legislative tool is issued by the President only in the event of an emergency, or a situation in which a law is immediately needed and there are no other options for legislating the issue.

Government regulations, which are issued by the President, sit immediately below government regulations in lieu of law and are used to set out the implementing regulations needed to realise a particular law. Government regulations may only be prepared if provisions for their existence are made in a law. Presidential regulations are situated at the next level in the legislative hierarchy, and are issued by the President. Like government regulations, presidential regulations are used to provide implementing regulations related to a given law and the execution of executive power. Unlike government regulations, a presidential regulation can be made even if it does not mention explicitly the law to which it relates. Provincial regulations, which are developed by the provincial House of Representatives in collaboration with the governor, follow. Finally, regency and city regulations represent the lowest level of the hierarchy, and are formulated by the regency/city House of Representatives in collaboration with the regent/mayor.

In general, there are no specific requirements stipulating the timeframe in which implementing regulations should be passed, although there appears to be a goal of enacting these regulations within one year of the passage of a law. In practice, however, this does not appear to happen systematically. For example, the Mineral and Coal Mining Law was passed in 2009, but implementing regulations are still being promulgated.

Instructions issued by the President (*Instruksi Presiden*) and Ministers (*Instruksi Menteri*); regulations issued by Ministers (*Peraturan Menteri*) and Director Generals (*Peraturan Direktur Jenderal*); decrees issued by the President (*Keputusan Presiden*), Ministers (*Keputusan Menteri*) and Director Generals (*Keputusan Direktur Jenderal*); and

joint ministerial letters (*Surat Kebersamaan Menteri*), are not a part of the official legislative framework.

Presidential Instructions have no legal standing, but are an important statement of political commitment or intent. They are used to highlight important issues that need to be addressed, direct bodies to co-operate and co-ordinate actions, and provide instructions on a range of measures that should be taken. They cannot include legislative amendments or contradict laws. The President can use them to call upon the House of Representatives and ministries to draw up appropriate legislation. In the case of decrees, they are only binding insofar as their respective sectors as an administrative decision.

Once legislation is enacted, it is published in the State Gazette of the Republic of Indonesia (*Lembaran Negara Republik Indonesia*). In addition, laws and government regulations are accompanied by an elucidation (*Penjelasan*), or official explanatory document. This explanatory document is then published in the Supplement to the State Gazette (*Tambahan Lembaran Negara*) and is meant to represent the authoritative document for purposes of interpretation. The State Report (*Berita Negara*) represents another publication in which the government publishes other government documents and public notices.

High-level teams tend to dominate the policymaking process…

One aspect of this decentralised approach is evident in the use of high-level teams formed by the President to advance major policy initiatives in Indonesia. Indeed, these teams tend to dominate the trade, and to a lesser extent investment, policymaking process.

Team Tariff

Team Tariff is a high-level, inter-ministerial body responsible for advising and designing tariff policy in Indonesia, and is one of Indonesia's longest standing policy institutions. All of Indonesia's major tariff reforms since the late 1980s were led by Team Tariff, supported by technical staff from various line ministries. In its early years, Team Tariff also took responsibility for customs issues and problems associated with the administration of Indonesia's trade policy, in addition to anti-dumping duties and safeguards prior to the establishment of Indonesia's anti-dumping authority (KADI) in the Ministry of Trade.

Team Tariff is composed of five ministries: the Ministry of Finance, the Ministry of Industry, the Ministry of Trade, the Ministry of Agriculture, and the Co-ordinating Ministry for Economic Affairs. The Ministers are supported by a Secretariat and supporting team (Technical Team Tariff) which is responsible for policy analysis and recommendations to the Ministers. The Team Tariff Secretariat is managed by a Chairman and Vice-Chairman with a small administrative staff. There is no other full-time staff assigned to the Team. Rather, officials are assigned to work for Team Tariff by their respective ministries.

The Secretariat meets regularly to discuss policy issues and formulate recommendations. Officials from other ministries are invited to participate and become part of the technical team if a policy question involves sectors under those ministries, e.g. the Ministry of Marine Affairs and Fisheries in the case of fishery products or the Ministry of Forestry in the case of forestry products. The private sector is invited occasionally to provide input at Team Tariff meetings. Team Tariff recommendations are

typically set out in policy memos that are sent to Ministers. Formal decisions on tariffs are contained in decrees from the Minister of Finance.

Although Team Tariff has been in existence for over twenty years, there are no overarching regulations determining its operational procedures. These seem to have been driven by the Chairman of the Secretariat and the Minister of Finance, who determine the overall work programme of the Secretariat. For example, meetings with the private sector and other stakeholders are *ad hoc* and not part of a formal consultative process. Since Indonesian regulations do not provide guidance on the decision making process or overall objectives of trade policy, tariff policy can be subject to considerable political pressure and may not always reflect Indonesia's overarching economic interest.

Under Indonesian Law, the Minister of Finance has the final authority to make changes in tariffs, export taxes, and other duties that are applied at Indonesia's borders. Since the mandate of Team Tariff is limited to tax issues that are under the authority of the Minister of Finance, it has no authority over other trade policy issues, such as non-tax issues involving NTMs. To fill this void, a new Team on Non-Tariff Measures was established in 2011.

The Team for Non-Tariff Measures (KNT)

In September of 2011, the Minister of Trade issued a decree establishing a Team for Non-Tariff Measures (KNT).[28] The primary task of the KNT is to formulate policies on NTMs implemented by Indonesia. In so doing, the Team should conduct impact analysis of proposed measures, ensure their compliance with Indonesia's international obligations such as under the WTO, and monitor and evaluate measures already in place. The impact analysis should include surveys and consultations with stakeholders.

Although the Team is to co-ordinate with other government agencies when considering non-tariff measures, its scope of activities appears to be limited to those measures that are under the authority of the Ministry of Trade. Unlike Team Tariff, the Non-Tariff Measures Team is not inter-ministerial; its members consist only of staff from the Ministry of Trade. As a result, the Team would seem to have no authority over, for example, sanitary and phytosanitary (SPS) measures introduced by the Ministry of Health or the Ministry of Agriculture. Standard operating procedures for the Team, including the establishment of a Secretariat as well as mechanisms for consultations and impact assessment procedures, are now being developed by the Ministry of Trade with an expected operational date in 2012.

The National Team for the Enhancement of Exports and Investment (Timnas PEPI)

The National Team for the Enhancement of Exports and Investment (*Tim Nasional Peningkatan Ekspor dan Peningkatan Investasi* or Timnas PEPI) is a high-level policymaking body led by the President and chaired by the Co-ordinating Minister for Economic Affairs.[29] Timnas PEPI consists of more than 20 Ministers and heads of institutions. The Chief Executive is the Co-ordinating Minister for Economic Affairs, who is also responsible for the Secretariat that supports Timnas PEPI in implementing its duties.

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28 Ministry of Trade Decree No. 709/M-DAG/KEP/9/2011.

29 Timnas PEPI was established in 2003 by Presidential Decree No. 87.

The main goal of Timnas PEPI is to accelerate national economic development through increases in exports and investment. Its duties include the development of policies to increase exports and investment, facilitation of policy implementation, resolution of problems hindering exports and investment, and economic deregulation and de-bureaucratisation. Initially, Timnas PEPI consisted of four working groups. In 2011, the Co-ordinating Minister for Economic Affairs reconfigured Timnas PEPI into just two working groups: one covering trade and one covering investment. Each Working Group now has sub-groups covering major issues:

- Working Group for the Expansion of Trade: Chaired by the Minister of Trade with sub-groups covering policy, implementation, facilitation, and promotion; and
- Working Group for the Expansion of Investment: Chaired by the Chairman of BKPM with sub-groups covering policy, implementation, facilitation, and promotion.

As was previously the case, there is a Secretariat financed by the Co-ordinating Ministry for Economic Affairs. The Working Groups are financed by the agencies of their respective Chairperson, namely the Ministry of Trade and BKPM. Currently, there is four senior staff in the Secretariat who cover trade, investment, public policy and law. The main goals and duties of the new Timnas PEPI appear similar to those previously under the old configuration. However, this body is currently inactive due to the absence of a Chair and it is unclear whether the government will revive this body in the future.

