The Improving Business Environment for Prosperity (IBEP) Program implemented by the World Bank Group aims to strengthen the design and implementation of business environment reforms in middle-income countries. IBEP is supported by the UK Prosperity Fund, whose mission is to support the inclusive economic growth needed to reduce poverty in partner countries, contributing to the UN Sustainable Development Goals.

REFORM STORY

MARCH 2021

OPENING INDONESIA TO FDI

With the support provided by the World Bank Group through the UK-FCDO funded Improving Business Environment for Prosperity (IBEP) Program, Indonesia has implemented one of the most ambitious investment liberalizations in the past decades. More than two thirds of previously restricted business activities have fully opened to foreign investments. This liberalization is expected to generate between US$4.1 and $6 billion additional (foreign and domestic) investments.

THE CHALLENGE

Indonesia attracts FDI worth only around 2 percent of its GDP, which compares unfavorably to other economies in the region, such as Malaysia (over 3 percent), Vietnam (over 6 percent) and Cambodia (over 12 percent).[1] As a result Indonesia loses an important source of technology and knowledge transfer and external funding for the economy. Furthermore, the composition of FDI has shifted from export-oriented sectors to natural resources sectors and production for the domestic market. This is a problem as export-oriented manufacturing FDI is associated with rapid labor productivity growth, higher average wages, larger introduction of new products, and higher investment rates. Additionally, more robust FDI inflows would be a more stable channel to finance the current account deficit than volatile short-term portfolio capital flows.

One of the major factors contributing to Indonesia's relative inability to attract FDI is a restrictive FDI policy environment. For instance, based on the 2007 Investment Law and various sectoral laws, Indonesia's negative investment list (DNI) stipulates different types of restrictions on investments, particularly foreign equity limits. The DNI applies at least one investment restriction to 813 business sectors, equivalent to around 28 percent of all economic sectors. Examples include onshore oil and gas upstream production installation, power plants with capacities below one megawatt, and supermarkets smaller than 1,200 square meters. In addition, the DNI reserves many agricultural, industrial, and services subsectors exclusively for MSMEs, effectively barring foreign investors, which cannot operate MSMEs in Indonesia. Investment restrictions deter entry of foreign firms, particularly export-oriented ones, which are crucial to link the Indonesian economy with Global Value Chains (GVCs) and increase its competitiveness.

1 These figures are based on the average net FDI inflow/GDP ratio for the period 2015-19, the latest with available data.

OBJECTIVES AND APPROACH

The World Bank Group team, with the help of UK-FCDO funded IBEP program, provided the government with a rationale to reform its FDI policy environment to encourage investment inflows. In high-level discussions with the Government, the program's team provided evidence that the full elimination of foreign equity limits across all sectors could increase FDI by US$3.8 billion per annum and domestic investment by US$3.1 billion per annum. The project also demonstrated how these restrictions translated into lower productivity and exports in both the sectors exposed to the restrictions and in the downstream sectors. Reconsidering these restrictions was particularly important to take advantage of the ongoing GVC reconfiguration with many investors looking for new production bases.

Acknowledging the importance of these reforms, the Government implemented one of the most ambitious investment liberalizations in the past decades. Anchored in the Omnibus Law on Job Creation, which amended the Investment Law (amongst 78 individual laws that were amended or abolished), the reform has opened majority of previously restricted sectors to investments. Along with its implementing regulation (issued in February 2021), the amended Investment Law has eliminated the government's legal obligation of reserving sectors to micro, small and medium enterprises (MSMEs); it has removed sectoral discrimination towards foreign investments in various sectoral laws, and it has reduced the number of business activities subject to at least one investment restriction from 813 to 260. The reform has fully opened many sectors such as fishing, horticulture, small and medium sized supermarkets, sea-ports, airports, shipping lines, mobile and fixed telecom services, power plant generation and distribution and auto repair services, to name a few. In these sectors FDI was not allowed or was only allowed with minority shareholding.

EARLY RESULTS

This liberalization of investments, particularly FDI, moves Indonesia from one of the most restrictive to one of the most open FDI regulatory regimes in South-East Asia. This could significantly raise Indonesia's attractiveness to FDI at an opportune time. According to preliminary World Bank estimates, this liberalization may generate US$3.8 billion and US$1.5 billion in additional foreign and domestic investments respectively in the liberalized sectors.

While the investment liberalization is very recent (the implementing regulation was issued in February 2021), various foreign investors have already announced plans to build export-oriented factories in Indonesia. These include investors in automotive, auto-parts, food processing and electronics, such as the Japanese conglomerate Honda which plans to produce a car model for export to more than 30 destinations by 2024, and Dutch multinational FrieslandCampina, which plans to produce milk products for export.

If realized these investments will help reverse the decades-long pattern of low export-oriented manufacturing investments to Indonesia.

ADDITIONAL RESOURCES

Omnibus Law on job creation enacted

Omnibus bill on job creation passed into law

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