Document of

The World Bank

FOR OFFICIAL USE ONLY

Report No. 3182-IND

INDONESIA

SELECTED ISSUES OF INDUSTRIAL DEVELOPMENT

AND TRADE STRATEGY

ANNEX 5

DIRECT PRIVATE FOREIGN INVESTMENT

July 15, 1980

East Asia and Pacific Regional Office

CURRENCY EQUIVALENTS

Currency: Rupiah (Rp)

US$1	=	Rp 625 (November 1978)
Rp 1	=	US cents 1.6
Rp 1,000,000	=	US$1,600

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

BAPPENAS	Government Planning Agency
BAPINDO	State-Owned Development Bank
BKPM	Badan Koordinasi Penanaman Model (Investment Coordinating Board), also ICB
BPS	Biro Pusat Statistek (Central Bureau of Statistics), also CBS
CBS	Central Bureau of Statistics
GOI	Government of Indonesia
IDFC	Indonesian Development Finance Corporation
KIK	Kredit Investasi Kecil (Small-Scale Investment Credit Program)
KMKP	Kredit Model Kerja Penanaman (Working Capital Credit Program)
NAFED	National Agency for Export Development
PDFCI	Private Development Finance Corporation of Indonesia
PLN	State Electricity Corporation
PMA	Penanaman Modal Asing (Foreign Investment Projects)
PMDN	Penanaman Modal Dalam Negeri (Domestic Investment Projects)

INDONESIA

SELECTED ISSUES OF INDUSTRIAL DEVELOPMENT AND TRADE STRATEGY

DIRECT FOREIGN INVESTMENT IN INDONESIA

ANNEX 5

Table of Contents

Page No.

TABLES IN TEXT

1. INTRODUCTION

1.01 There has been an intense debate over the appropriate role for private direct foreign investment in Indonesia with corresponding wide swings in Government policies. Under President Sukarno, the international economic system was viewed as exploitative; the nationalization of foreign firms and the rejection of foreign aid were central points in economic policy. Under President Suharto, the post-1965 "new economic order" has placed considerable emphasis on external resources. Nationalized firms were returned to the private sector, liberal laws providing guarantees and incentives for direct private foreign investment were introduced, and foreign aid was welcomed. Despite substantially improved economic performance in the following decade,/1 there has been a significant tightening of controls on the foreign investment process during the last half of the 1970s in line with a general increase in regulation and public sector intervention in the economy.

1.02 Recent developments provide the background for the World Bank's analysis of the industrial sector in Indonesia with an emphasis on evaluating the regulatory and interventionist policies of the recent past. Given its importance in the past and the potential for future capital inflows based on the size of the Indonesian market, the quality and cost of labor, and the availability of natural resources, an analysis of the direct private foreign investment process is an important element in such a review.

1.03 Given the available data in Indonesia, an analysis of the private foreign investment process is a difficult task. The basic data on the foreign investment process is limited to information on investment approvals and fragmentary information on actual implementation the reliability of which is open to serious question. Data are available from censuses of industry on both foreign and domestic firms (both public and private) which should permit a useful analysis of the relative efficiency of different types of firms. However, such research is already in its preliminary stages with World Bank support and is, in any case, beyond the scope of this study.

1.04 The social versus private profitability of foreign investment, given the widespread interference with prices through various taxes and subsidies, similarly represents an area for research which again requires a data ollection and analysis effort that is beyond the scope of this project. While more limited empirical work has been attempted to quantify the costs to the Government of various types of incentive programs or the costs of various regulations and controls to firms, the attempt proved impossible for a variety of reasons. The contribution in the empirical analysis of Chapter 3 has, therefore, been limited to using data on approvals and realizations to define trends and characteristics of the private foreign investment process. This effort has been reasonably successful since, with

---

/1 A useful evaluation of the effect of the liberalized policies towards private foreign investment is available in D.W. Carr, Foreign Investment and Development in the Southwest Pacific with Special Reference to Australia and Indonesia, Praeger, 1978.

data provided by the Investment Coordinating Board (BKPM), it has been possible to define some sharp changes in the level and nature of private foreign investment flows that tend to be obscured in the published data. It has, then, been possible to obtain considerable insight into the impact of the changing policy environment (also documented in Part II) on direct private investment inflows.