The Investment Law of 2007 and the role of Timnas PEPI

Timnas PEPI played a key role in the formulation of the Investment Law of 2007, an important step in improving the investment environment in Indonesia. One goal of the Investment Law of 2007 is to increase investment by providing greater certainty to investors. The substance of the law is discussed in detail in Section II.

While the Investment Law represents an important step in improving the investment environment, some issues remain. The 2007 Investment Law allows line ministries to issue "technical" regulations, and some line ministries have used this power to limit foreign investment even though this is in contradiction to the spirit of the Investment Law itself.[30] As a result, the implementing regulations have created considerable uncertainty for foreign investors. The government also did not systematically involve the private sector and other non-governmental actors in the development of the implementing regulations of the Investment Law, and this has created some concerns.

Due in part to concerns expressed by foreign investors, Timnas PEPI launched a review of the implementing regulations for Indonesia's Investment Law using several case studies in 2008-09. In so doing, it conducted numerous interviews with government officials, the private sector, and business associations. It determined that uncertainties regarding the implementing regulations were a major concern of foreign investors, and that this uncertainty could be just as detrimental to investment as the limits placed on investment in the Investment Negative List.[31] On this basis, Timnas PEPI developed early drafts of revised implementing regulations for the Investment Law.

30 Some examples include horticulture, telecommunication towers and security services.

31 Many business sectors appear to face greater restrictions on investment than in the past. However, determining whether the current investment environment is more or less restrictive

During the latter part of the decade, Timnas PEPI also served as an "independent" analytical unit on investment issues. The Secretariat, in collaboration with BKPM, conducted inter-departmental meetings on proposals by line ministries to revise the Investment Negative List, and co-ordinated cost/benefit analyses of ministry requests. By requiring such an analysis, it is likely that the Secretariat successfully limited the number of new restrictions added to the Investment Negative List (Magiera, 2011a).[32]

Finally, the Secretariat of Timnas PEPI served as a repository for information on investment policy, and facilitated the transparency and ease with which investors were able to obtain information and legal interpretations of the Investment Law. It provided technical support to other Ministers for meetings with the private sector and international investors on the Investment Law, and sometimes met directly with the private sector and associations to resolve problems related to the interpretation of the Investment Law and its implementing regulations.

During the run-up to the Presidential elections of 2009 and for most of 2010, Timnas PEPI ceased to function while awaiting a new ministerial decree on its operations and for the appointment of a new Chair. This perhaps illustrates the drawback of not having permanent independent bodies devoted to trade and investment policy. During this time, investment policy fell under the authority of BKPM which then took on all responsibilities for the issuance of a new Investment Negative List – Perpres 36/2010.

Perpres 36/2010 and the role of BKPM

Presidential Regulation 36/2010 revokes the previous implementing regulations for the Investment Law and contains revised implementing language and several changes to Indonesia's Investment Negative List. This regulation was meant to resolve many of the uncertainties of the past, and also includes several improvements that make the Investment Negative List more comprehensive and transparent. In particular, the decree codifies a number of Indonesia's commitments in ASEAN and therefore improves the Investment Negative List as a single source of information on investment (Magiera, 2011b).

Despite these improvements, ambiguities persisted (see Section II). As a result, BKPM began the process of reviewing Perpres 36/2010 in 2011. BKPM organised consultations with the investment community on each of the major implementation issues, and also requested input from international investors through Indonesia's Chamber of Commerce (KADIN). Based on these consultations, BKPM prepared a position paper on changes to the implementing language of the presidential decree. The position paper has been presented to the Co-ordinating Ministry of Economic Affairs for submission to the Timnas PEPI Working Group for the Expansion of Investment.

The Government has now issued three presidential decrees on Indonesia's Investment Negative List. Although it held consultations with the private sector during the drafting of the main body of the regulations, problems with the implementing language remain and

than before 2007 is made difficult by the fact that before 2007, many restrictions on investment were contained in ministerial decrees or were otherwise not transparent. An objective of the Investment Law is to increase transparency by listing all restrictions in one presidential decree.

32 One notable exception was a ministerial decree banning foreign investment in telecommunication towers. This decree was eventually incorporated into the Investment Negative List.

cause uncertainties for investors. This reflects the fact that the drafting of economic regulations for policies that restrict market behaviour can be extremely difficult. There may also be a problem with the regulatory process itself since the final drafts of the implementing regulations, such as Perpres 36/2010, were never submitted for broad public comment.

…but ministries also play an important role in the policy process

The Ministry of Trade is responsible for supporting Indonesia in international trade negotiations. Within the Ministry, there are directorates for handling WTO and regional issues, as well as substantive issues such as services. The Ministry of Trade has also formed an inter-governmental working group on trade matters, with the aim of assisting trade negotiations. The Secretariat for Indonesia's antidumping committee (KADI) is also located in the Ministry of Trade.

The Ministry of Trade does not have primary responsibility for policy reforms except in those areas in which it is the principal sectoral ministry, such as wholesale and retail trade, commission agent services and franchising. The overall responsibility for other services, such as telecommunications, falls under their respective sectoral ministries.

Responsibility for NTMs lies across various ministries with the Ministry of Trade having final authority over about half as measured by the percentage of HS codes covered. The Ministry of Trade has formed a Non-Tariff Team and is developing standard operating procedures for the evaluation of proposed NTMs under its control.

The Ministry of Finance is responsible for tariffs, and is assisted by Team Tariff, of which the Ministry of Trade is a member. The Ministry of Finance is also involved in regulating certain professional services[33] and is the primary sectoral ministry (together with Bank Indonesia in certain sub-sectors) for regulations concerning financial services.

Investment policy had been handled primarily by Timnas PEPI, and more recently shifted to BKPM. BKPM administers domestic and foreign investment applications and promotes investment. Its Chairman reports directly to the President, which has enabled it to exert strong influence over government policy. Indeed, since 2009 the Chairman's position has the same level as a Minister (OECD, 2010a). The Investment Law of 2007 enshrined BKPM's role as the key governmental actor on investment policy.

The Co-ordinating Ministry of Economic Affairs plays an important role in co-ordinating various ministries and government agencies that deal with cross-cutting economic policy issues. For example, the Co-ordinating Ministry for Economic Affairs was responsible for drafting the government Masterplan for the Acceleration of Economic Development 2011-2025, and has a specific role *vis-à-vis* regulatory reform in the most recent 5-year development plan. In the government's structure, the Co-ordinating Ministry of Economic Affairs sits above line ministries and should play a pivotal role in ensuring the coherence of economic policy across the government, including in the formulation of regulations.

The National Development Planning Agency (Bappenas) holds responsibility for formulating national (annual, five-year, and long-term) development plans. Bappenas has developed several regulatory reform tools, including a well-developed framework to perform RIAs. However, it appears that in practice these tools are not always applied

33 Accounting, auditing and bookkeeping services as well as tax services.

systematically. As a result, sub-optimal regulatory outcomes can occur that are not in Indonesia's best economic interest. Thus, it appears that scope exists for expanding Bappenas' role in the regulatory review process.

Overall, the trade and investment policymaking process in Indonesia is fragmented across many ministries and government agencies. There is no formal, independent body to evaluate trade and investment policies from an economy-wide perspective, or to ensure public consultations involving a broad base of stakeholders. Various high-level teams have sometimes been engaged to conduct regulatory reviews and hold consultations with stakeholders, but this occurs on an *ad hoc* basis and is the result of strong, effective leadership rather than an inherent requirement embedded in the regulatory process.

IV. Integrating Indonesia's domestic market and linking it to world markets

Indonesia is a large and geographically diverse country that relies heavily on natural resource-based products for its exports. It suffers from high logistics costs and infrastructure bottlenecks that can fragment the domestic market. To achieve the kind of growth needed to absorb new entrants into the labour market and allow Indonesia to reach its growth potential, Indonesia needs to better integrate its domestic market. This would allow greater returns to scale and scope, improve efficiency, and create more competitive markets so that Indonesia can move into higher value added products, and lead to more innovation among domestic firms.

Moreover, better linking Indonesia to world markets will spur trade, which in turn will help boost domestic production, with positive knock-on effects for employment and domestic consumption. Access to a wider variety of imported inputs will also decrease costs for consumers and producers, as well as encourage productivity gains via technology transfer.

Connecting Indonesia's domestic market more effectively

Although inadequate infrastructure and the terrain of the country are major causes of high costs, government barriers to interregional trade can raise these costs even further and lead to the artificial division of domestic markets. Local governments in Indonesia have a long history of restricting domestic trade. Such barriers are one of the factors behind Indonesia's "high cost economy" and are also detrimental to rural poverty alleviation since they lower rural incomes.

The evolution of the regulatory process in light of decentralisation

The issue of local regulations was greatly complicated in the late 1990s by Indonesia's efforts to decentralise its political and economic decision making processes. In 1999, Parliament passed two laws on regional autonomy.[34] These laws granted regional governments greater authority over their domestic economies, but in the process made the Indonesian legal system more complex. To begin with, the number of lawmaking bodies increased from approximately 292 districts/cities (outside Jakarta) in 1998 to 33 provinces and 484 districts/cities in 2009, with even more bodies and individuals having lawmaking powers (Butt, 2010). The pressure to raise revenue to support local policy priorities led to a proliferation of new local laws (*peraturan daerah* or *perda*). By

[34] Law 22/1999 concerns administrative decentralisation; Law 25/1999 involves financial administration.

2006, at least 12 000 regulations had been registered with the central government, but the actual number is probably much higher because of underreporting (Butt, 2010).

Under regional autonomy, the central government retains authority over national concerns such as international affairs, defence, justice, national monetary and fiscal policy, religion and national standards, among other areas. The laws also prohibit local governments from using income, value-added and property taxes as ways to raise revenues. In so doing, the laws increased the pressure on local governments to find alternative sources of income and led to many new taxes (*pajak*) and fees (*retribusi*) at the local level.[35] The laws make no mention of domestic or international trade. Similarly, Indonesia's Constitution does not contain provisions that ensure free internal trade (Ray and Goodpaster, 2001).

The laws on regional autonomy originally focused on expanding the authority of sub-districts and other local governments. Provincial powers were confined mostly to mediating disputes between districts and facilitating development across districts (Butt, 2010). In 2004, Parliament replaced Law 22/1999 with Law 32/2004 on Regional Autonomy. The new law increased the powers of the provinces by making governors officials of the central government under the responsibility of the President. As such, governors co-ordinate central government affairs in the provinces, districts and cities. This allows the central government to retain some control over sub-provincial policy and lawmaking. Governors are also charged with reviewing district and city laws.

The government's regulatory review process in the context of decentralisation

Under the laws on regional autonomy, taxes and local user fees all require review by the central government. The review process is set forth in Ministerial Regulation 53/2007 and depends on where the local regulation originates. Provincial legislation and governor regulations are reviewed by the Ministry of Home Affairs (MoHA); district and city regulations and other lower-level regulations are assessed by a team established by the governor of the province in which the district or city is located (Butt, 2010).[36] Failure to meet the proper procedure may result in invalidation in certain circumstances.

The reviews and assessments are based on whether the regulations are in accordance with the public interest and with higher-order regulations. Under Indonesia's legal hierarchy, national laws, government regulations, and presidential regulations all prevail over local regulations (Figure 9). In principle, therefore, local laws are legally valid only if they do not contradict a law or regulation at a higher level of the hierarchy. They can also be overridden by laws and regulations higher on the hierarchy. Under the Law on Regional Autonomy, the power to review local regulations lies with the central government. Local laws that do not meet the public interest criteria or contradict higher-order laws and regulations can be invalidated by the central government through a presidential regulation (Butt, 2010).

Local laws on tax and fees also require pre-approval by the central government. Local laws must be sent to the central government and/or relevant governor prior to enactment. MoHA and/or the provincial governor, after co-ordinating with the Ministry of Finance,

35 *Retribusi* is the Indonesian term for fees that are paid in return for a service.

36 Regional lawmakers must send their regulations to the central government within seven days of enactment. The central government has 60 days in which to conduct the review. Local regulations not reviewed within this time period enter into force by default.

have 15 days to determine whether the local law can be enacted. The enforcement process has been tightened considerably by Law 28/2009 on Taxes and Fees. Under this law, the central government can withhold or withdraw budget grants and allocations to regions if they fail to comply with the procedures. Presumably, this will make local governments more hesitant to enact local laws without prior central government approval.

Nearly ten thousand local laws have been reviewed under these processes. Between 2001 and 2009, 13 387 local laws were received by the central government; 9 772 were evaluated; and 3 513 were recommended to be revoked (Radaksi, 2009). In addition, about 500 local laws have also been invalidated during the pre-approval process (Butt, 2010).

In an analysis of 500 decisions on the MoHA website, Butt (2010) concludes that the most common reason for invalidating local laws is that they imposed illegal taxes or user charges, and thus contradicted national laws on regional taxes and fees.[37] Only a very small number of local laws appear to have been invalidated for other reasons. These local laws involved the establishment of co-operatives, business permits, and rickshaw (*becak*) licenses. Even though most local laws likely pertain to charges and user fees, one would have expected more local laws to have been invalidated for other reasons as well (Butt, 2010).[38]

In addition to focusing on illegal taxes and fees, Butt (2010) argues that the review process may not work effectively for other reasons as well. First, the reviews are conducted by relatively small teams from MoHA and governors' offices. These teams may decide not to review many local laws simply because they lack the human and other resources needed for a review. Second, many regional governments may not send their local laws to the central government for review, and even fewer for pre-approval, as required by the Law on Regional Autonomy of 2004. This may change now as a result of the sanctions that were introduced under the Law 28/2009 on Taxes and Fees. Finally, local governments also rarely use RIAs to consider the likely effects of proposed regulations. Very few regions seem to maintain formal consultative processes with the private sector, and only interact with the private sector to "socialise" regulations after they have been enacted.

The laws on local taxes and fees[39]

Even before decentralisation, the contradictory objectives of local and central government laws were well-recognised. Indeed, the Indonesian government embarked on a major effort to free up the internal domestic market in 1997 when Parliament passed Law 18/1997 on Local Taxes and Fees. The goal was to reduce the regulatory burden on

37 See Indonesia's national law on regional taxes and user charges (Law 18/1997) and its amendment (Law 34/2000).

38. None of the studies conducted during the past several years have documented instances of quantitative restrictions on domestic trade. However, Ray and Goodpaster (2001) found a variety of such restrictions, including: 1) Quotas on goods and commodities involved in inter- and intra-regional trade (e.g. for the movement of cattle out of South Sulawesi and Nusa Tenggara Barat); 2) local processing requirements that force local farmers to sell their produce to in-region processors and restrict sales outside of the region; 3) requirements for local producers to sell their produce to particular buyers, such as local government co-operatives; and (4) marketing restrictions that reserve markets for particular sellers or buyers.

39 This section is based primarily on Ray and Goodpaster (2001).

business. The government also issued new regulations that prohibited taxes on export commodities and implemented a programme to abolish taxes on inter-provincial and inter-district trade.[40]

Law 18/1997 placed restrictions on the types of local taxes and fees that could be charged by provincial and district/city governments, and prohibited them from taxing trade on commodities moving across district and provincial borders. To offset the loss in revenues, local governments were allowed to collect land transfer taxes and to levy taxes on gasoline, underground water, and certain mining activities. The law was successful in reigning in trade restrictions by local governments and led to a 12% increase in gross farm revenues (Ray and Goodpaster, 2001).

However, the law also proved unpopular since it did not provide local governments with enough flexibility to raise revenues (Ray and Goodpaster, 2001). Local governments could also argue that the Law on Regional Autonomy gave them the authority to regulate their local economies, including the imposition of taxes and fees on business activities. Bowing to pressure from the regions, Parliament replaced Law 18/1997 with Law 34/2000. Law 34/2000 allows local governments the flexibility to introduce the following types of taxes and fees:

- ***Public service fees*** which can be levied only for specific services and cannot contradict central government authority;
- ***Business services fees*** which can be levied on commercial services not adequately provided by the market, or services using under-utilised assets controlled by the local government; and
- ***Specific licensing fees*** which can be levied to protect the public interest or to cover the costs of specific local government licensing activities.