1.05 The primary objective of this report is to provide recommendations on policy towards private foreign investment. The recommendations put forward are generally consistent with recent policy advice to the Government of Indonesia in the area of foreign investment and with the general thrust of World Bank analysis suggesting high costs relative to the benefits of the increase in regulation and intervention in many economic processes. However, it was felt important to provide a strong foundation for these recommendations. Past work has sought such foundations in comparisons with policies in the countries which have been most successful in attracting foreign investment. This, however, presumes that the objective of increasing foreign investment is well established and that what is required is guidelines for achieving this goal. In Indonesia, this prescription is not widely accepted and priority must be placed on identifying and analyzing the arguments and conditions that have provided the rationale for the decisions underlying the post-1974 spread of restrictions and controls on the foreign investment process.

1.06 The policy recommendations of Chapter 4 suggest high costs and little or even negative benefits to intervention with either domestic or foreign investment decisions when the domestic price system is not badly distorted./1 While there has been a tendency to attempt to devise interventionist policies designed to account for price distortions typically resulting from other Government policies, this approach has not worked well for both theoretical and practical reasons. The policy recommendations are, therefore, aimed at restoring conditions under which private profitability is a close approximation of the net benefits to the economy, and which then allow for greater scope for market mechanisms and incentives to guide the economy. Within this context, many specific recommendations are put forward for the appropriate role for the Investment Coordinating Board (BKPM), investment policy, labor policies, equity sharing policies, policy support for weaker economic groups, incentive systems, and financial policies in the areas in which these policies, programs, or institutions affect the direct private foreign investment process.

/1 A separate document to this annex, which lays the theoretical foundations for the policy recommendation made in Chapter 4 is available on request.

2. POLICIES TOWARDS PRIVATE FOREIGN INVESTMENT SINCE 1967

2.01 The policy framework for private foreign investment under the "new economic order" policies can be usefully classified into an "open door policy," from 1967 through the early 1970s, followed by a much more restrictive set of policies from 1974 onwards. The present state is in flux with considerable pressure for both a further tightening of controls, counterbalanced by concern that Indonesia is becoming less attractive for the type of foreign investment in activities that are competitive in world markets (for both importables and exportables) and that yields the greatest benefit to the Indonesian economy. In this chapter, we will briefly review the main elements in foreign investment policy. The specifics of the different policies and procedures are discussed along with the recommendations in Chapter 4.

The "New Economic Order" and the Open Door Policy

2.02 Investment in Indonesia is regulated by two Laws, the Law on Domestic Investment /1 and the Law of Foreign Investment./2 A domestic investment (PMDN) must have 100% domestic equity capital, but may make use of foreign technical assistance and loan capital. Investments with less than 100% domestic equity are, by definition, foreign investments (PMA)./3 The limited liability company (PT) is the usual form of company organization requiring an Act of Incorporation approved by the Ministry of Justice. The formation of the PT is subject to some restrictions,/4 but primary control is required for approval of an investment application by the BKPM (Investment Coordination Board) or via the BRO (Bedrijfs Replementeering Ordonaties, 1934) process; the latter generally requires approval from the Ministry responsible for the sector where the investment takes place.

2.03 Domestic investments have the option of using the BKPM or the BRO procedures. As discussed in detail in Annex 3, the domestic investor must use the BKPM option if the firm wishes to make use of the incentives, or facilities, administered by the BKPM. The disadvantage of this procedure is in possible time delays and in being subjected to the various controls on

---

/1 Law No. 6 of 1960 and Law No. 12 of 1970.

/2 Law No. 1 of 1967 and Law No. 11 of 1970.

/3 This is in contrast to the usual convention in many other countries where foreign equity must reach a certain level before the investment is classified as foreign.

/4 The formation of a P.T. is also subject to some general restrictions, the main one being that 20% of authorized capital has been issued and 10% of issued capital has been paid up.

initial investments and future expansions that are also administered by BKPM. Data on domestic investment approvals is available for BKPM sector, but there is no comprehensive data on firms entering via the BRO route.

2.04 Prior to 1973, it was technically possible for foreign investors to forego BKPM procedures and still be incorporated with the approval of the Ministry of Justice as advised by the relevant economic sector Ministry. But after 1973, by a Presidential decree (of 1973), the BKPM became the only agency with the authority to process direct foreign investment in all areas except oil, banks, and insurance./1 The BKPM receives recommendations with respect to foreign investment applications from the relevant Ministries, from its own regional offices and from regional Governments before formulating its recommendations for final approval by the President. In 1977, the position of the BKPM was further strengthened by making it a 'one stop' service with powers previously held by Ministries being transferred to BKPM. However, since officials of the BKPM are still attached to the various Ministries, the change was not as substantive as perhaps intended. BKPM officials still refer back to, and defer to, the relevant ministries in carrying out their functions. The BKPM, however, does issue a list of permits that were previously issued by other agencies /2 and this is generally argued to have speeded up the processing of investment applications. This is, however, controversial with some foreign investors who argue that they were better off when they could deal directly with the Ministries or Departments.