The law also contains several monitoring requirements. These include the stipulation that local regulations must be submitted for central government review within 15 days of issuance and that if a regulation is found to contradict the public interest and/or laws and regulations at a higher level, the central government can rescind the regulation. This must be done no later than one month after receipt of the regulation.

In their evaluation of Law 34/2000, Ray and Goodpaster (2001) conclude that many of the criteria governing the types of permitted taxes and fees were either too vague, and thus created uncertainty, or too general, and allowed almost everything. Local governments could even argue that highly distortive trade taxes were consistent with the public interest from their perspective. Finally, the monitoring requirements appear overly ambitions given the large number of local governments and the lack of a centralised institution with adequate staff to perform the reviews. With local governments under significant pressure to raise revenues, Law 34/2000 would most likely be used as a basis for expanding trade and other types of local taxation.[41]

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40 In part, the impetus for these reforms was the Asian financial crisis and Indonesia's Letter of Intent with the IMF.

41 Ray and Goodpaster (2001) go so far to say that "if Law 18/1997 was written in the spirit of eradicating the 'high cost economy', then the new law (34/2000) was written to authorise regency-level (*kabupaten*) governments to create new taxes and charges." They also suggest that many local governments chose simply to ignore Law 18/1997.

Law 28/2009 on local taxes and fees

During the eight years following passage of Law No. 34/2000, the general consensus is that the Indonesian business community faced thousands of regional government regulations covering licenses, taxes, fees, third-party contributions and other levies on the production and distribution of goods.[42] In August 2009, Indonesia's Parliament moved to rectify the situation with the passage of Law 28/2009 on Regional Taxes and Fees. Law 28/2009 replaces Law 34/2000 and provides a revised legal framework for sub-national regulations on taxes and user fees. The law is a compromise that expands the tax powers of regional governments by giving them new authority over some types of taxes (e.g. cigarette taxes). At the same time, the law attempts to improve the business environment by, for example, earmarking tax increases to the provision of public benefits such as the construction of public facilities (Jaweng, 2009).

There are also new monitoring requirements and penalties for non-compliance. Under Law 34/2000, regional governments had discretion to impose new taxes and fees without central government approval. Under a new "closed list system" introduced by Law 28/2009, local regulations that do not meet the criteria contained in the new law or that fall outside the jurisdiction of provincial and regency/city governments will become unlawful after a two-year transition period. The central government's monitoring system is strengthened by requiring that local regulations be reviewed by the central government before they are implemented. The central government also has the authority to penalise regions for non-compliance by withholding grants and budget allocations (Jaweng, 2009).

Domestic measures affecting the local business climate

The general perception in Indonesia is that decentralisation has led to a tremendous increase in the use of taxes, user charges, and other regulations with negative impacts on the business community (Lewis, 2006). With the advent of Law 34/2000, local governments often use local taxes and user charges as sources of revenue. Although Indonesia's regulations state that fees should be based on the value of the service provided to business, there often is no service other than the issuance of a license. An overview of some of the more questionable measures related to business licensing, taxes and *retribusi*, and third party contributions are discussed below.

Business licensing

Complex licensing procedures have been identified as an important factor underlying Indonesia's business climate. They can also be particularly detrimental to micro-, small- and medium-sized enterprises. Before regional autonomy, licenses were issued by the local offices of government ministries. After regional autonomy, these local offices were converted to local departments (*dinas*) and retained their authority to issue licenses. With licensing now under local control, there appears to have been a proliferation of new licensing requirements (KPPOD and the Asia Foundation, 2008).

Six of the most important types of licenses and permits are described below. Each of these permits is administered by district or city governments.

- ***The construction permit (IMB)*** is one of the most complicated licenses since it combines building function, land use, road access, and safety.

[42] Third-party contributions are voluntary payments and are discussed later.

- ***Business registration (TDP)*** provides information on the business to the government. Businesses can register only after all other physical and sectoral licenses are obtained.
- ***The industrial registration (TDI)*** is the major technical license for industrial activities of small- and medium-sized enterprises.
- ***The trading license (SIUP)*** is the main technical license for trading activities, but is also required by any manufacturer who buys or sells on the domestic market.
- ***The nuisance permit (HO)*** requires approval by neighbours of the business after assessing the disturbance caused by business activities, such as traffic or noise.
- ***The operating license (IUT)*** represents the primary operating license needed for a manufacturing firm. For service providers, the operating license is usually issued by the line ministry responsible for the service sector.

To provide some sense of the complexity of the licensing process, Table 13 provides a list of the licenses and permits needed to start a manufacturing business in Indonesia.

Table 13. Key licenses and permits for starting a manufacturing business in Indonesia

Stage in the licensing process	Name of license/permit	Name of institution in charge
Company Formation	Personal Identification (KTP)	Sub District Office
	Deed of Establishment	Notary
	Domicile Letter (*Surat Domisilii*)	*Kelurahan* (sub District Office)
	Tax ID (NPWP)	Tax Office of Ministry of Finance (Central Government)
	Approval of Deed of Establishment (SK *Pendirian* PT)	Ministry of Law and Human Right (Central Government)
Initial Approvals	Approval Letter (SP)	Investment Coordinating Board (Central Government)
	Principal Permit	*Dinas Perindustrian dan Perdagangan* (Local Office of Industry and Trade)
Land and Building License	Land Usage Permit (SIPPT)	*Dinas Tata Kota* (city Planning Office)
	Environmental (ANDAL/UKL/UPL/SPPL)	*Badan Pengelola Lingkungan Hidup Dearah* (Local Environmental Body)
	Building Construction Permit (IMB)	*Dinas Penataan dan Pengawasan Bangunan* (Local Office for Building Permit and Control)
	Nuisance Permit (UUG)	*Dinas Keamanan dan Ketertiban* (Local Office for Civil Security)
Final Operating License	Permanent Operating License (IUT)	Investment Co-ordinating Board (Central Government, BPMPKUD)
	Industrial Permit (TDI or IUI)	*Dinas/Sudin Perindustrian dan Perdagangan* (Local Office of Industry and Trade)
	Trade License (SIUP)	*Dinas/Sudin Perindustrian dan Perdagangan* (Local Office of Industry and Trade)
Business Registration	Business Registration (TDP)	*Suku Dinas Perindustrian dan Perdagangan* (Local Office of Industry and Trade)

Source: Nurridzki (2010).

The process of forming a manufacturing firm begins with the investment approval. This is required of all foreign companies and foreign and domestic firms that seek special tax facilities. This is followed by obtaining various permits, the technical licenses authorising the business, and the registration process. Several of the steps needed to obtain licenses and permits must be done sequentially. Moreover, many approvals are now under the authority of local governments because of decentralisation.[43]

Examples of some of the problems associated with local licensing and permit requirements are outlined below.

- Many of the core business licenses required to start a business in the services sector entail high-level government approval (e.g. at the level of Minister). In some manufacturing and service industries, approval by a local trade association may also be required. As a result, informal economic needs tests may be introduced into the licensing process where none exists in the law. Such informal tests can be used to limit entry and to protect domestic producers.
- The fees for obtaining licenses at the local level often appear arbitrary and are not cost-based. For instance, the Minister of Trade issued regulations in 2007 that set the administrative fee for a new trading license (SIUP) and company registration (TDP) at zero. Yet SMERU (2009) could not find examples in which businesses had paid nothing for these permits. Furthermore, the average time to obtain a TDP was 14 days, twice the maximum period of 7 days as required by national regulations (KPPOD and the Asia Foundation, 2008).
- The purpose of some licenses and permits is not clear. For example, nearly all manufacturing companies obtain a trading license (SIUP) even though trading is not their core business. Manufacturing firms are required to obtain the license because they purchase inputs from or sell products to the domestic market. In the case of the TDP, the purpose is to provide information to the government. Yet surveys indicate that the information collected is very inaccurate (Nurridzki, 2010).
- The business location permit (SITU) is one of the most difficult permits to obtain, but must be obtained before all other permits. In one location, there were 270 different tariffs depending on the size and type of business. The permit must be renewed every year even though it is valid for three years (Bachtiar, 2009).
- Many regulations do not lay out a clear fee structure and clear procedures for obtaining licenses and permits (KPPOD and the Asia Foundation, 2008).
- After the steps to set up the business are completed, manufacturing companies may also be required to obtain numerous permits, such as for elevators, electronic scales, tanks, boilers, conveyors, forklifts, groundwater extraction and disposal. These permits are renewed each year and may be required for each piece of equipment. Frequently, the issuance of these permits is not dependent on valid safety inspections.

Often, it is not the cost but the complexity of the licensing process which is the problem. Many licenses and permits must be obtained sequentially. For example, all

43 For companies entering a services sector, the steps vary according to the type of service and can be more complicated than for manufacturing. The Ministry of Trade handles 122 types of business permits (KPPOD and Asia Foundation, 2008). According to the Indonesian Chamber of Commerce, 44 permits are needed by a retail firm (Samboh, 2011).

manufacturing companies must obtain a registration (TDP) from the Ministry of Trade. This can only be done after all other permits have been obtained, yet the information needs are similar if not identical to those of other permits (Nurridzki, 2010). In one major improvement, the government has simplified the application process by allowing applicants to obtain the trading license and business registration at the same time.

The 2007 Investment Law mandates the establishment of one-stop shop investment services (*Pelayanan Terpadu Satu Pintu* or PTSP) for investment licenses and permits. In 2009, a Presidential Regulation was issued which sets out implementation guidelines for the PTSP. The guidelines are outlined below.

- One-stop shops are run by the central government (through BKPM) and by sub-national governments. For example, all licenses could be issued under one roof, with representatives of technical ministries stationed in BKPM.
- The authority to issue licenses and other non-licensing facilities may be delegated by the technical ministries to the the Head of BKPM.[44]
- Further provisions regarding one-stop shops will be issued by regulations from BKPM.

BKPM has issued service standards for the implementation of one-stop shops at the regional level. Regional one-stop shops will then be evaluated against these service standards. Those one-stop shops that meet the service standards would be authorised by BKPM to issue investment licenses. Otherwise, licensing authority would remain with BKPM.

The 2009 Presidential Regulation on one-stop shops also calls for the development of an electronic online system (SPIPISE) for investment licenses by BKPM within three years. With that in mind, a software application for investment licensing can now be accessed on the BKPM website. The system aims at providing a national single window for licensing applications and approvals, and involves BKPM, provincial governments, and district level one-stop shops.[45] Currently, the licensing processes for five sectors are included in the system – trade, industry, tourism, agriculture and health – although line ministries have not devolved authority to BKPM to administer a majority of these licenses. For the system to become fully operational, a number of technical issues must be worked out (e.g. a data model needs to be developed with common formats for all data elements needed for each license).

The on-line system will also provide access to the business processes for the licenses issued by Indonesia's technical ministries to provide a single source of information for investors. With that in mind, BKPM has requested each ministry to provide manuals and business processes for their licenses. It would also like to issue an updated *Petunjuk Teknis* (Technical Manual) on investment regulations in Indonesia.

Most recommendations to improve the licensing process in Indonesia have focused on streamlining the process, rather than on reforming the licenses themselves. Since many licenses have been devolved to the local level, improvements have been sought through

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44 According to BKPM, fifteen ministries have delegated some of their licensing authority to BKPM, but the true scope of that authority is unclear and does not appear to include all of the licenses issued by each ministry.

45 By 2011, the system should have been available in 33 provincial and 40 districts of Indonesia.

the development of one–stop shops in the regions.[46] But according to the KPPOD and the Asia Foundation (2008), only 7% of all businesses used these shops. Most obtained licenses directly from the line ministries, often using agents. This could change as one-stop shops continue to be developed throughout the country.

Other taxes, charges and third-party contributions

In using their powers to make regulations, regional governments have at times appeared more concerned with achieving the short-term goal of increasing local revenue by collecting regional taxes and charges. Most of these taxes and charges fall disproportionately on the business community. They include illegal user charges, taxes and security payments, and are collected in a number of ways, including road fees and at district border crossings, and by different government departments based on the type of commodity. Some examples are outlined below.

- Duplicative fees required by different levels of government for the same purpose (SMERU, 2009).
- Quarantine inspections carried out by the local government on all agricultural products entering or leaving a province. Fees are reportedly collected even if the inspections are not carried out (Ray and Goodpaster, 2001).
- Fees and taxes on the production, marketing and sales, and transport of primary products, especially agricultural, animal, fishery, and forestry products. There are cases in which the fees are higher for export products than for products consumed locally (Ray and Goodpaster, 2001; SMERU, 2009).
- Service fees that are collected even when no service is provided (SMERU, 2009).
- Transportation fees, including trucking road permits, user fees and charges at weigh stations and bridges. Trade is an easier target for such fees. Truck drivers are liable to pay legal and illegal local user charges, payments at weigh stations, and payments to police and others for security reasons (Asia Foundation, 2008).

Third-party contributions (SPK) are also very common in Indonesia and consist of "voluntary" payment to governments.[47] Although operating like a tax, the contribution is not recorded as such on government accounts and is classified instead as "other sources of income." As a result, the contributions do not technically fall under Indonesia's laws or regulations restricting the types of taxes that may be imposed by local governments. Sometimes the fees are paid by businesses that bid on construction projects or for the supply of goods and services to local governments (Bachtiar, 2009). There are also several examples of SPK being paid on traded commodities, such as cattle.

Linking Indonesia to world markets

Enhancing Indonesia's connectivity to world markets will improve trade performance and enhance growth. Stronger export growth will help spur domestic production, with positive knock-on effects for employment and domestic consumption. Import growth

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[46] See LPEM (2008) and Asia Foundation (2007).

[47] Some third-party contributions are in fact compulsory and serve as an unofficial tax on businesses (KPPOD and the Asia Foundation, 2008).

helps decrease costs for consumers and producers, in addition to the productivity-related spillovers derived from technology transfer.

Indonesia's National Single Window (INSW) for trade

Indonesia's National Single Window (INSW) represents a major government effort at facilitating trade. The goal is to expedite the clearance of goods across Indonesia's borders by simplifying and streamlining customs clearance and cargo release procedures. When fully established, traders and government agencies will be able to process all official export/import documents through a single point of contact.

The development of the INSW was driven by Indonesia's commitments to ASEAN under the Agreement to Establish and Implement the ASEAN Single Window. This agreement was signed by Economic Ministers in 2005, and was followed by the *ASEAN Protocol* for single windows, which was signed by Finance Ministers in 2006. These agreements require the establishment of national single windows (NSWs) by each ASEAN Member State. The ASEAN Single Window will then provide the regional architecture that connects and integrates the NSWs so that information can be exchanged electronically among countries.

Development of the INSW is managed by the Indonesian National Single Window Preparatory Team (INSW-PT). The INSW-PT was established in 2006 and is headed by the Minister of Finance. It is led on a daily basis by a Deputy Minister and supported by a Secretariat from the Co-ordinating Ministry of Economic Affairs.

The INSW-PT completed its blueprint for the establishment of its national single window in 2007. The Blueprint formally adopts the ASEAN definition of a national single window, which states that a NSW is a single point for the submission, synchronous processing, and approval of trade documents needed for the customs release and clearance of cargoes.[48] Indonesia's NSW Blueprint broadens this definition to also include ports and e-payment systems in its single window. In other words, the INSW will link not only government agencies, but also ports, financial institutions and transport operators.

Development of the INSW is proceeding in stages. In 2010, the INSW became formally operational and is now mandatory in five Indonesian ports with 18 participating government agencies (out of 39 agencies involved in export and import activities). These ports handle about 90% of all Indonesian trade. Electronic linkages have been created between the participating government agencies and Customs so that Customs is notified electronically when an import license or permit is issued. Some government agencies have also implemented electronic "track and trace" so that importers can quickly identify problems.