2.05 The incentives administered by the BKPM to foreign (and domestic) investments are all in the nature of reduction or elimination of various taxes. The basic tax incentive is a two-year corporate tax exemption starting from the time an enterprise begins production. This tax holiday can be extended for one year if the investment saves or earns a significant amount of foreign exchange, for another year if the firm locates outside Java, for yet another year if the project is in an area given special priority, and for a final year if the project is very large, risky, or serves to improve the economic infrastructure in some way. A special investment allowance is

---

/1 Investments in these sectors fall under different sets of regulations that will not be considered in this annex.

/2 These licenses and permits include; (a) investment permits; (b) tax facilities from the Department of Finance; (c) Import tariff reductions or exemptions from the Department of Finance; (d) Incorporation documentation from the Department of Justice; (e) Import-export trade permits from the Department of Justice; (f) Immigration permits from the Department of Justice; (g) Foreign work permits from the Department of Manpower; (h) Investment location permits from the Department of Home Affairs; (i) Land use permits from the Department of Home Affairs; (j) Construction permits from the Department of Home Affairs; and (k) Environmental Ordinance permits from the Department of Home Affairs (see Annex 3 for the details).

permitted with 5% of the amount of investment deductible from before profits taxes for a maximum of four years. This incentive also dates from the start of production and is, therefore, an alternative to the more favorable tax holiday. A carry over of losses for four successive years is possible, and losses incurred during the first six years of operation can be carried over indefinitely. There is a provision for accelerated depreciation with a firm able to adjust depreciation allowances within four years of a capital expenditure to reduce tax liabilities; this is done by increasing depreciation allowances above normal by 10% for buildings and by 15% for infrastructure or equipment. These allowances may be delayed until after the tax holiday period for firms with tax exemptions. Import duty reductions or exemptions can be granted for capital equipment and, for up to five years, for raw material inputs. The 1/10 of 1% stamp duty on shares issued in return for foreign capital can be waived, and a two-year dividend tax holiday can be granted to shareholders, provided the dividend is then exempt from income tax in the country of the recipient.

2.06 Although not directly controlled by the BKPM, the adjustment of trade restrictions has been a major incentive used to promote specific activities. The Government has frequently lowered import duties on raw materials to encourage investment or to provide greater incentives to existing industry. Thus, in 1971, the duty on component parts for radios and TV's were reduced to provide an incentive for local assembly. In 1974, the duties on sulphur used in fertilizer manufacture, on polyisoprene used in the tire and rubber industries, and on emulgators and propellants used in the agrochemical industry were all reduced for similar reasons. Increased import duties on competing final products have been used to even a greater extent. Recent examples include duties imposed on copper wire and electric cable, tires and tubes, sheet glass, iron or steel rods, and printing ink. Similar effects have been achieved by requiring advanced payments, inclusive of import duties, /1 for certain products such as, imports of synthetic yarn, gunny sacks and some types of textile and steel products (in 1976). The Government has also been ready to completely ban the import of competing products if convinced that capacity in a particular sector with more than one firm is sufficient to meet the local demand. Such bans have been imposed on some types of bulbs, some sizes of tires, completely assembled cars, motorcycles, radios, and televisions, dry batteries, tape recorders, and weaving yarn./2

2.07 In addition to tax incentives and protection, foreign investors are given guarantees that profits, depreciation funds, and compensation in the event of nationalization can be repatriated in the currency of the original investment. The foreign investment law also states that there is

---

/1 These are more restrictive than standard requirements for prepayment of part of the import cost prior to the issuing of letters of credit.

/2 The use of trade restrictions as an incentive to investment has been analyzed by D.W. Carr (Foreign Investment and Development in the Southwest Pacific; With Special Reference to Australia and Indonesia, Praege 1978) with a follow-up analysis of the effects on production.

no intention to nationalize any enterprise, revoke its ownership rights, or reduce investors' control of management except in special cases affecting the national interest. Nationalization of a firm would require an Act of the Legislature and the level of compensation, if not agreed to by the owners, would go to arbitration. Indonesia has entered international agreements to protect the rights of foreign investors from double taxation with source countries to provide guarantees against loss due to nationalization, war, revolution, and sometimes foreign exchange restrictions. Indonesia also adheres to the Convention for the Settlement of International Investment Disputes.