The INSW portal serves as the gateway to the system for users with a password/ID. When fully developed, exporters and importers will be able to submit clearance and licensing requests, monitor the clearance process and obtain clearance/licenses online. In addition, the portal provides open access to trade policy information concerning tariffs and the various permits required for import and export. Users can also obtain the service-

48 Under the INSW framework, a trader will be able to submit a single application to the National Single Window, which distributes the application to each permit-issuing agency. Approvals are then returned to the NSW from each agency and the trader receives a single response.

level agreements and standard operating procedures for the processing of trade documents by 18 government agencies.

Stakeholders in the INSW consist of the private sector and the various government agencies that are responsible for imports and exports. With that in mind, the INSW Secretariat has established standard operating procedures for public-private consultations on the INSW. The consultations provide a forum for the private sector to bring implementation problems to the attention of the government, and for the government to co-ordinate and socialise various aspects of the INSW with the private sector and with government agencies (Box 5).

Box 5. The Indonesian National Single Window – Public-Private Consultations (INSW – PPC)

In 2010, the Secretariat of the INSW issued guidelines on a new consultative process involving government agencies and the private sector. The objective is to ensure the most efficient implementation of the INSW in a way in which all stakeholders benefit. In particular, the forum provides the private sector with a vehicle for voicing concerns regarding the operation of the NSW and to actively participate in its development. It also allows the government to "socialise" the single window with the private sector and participating government agencies.

The chair of the INSW-PPC is the head of INSW-Secretariat, namely a Deputy Minister of the Co-ordinating Ministry of Economic Affairs, or a delegated official. The chairperson co-ordinates INSW-PPC meetings and ensures that there is follow-up on issues. Participants include the private sector, which is usually represented by chambers of commerce or trade associations, and concerned government agencies, such as the Ministry of Trade, Customs, BPOM, and quarantine agencies. These and other government agencies are invited to participate in the consultative process depending on the topic to be discussed.

A consultation may involve five steps: (1) submission of a request for consultations; (2) review and development of a PPC issues brief and agenda; (3) call for formal consultations; (4) organisation of the PPC; and (5) minutes of meetings and follow-up actions. The INSW-PPC provides guidelines on the types of issues that can be addressed through the consultative process and the information that should be provided when requesting consultations. The INSW-PPC Secretariat will also work with the private sector to develop an issues brief and agenda for those cases in which formal consultations are warranted.

The INSW-PPC has been operational for over three years and has held consultations with several international chambers of commerce and some Indonesian trade associations. Several of the consultations led to the successful resolution of problems, such as conflicts between harmonised system (HS) codes and the product descriptions used by permit issuing agencies and requirements for both hard copy and electronic documents. Although meant to be a forum on the INSW, other concerns dealing with trade regulations more generally and with operations at the port have also been addressed.

Although much progress has been made, the INSW has not yet reached its goals of single sign-on, submission and synchronous processing of trade documents. The INSW involves the co-ordination and transformation of the operating procedures of a large number of agencies. The IT systems of these agencies may need updating, back office systems for the issuance of permits need to be modernised, and legal and IT issues pertaining to the transfer of information between the private sector and government agencies, and among government agencies, need to be addressed. There are also legal issues related to the transmission, security, and confidentiality of data, and with the translation of decrees in a way that will allow electronic decision making.

One consequence is that full paperless clearance through the INSW is only available for a relatively small group of about 100 priority traders (MITA). These are generally large companies that have sophisticated IT systems and that qualify for post-clearance audit facilities. In addition, there are about 350 non-priority traders that also use INSW facilities due to their sophisticated IT systems, but are not qualified for the post-clearance

audit facility. Going forward, Indonesia's goals are not only to achieve the full definition of the INSW, but also to enlarge significantly the number of users that benefit from the system – currently there are about 8 000 potentially active traders – that benefit from the system.

With this in mind, the INSW Preparatory Team has developed the following comprehensive program of work for 2012.

- ***Formation of the INSW Body***. Currently, the INSW is managed by an ad-hoc team of officials who have other responsibilities in their respective government agencies. Over the longer term, the government wishes to establish an independent agency (*Badan*) that will have management and policy roles related to the NSW, while operation of the INSW will likely be done by a public-private partnership. A draft presidential regulation outlining the functions and structure of the agency has been prepared.
- ***Single sign-on and submission***. Work plans have been developed and a pilot project is now being implemented for single sign-on for MITA traders and two agencies – Customs and BPOM. This represents the first step towards the roll out of single sign-on for a broader group of agencies.
- ***Integration of TPS online and INSW Portal***. The TPS (*Tempat Penimbunan Sementara/*Temporary [container] Storage Yard) is an online system that links Customs to the Container Yard Terminal (CYT) in the ports. The system allows Customs to obtain container data from the CYT and to send customs clearance electronically to the CYT. The government plans to implement the system, starting with the Tanjung Priok Port. This will expedite cargo arrival services and handling processes, as well as allow better management of cargo in port.
- ***The Indonesian National Trade Repository***. The government envisions that the Indonesia's National Single portal will eventually become an electronic gateway for supply-chain management in Indonesia. One key component of that gateway will be the Indonesia National Trade Repository, which will contain all regulations related to Indonesian import and export (Box 4).
- ***Other aspects of the work programme***. The INSW-PT is engaged in numerous other activities to improve the functioning of the INSW. Improvements to the portal are on-going, and involve eliminating inconsistencies, misspecifications, and overlapping HS codes in the policy database. The government hopes to develop a memorandum of understanding with international shipping lines that will allow the sharing of cargo manifest data so that it becomes possible to clear cargo before ships arrive at port. Similarly, the government would like to cut cargo release times by expanding the use of automated risk management procedures by various government agencies.

In summarising Indonesia's efforts to further integrate Indonesia's domestic market and better link to world markets, significant steps are being taken. In particular, the INSW has served as a useful platform for better linking to world markets, with progress in implementing this process on-going. Indonesia has also been taking steps to successfully group the many licenses needed to start and operate a business in Indonesia into one-stop shops, but more effort is needed to streamline the licenses themselves. This section highlights some of the duplicative licenses that currently exist, as well as others that appear to have rent-seeking or budgetary support objectives rather than clear policy goals.

In particular, efforts to ensure that sub-national licenses have clear policy objectives and do not contradict or duplicate national licensing requirements are important.

Better co-ordination between the central government and the periphery is an important component of ensuring overall national interest. Toward this end, independent and objective evaluations could be institutionalised for reviewing local laws and regulations. An institution such as Bappenas, the Ministry of Finance or the Co-ordinating Ministry for Economic Affairs could be empowered to review local laws beyond the time frames imposed by the bureaucratic process, could arbitrate jurisdictional disputes between the central and regional governments, and would ensure that the regulatory review covers all regulations impacting the business environment, not just those that impose taxes and *retribusi*.[49] Other legal problems with the review process (e.g. the legal instruments used by MoHA to invalidate local laws) may also be usefully addressed by such an institution. It is important to create mechanisms to ensure that local governments cannot easily ignore national laws.

V. Conclusion

The Indonesian economy is healthy, with GDP, inflation, unemployment and external balances all on solid footing. Investment has also been robust, with inward stocks as a share of GDP reaching their highest point in 2009, the worst year of the global economic crisis. However, foreign direct investment (FDI) is not spread equally across the archipelago. Moreover, the effects of the 1997-98 Asian financial crisis still linger. GDP growth rates and Indonesia’s share of world trade remain below pre-1997 levels, and Indonesia has experienced a steady deterioration in its terms of trade.

Indonesia’s goods trade is concentrated in energy-related products, and there has been no change in this general orientation in the past 5-10 years. However, Indonesia has lost competitiveness in some traditional export sectors, such as textiles and wood. In other sectors, such as motor vehicles, Indonesia is increasing its competitiveness on world markets. Services trade is less developed and concentrated in a few sectors (tourism and transportation make up the bulk of Indonesia’s services trade), but business services are also increasingly important. Trade patterns for both goods and services have shifted markedly toward Asian and developing countries, in part due to the rise of production networks in the region as well as regional integration, in particular through ASEAN.