Increased Control and Restrictions

2.08 The view that private foreign investment could play a leading role in the development process underlying the highly favorable incentives and guarantees to foreign investors just outlined, was dominant for only a relatively brief period after 1967. A series of policy decisions in the mid-1970s significantly qualified the "open door" policy. The most important of these were requirements for greater and more rapid increases in local participation in ownership; greater controls on investment including the closing of significant areas to private foreign investment; prohibitions on foreign firms engaging in any distribution activities (even for their own products); requirements for more rapid promotion of Indonesians into high skilled and managerial positions; and renegotiation of terms affecting foreign investment in the natural resource-based industries.

2.09 The requirements on local ownership were set out in a series of policy statements over the 1974-75 period indicating that all foreign firms should be majority owned by Indonesians within ten years. These statements were subsequently qualified by restricting their applicability to sectors other than oil, mining, banking or insurance (these areas are covered by other regulations and are not considered in this annex). Even within the areas covered, however, there is considerable ambiguity about the 51% local ownership policy. First, this policy, at present consists of statements by leading political leaders, guidelines issued by the BKPM, and Presidential Decrees which may be interpreted as statements of policy intent rather than as legally binding legislation. Second, there is considerable ambiguity about the coverage, timing, and penalties for violation of these guidelines.

2.10 Firms established prior to 1967, many of which were wholly owned subsidiaries of foreign firms that were nationalized and subsequently returned, have never been under any specific legal requirements for local ownership. Most of the firms established after 1967 went through an investment application process administered by the BKPM which often required negotiations and commitments on the initial Indonesian equity share and on a time schedule for subsequent transfers./1 Since 1974, investment applications

---

/1 Article 27 of the Foreign Investment Law No. 1 of 1967 states: "Enterprises ... of which the capital is entirely foreign are required to give opportunity for national capital to participate, following a specified period and in proportions to be specified by the Government."

to the BKPM have, in general, been subject to the requirement that the initial Indonesian share be at least 20% and that this share be increased to 51% in, at most, 10 years from the start of operations. While there have been exceptions, present policy at the BKPM has apparently strengthened the 20% initial Indonesian share requirement, although uncertainty remains as to whether high priority firms may be given exemptions./1 The legal implications of being in violation of these decrees are not clear.

2.11 Given these ambiguities, only actual practice (or new legislation) can clarify the scope of the ownership policies. To date, practice indicates that there is a strong Government commitment to the 51% ownership principle, but that the approach to this goal is being instituted in a flexible way aimed at encouraging or negotiating rather than forcing compliance. It appears that the ten-year compliance period will not be applied to firms that obtained their investment permits before February 1974./2 For these firms, which represent the vast majority of foreign firms operating in Indonesia (see Chapter 3), the Government appears to be relying heavily on incentives or on controls on investments for expansion as a lever for negotiating the increase in local participation. Another apparent aspect of the policy is to seek wide distribution of the increased Indonesian shares rather than transfer to a few Indonesians or local firms. Thus, very attractive incentives, in terms of reduced taxation through lower rates and special tax credits in the form of special depreciation allowances on revalued assets, are being offered to firms going public on the recently revitalized Jakarta stock exchange. These incentives are sufficiently attractive that many firms, in addition to the four that have already gone public, are reported to be planning to make public offerings./3

/1 Past exceptions to these requirements have excluded some significant projects. The large aluminum smelter project of 1975 had a proposed Indonesian share of 10% with a commitment to raise this to 25% in 10 years; a 1975 project to produce surgical products, medicines and cosmetics had a proposed Indonesian share of 10% with a commitment to raise this to 51% in 10 years; a 1975 tobacco project had a proposed Indonesia share of 10% with a commitment to increase this to 51% in 10 years. A BKPM circular of February 1975 indicated that the equity sharing requirements might be relaxed for projects with special characteristics concerning their invested capital, technology, location, and labor intensity. The treatment of labor-intensive export-oriented manufacturing, in particular, is still open to debate within the Government.

/2 This is stated explicitly in a BKPM circular of February 1975; however, it appears that, in some cases, compliance has been requested by firms established prior to 1974.

/3 See Annex 4 for a discussion of the Jakarta Stock Exchange.