The ASEAN commitment to build the AEC by 2015 is pushing the reform effort forward in Indonesia and other countries in the region. As a result, tariff liberalisation has been deep and successful, with falling rates of effective protection. On the services side, liberalisation is less advanced, and recent regulatory changes are causing concern among some foreign providers of services, especially in the logistics and telecommunications sectors. While some of the changes are welcome, other aspects of the new legislative framework will almost certainly increase Indonesia’s trade costs and reduce its competitiveness on world markets. Investment Law 25/2007 and its implementing regulations represent an important step toward improving the investment environment in Indonesia, but important ambiguities remain, and conflicts between the law and lower-order regulations have created confusion (e.g. horticulture).

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49 Butt (2010) also points out other legal problems with the review process (e.g. the legal instruments used by MoHA to invalidate the *perda*). Some of the issues might be addressed by an independent review. Others might require decisions by the Indonesian Supreme Court.

The use of NTMs also appears to be increasing, a worrying development given that these measures are less transparent and more easily influenced by special interests. An increase in NTMs undermines Indonesia's overarching intent to be more open, and creates less predictability. It also reduces the domestic economy's access to imported inputs, which play a critical role in connecting global value chains and driving export performance. It is also not clear that all NTMs have a clear policy objective – rather than budgetary support or rent-seeking – and are in Indonesia's national interest. This is notable in the licensing structure, which includes some cases of duplicative requirements. Authority for NTMs is also spread across a wide range of ministries and government agencies, which makes a whole-of-government approach to policymaking in this area more challenging.

Similarly, other aspects of the trade and investment policymaking process in Indonesia are fragmented across many ministries and government agencies. There is no formal, independent evaluation process to assess regulations from an economy-wide perspective, or to ensure public consultations involving a broad base of stakeholders takes place. Various high-level teams have sometimes been engaged to conduct regulatory reviews and held consultations with stakeholders, but this occurs on an *ad hoc* basis and is the result of strong, effective leadership rather than an inherent requirement embedded in the regulatory process.

Moreover, new policies and regulations are not always preceded by RIAs. While well-developed RIA frameworks have been put in place in some parts of government, RIAs do not appear to be used systematically. As a result, sub-optimal regulatory outcomes can occur that are not in Indonesia's best economic interest.

Indonesia has taken significant steps to better integrate with world markets, in particular via Indonesia's National Single Window (INSW). Progress so far in implementing the INSW has been successful and is on track for full realisation. Indonesia is also pushing to better integrate Indonesia's domestic market. For example, an ambitious programme to create one-stop-shops for investment licensing is notable. However, more can be done to rationalise licensing requirements. In addition, efforts to ensure that sub-national licenses have clear policy objectives and are not contradictory or duplicative are important. Indeed, better co-ordination between the central government and the periphery, as well as among central government agencies, represents an important component of ensuring overall regulatory quality and national interest.

Overall, Indonesia has made important strides in enhancing market openness. However, problems have emerged, in part because of the decentralised nature of the policymaking process. With more structure and independence in the policy process, Indonesia should see sustained improvements in regulatory outcomes. To close the gaps in the regulatory process identified in this paper, five key recommendations are outlined below.

1. Institutionalise independent and objective evaluations of policies from an economy-wide perspective

Independent and objective evaluations of policies from an economy-wide perspective are not currently institutionalised in Indonesia. Various high-level teams have sometimes been engaged to conduct regulatory reviews, but this occurs on an *ad hoc* basis and is the result of strong, effective leadership rather than an inherent requirement embedded in the regulatory process.

To conduct such evaluations, stronger co-ordination among line ministries is critical. In recent years, there have been several prominent examples of new regulations that contradict higher order laws and regulations, thus creating uncertainty. Such co-ordination is particularly important in the context of the decentralisation of authority and the increasing influence of the Parliament in regulatory policy. As a result of these changes, line ministries now seem to have more control over the policies within their sectors and sectoral interests have greater political sway. This leads to potential protectionist tendencies that can only be offset by independent evaluations that take an economy-wide approach to policymaking.

An institution within the existing regulatory framework can be given the authority to conduct these types of evaluations. For example, Bappenas, the Co-ordinating Ministry for Economic Affairs or the Vice President's Office could be empowered to perform this function. Stronger powers, particularly *vis-à-vis* the institution's ability to act as a broker and clearing house for conflicting regulations, would be useful in this regard. Regardless of location, the priority is that some institution is empowered to undertake objective and independent evaluations of policies from an economy-wide perspective, that it has the capacity to ensure proper evaluations take place, and inter-ministerial co-ordination is enhanced.

2. Institute a process in which broad public consultations are systematically required

Although the government has held consultations with the private sector and non-governmental actors, this is also the result of *ad hoc* processes, usually driven by the leader of a high-level team, rather than embedded in the regulatory process itself. A mechanism is needed to ensure public consultations involving a broad base of stakeholders are held systematically to enhance transparency and avoid unintended trade restrictions.

As one part of the process, a position paper distributed to all stakeholders as a consultative document with a formal "request for comment" could be useful. The process might also include a review of the final language by stakeholders before a draft regulation is sent to Parliament. Although this review might not lead to language that is acceptable to all parties, it would at least ensure that the regulations reflect the government's intent. It would also provide additional opportunities to discuss regulatory alternatives and best practices.

Rules or guidelines that ensure contact and consultations with experts in the relevant policy evaluation teams and interested parties would also be useful. Public hearings could then be designed to formally involve "interested parties" in the policy process while providing information that will facilitate the government in forming decisions more transparently. An on-line mechanism would ensure the broadest possible reach and facilitate interactions with stakeholders, including other governments. More comprehensive public consultations would also serve to lessen the implementation burden for both domestic and foreign firms once regulations have been enacted. Systematic notification of new trade-related laws and regulations would also greatly improve predictability and transparency, for example via the WTO and other relevant international bodies to which Indonesia is a signatory.

3. Streamline the licensing process

While significant steps have been taken to successfully group the many licenses needed to start and operate a business in Indonesia into one-stop shops, more effort is needed to streamline the licenses themselves. This paper highlighted some of the duplicative licenses that currently exist, as well as others that appear to have budgetary support or rent-seeking rather than clear policy objectives. In particular, efforts to ensure that sub-national licenses have clear policy objectives and are not contradictory or duplicative are important.

To further this aim, a first step could be to empower BKPM to undertake a review of all national licenses with a view to streamlining the licenses themselves. Duplicative licenses should be eliminated, as should licenses without a clear policy objective. Alternative compensation mechanisms could then be employed to create the necessary incentives for ministries to devolve their licensing power to BKPM, thus improving one-stop shop servicing. A second step could then involve an assessment at the sub-national level, thus reconciling national and regional licensing regimes. It would be important to grandfather existing licenses to avoid the need to re-license.

As part of the streamlining process, the government could also develop an inventory of all business licenses and permits at the national level. The inventory could document the objectives of each license/permit, the issuing authority, and examine whether the license/permit represents a barrier to entry that should be included on the Investment Negative List. Requirements for licenses/permits, as well as other regulations impacting investment at the sector level, could be compiled and included in an updated version of BKPM's Technical Bulletin, as well as be made available on Indonesia's National Single Window for Investment. This review process would represent a preliminary step in considering whether Indonesia would benefit from a guillotine approach to regulatory reform.

4. Ensure that new laws and regulations benefit Indonesia as a whole

The fragmentation of the policymaking process has led to an increase in opportunities for special interests to exert influence over government policy. As a result, the government may wish to consider embedding RIAs systematically into the policy process for any new law or regulation that meets a pre-determined "threshold test." Threshold tests vary from country to country, and may combine both quantitative (i.e. likely costs will exceed USD 100 million) and qualitative (i.e. more than 100 million people will be affected) targets. RIAs are one of the most important tools governments have for making informed decisions on the *ex ante* impact of new laws and regulations. While there are already instruments in place for this (practical guidelines issued by both Bappenas and MoHA), they are not applied systematically. As a result, sub-optimal regulatory outcomes can occur.

One way to facilitate the process is to develop well-defined regulatory impact assessment requirements as a guide to the evaluation of policy measures. This would advocate an assessment of the national interest taking account of the economic welfare of the majority of Indonesian citizens, but might also give specific priority to other policy goals. These principles would need to be transparently enshrined in a national law so as to supersede local or provincial regulations. It would also need to be carefully crafted so as to ensure that special interests do not use national interest as a guise for protectionism.

In the case of investment, there has been no formal review of the entire body of restrictions on investment in the Investment Negative List. Moreover, there is no certainty that the regulatory impact processes used by Timnas PEPI will continue. For proposed changes to the restrictions, formal consultations involving regulatory impact assessments could be required so as to ensure that Indonesia's national economic interest is being met, as called for in the 2007 Investment Law. A re-confirmation and strengthening of Timnas PEPI could be a useful way to move forward.

5. Improve co-ordination between the central government and the periphery

Better co-ordination between the central government and the periphery is a critical component of ensuring overall national interest. Toward this end, an objective review of local laws and regulations is important. This review could take place through empowerment of Bappenas or the Co-ordinating Ministry of Economic Affairs to review local laws beyond the time frames imposed by the bureaucratic process, arbitrate jurisdictional disputes between the central and regional governments, and ensure that the regulatory review covers all regulations impacting the business environment, not just those that impose taxes and *retribusi*.

Other legal problems with the review process (e.g. the legal instruments used by MoHA to invalidate local laws) may also be usefully addressed by such reviews. It is important to create mechanisms to ensure that local governments cannot easily ignore national laws.

An essential aspect of improving co-ordination between the central government and the periphery involves improving human resource capacity. If officials reviewing new and existing laws and regulations do not have the proper training and incentives to carry out such a task, efficient regulatory outcomes will not happen. One way to improve co-ordination involves upgrading the analytical capability of policy institutions by creating permanent staff positions and career tracks. Developing the capacity of officials to implement effectively Indonesia's regulatory regime is an important long-term structural change.

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Annex

Annex Figure 1. GDP growth (annual %), Indonesia

Source: World Bank's World Development Indicators.

Annex Table 1. Inward stock of FDI as a share of GDP, ASEAN Economies and China

	2003	2004	2005	2006	2007	2008	2009	2010
Brunei Darussalam	134%	116%	99%	86%	83%	72%	100%	n/a
Cambodia	42%	39%	39%	41%	44%	45%	50%	53%
China	14%	13%	12%	11%	9%	8%	9%	10%
Indonesia	4%	6%	14%	15%	18%	14%	20%	17%
Lao PDR	30%	26%	25%	25%	28%	26%	29%	29%
Malaysia	37%	35%	32%	34%	41%	33%	41%	43%
Philippines	14%	14%	15%	14%	14%	13%	14%	12%
Singapore	155%	155%	158%	174%	192%	184%	182%	225%
Thailand	34%	33%	34%	37%	38%	34%	42%	40%
Vietnam	70%	64%	59%	55%	57%	55%	59%	62%

Source: World Bank's World Development Indicators and UnctadStat.

Annex Table 2. Comparison of Investment Negative Lists and other regulations over time

	Pre-2007 lists and regulations	Perpres 111/2007	Perpres 36/2010
Hospitals	Allows 99% foreign equity. BKPM's technical instructions allow 49%. Foreign hospitals must have at least 200 beds.	Investment is allowed in Medan and Surabaya with a 65% foreign equity limit.	Investment of at least 200 beds is allowed everywhere in Indonesia with a 67% foreign equity limit.
Higher Education	No restrictions. Foreigners may coooperate with local partners in non-profit foundations.	Foreign investment is permitted in limited liability companies with 49% foreign equity limit.	Foreign investment is permitted subject to the Laws on Education.
Telecommunications	Alows 99% foreign equity. Limitations on certain types of licenses.	Foreign equity limits vary from 49% to 100% depending on the type of network and service. Limitations on certain types of licenses.	Foreign equity limits vary from 49% to 100% depending on the type of network and service. Foreign investment in cell towers is banned. Limitations on certain types of licenses.
Express Delivery	Open to 100% foreign equity. BKPM technical instructions allow foreign equity of 95%.	Reserved for small- and medium-sized businesses. Effectively closed to foreign investment.	Open to foreign investment with 49% equity limit subject to the Postal Law, which appears to have contradictory clauses.
Ports	Foreign equity ceiling of 99%.	Foreign equity ceiling of 49%.	Foreign equity ceiling of 49%.
Shipping	Foreign equity ceiling of 99%. According to Presidential Instruction of 2005, cabotage to be introduced gradually.	Foreign equity ceiling of 49%. Cabotage under 2009 Shipping Law.	Foreign equity ceiling of 49%. Cabotage under 2009 Shipping Law.
Insurance	Initial foreign equity ceiling of 80%, but can increase equity by issuing new shares.	Foreign equity ceiling of 80%. A ministerial decree from 2008 allows a higher ceiling.	Foreign equity ceiling of 80%. A ministerial decree from 2008 allows a higher ceiling.

Source: Compiled by the author based on Indonesian regulations.

Annex Table 3. Indonesia's Bilateral Investment Treaties, 1 June 2011

	Date of Signature	Entry into Force
Algeria	21 March 2000	..
Argentina	07 November, 1995	01 March 2001
Australia	17 November 1992	29 July 1993
Bangladesh	09 February 1998	22 April 1999
Belgium and Luxembourg	15 January 1970	17 June 1972
Bulgaria	13 September 2003	23 January, 2005
Cambodia	16 March 1999	..
Chile	07 April 1999	..
China	18 November 1994	01 April, 1995
Croatia	20 September 2002	..
Cuba	19 September 1997	29 September 1999
Czech Republic	17 September 1998	21 June 1999
Denmark	22 January, 2007	..
Egypt	19 January 1994	29 November, 1994
Finland	12 September 2006	02 August 2008
France	14 June 1973	29 April, 1975
Germany	14 May 2003	02 June 2007
Guyana	30 January 2008	..
Hungary	20 May 1992	13 February 1996
India	10 February 1999	22 January 2004
Iran	22 June 2005	28 March 2009
Italy	25 April 1991	25 June, 1995
Jamaica	10 February 1999	..
Jordan	12 November 1996	09 February 1999
Korea, Republic	16 February 1991	10 March 1994
Korea, DPR	21 February 2000	..
Kyrgyzstan	19 July 1995	23 April 1997
Lao, PDR	18 October 1994	14 October 1995
Malaysia	22 January 1994	27 October 1999
Mauritius	05 March 1997	28 March 2000
Mongolia	04 March 1997	13 April 1999
Morocco	14 March, 1997	21 March 2002
Mozambique	26 March 1999	25 July, 2000
Netherlands	06 April 1994	01 July 1995
Pakistan	08 March 1996	03 December 1996
Philippines	12 November 2001	..
Poland	06 October 1992	01 July 1993
Qatar	18 April 2000	..
Romania	27 June 1997	21 August 1999
Russian Federation	06 September 2007	..

Annex Table 3. Indonesia's Bilateral Investment Treaties, 1 June 2011 (*cont.*)

Saudi Arabia	15 September 2003	05 July 2004
Singapore	16 February 2005	21 June 2006
Slovakia	12 July 1994	01 March 1995
Spain	30 May 1995	12 February 1997
Sri Lanka	10 June 1996	21 July 1997
Sudan	10 February 1998	..
Suriname	28 October 1995	..
Sweden	17 September 1992	18 February 1993
Switzerland	06 June, 1974	09 April 1976
Syrian Arab Republic	27 June 1997	20 February 2000
Tajikistan	28 October 2003	..
Thailand	17 February 1998	05 November 1998
Tunisia	13 May 1992	12 September 1992
Turkey	25 February 1997	28 September 1998
Turkmenistan	02 June 1994	..
Ukraine	11 April 1996	22 June 1997
United Kingdom	27 April 1976	24 March 1977
Uzbekistan	27 August 1996	27 April, 1997
Venezuela	18 December 2000	23 March 2003
Vietnam	25 October 1991	03 April, 1994
Yemen	20 February 1998	..
Zimbabwe	10 February 1999	..

Source: UNCTAD's BIT Database.