2.12 A second broad area of increased restrictions on the foreign investment process results from increased controls on investment. Certain fields of investment have been closed for foreign investment from the start of the "open door" policy; the basic Law on Foreign Investment No. 1 of 1967 prohibited any foreign investment in industries vital to national defense (i.e. munition manufacturers) or in public utilities (i.e., harbors, electric power, telecommunications). Subsequent decrees prohibited new investment or continued operation of foreign firms in particular activities. An early example was the cessation of all forestry concessions to foreign firms in 1974. Another very important case occurred in the area of distribution. After December 31, 1977, no foreign firms (i.e., PMA firms with any foreign equity whatsoever) can carry out marketing or distribution activities. This meant that not only were new investments in these areas not permitted, but that existing firms had to sell their interests in such activities. Restrictions were also imposed on at least some aspects of activities on some 40 light industries (i.e. small tire manufacturers, paint, cigarettes, soft drinks and beverages, automotive assembly and distribution, real estate, certain types of construction activities, certain types of textile manufacturers, pharmaceutical plants in West Java, shrimp fishing, mining of bauxite, nickel and tin). Such restrictions became so pervasive that a systematic procedure for controlling and restricting foreign investment was introduced in February 1978 with the first publication of the Investment Priority List (DSP).

2.13 The Investment Priority List (DSP) document of February 1978 was revised one year later, but a new DSP was issued only recently in February 1980. It is now planned to revise the DSP every six months. The broad objective of this system is to control foreign and domestic investments to ensure that the objectives established in Repelita III are attained./1 The crucial factor in deciding whether incentives or restrictions were to be imposed on foreign rather than domestic investments appears to have been the extent to which domestic capability for investment in the sector exists. In general, the 1980 DSP has contributed to the trend towards increased detailed intervention in the economy evident since 1974. The willingness to restrict foreign investment and close off areas to new investment or expansion so as to favor domestic and particularly firms owned by those in the weaker economic group - a major element in the closing of "the open door" to foreign investment appears to have increased with the 1980 DSP.

2.14 The trend towards greater restriction in the private foreign investment process is also observed in restrictions on the use of foreign skilled labor and management. A January 1974 guideline classified employment in a number of sectors (mining, oil, gas and textiles) into four categories: (a) jobs that are closed to foreigners; (b) jobs that foreigners may hold

---

/1 Annex 3 discusses the DSP system in much greater detail.

until qualified Indonesians are available; (c) jobs for which Indonesians must be trained by a specified date; and (d) all other jobs that will remain open to foreigners. Schedules for phasing out the use of foreigners in jobs affected by these guidelines were introduced in April 1974 for the forestry sector - the sector with the greatest employment of foreigners - and in January 1975, for the oil and gas sectors. A fine of US$100 per month per foreign employee is to be levied against firms in violation of these decrees. It is widely felt that such restrictions will also be extended to other sectors of the economy.

Government Negotiations in the Resource-Based Industries

2.15 The trend towards increased restrictions and less favorable treatment of foreign investment is also evident in Government negotiations on prices, royalties, share contracts, and taxes for communally held resources used in natural resource-based industries. Indonesia incurred substantial losses from the underpricing of oil /1 prior to 1972 and has gained substantially from oil price increases and the renegotiation of the terms on foreign investment in the petroleum sector./2 There have also been less

---

/1 An argument can be made that this underpricing was more a result of under-costing oil reserves rather than foregone monopoly rents.

/2 At first, Indonesia used concession agreements in which the Government received 10-20% of the Gulf price as a royalty. Contracts of work were introduced in which foreign oil companies received 40% of net income (renegotiated in 1975 to increase the Government share) and also supplied crude at recovery cost plus a fixed fee per barrel of oil. Some of these 20-year contracts (entered into in 1963-67) are still in effect. These were followed by production sharing contracts in 1967-76 in which: (a) discovered oil goes to the company until the investment is recovered (with a maximum annual share of 40%) and with the remaining oil shared with the Government share starting at 65-70% (raised to 85% in 1975) with further increases after specified production levels are reached; and (b) crude is supplied at concessionary prices to the domestic market at a rate not to exceed 25% of the contractor's share of crude. Present arrangements operate on work sharing contracts which have again increased the Government share.

successful attempts to increase domestic returns in other natural resource-based industries - an attempt that has taken the form of replacing "first generation" contracts with more restrictive "second" and "third" generation contracts./1 The terms for foreign investment in the forestry sector have also become less favorable to foreign investors over time./2 The trend in these sectors has been interpreted as a prelude to greater restrictions in other sectors.

/1 The "first generation" contract was used only once for a firm mining copper in Irian Jaya. The foreign firm received a three year tax holiday, a concessionary tax rate of 35% for the subsequent seven years, and an exemption from all other taxes or royalties save for a 5% tax on sales. After the incentive period, the corporate income tax increased to 41.75% of profits or 10% of net sales, whichever was greater. Subsequent renegotiation reduced incentives and changed the project to a joint venture. The "second generation" work contracts stipulated that the ore belonged to the Government until it is extracted with profits of the foreign firm shared with the Government via the corporate income tax. This led to difficulties due to the arbitrary imposition of additional taxes. A "third generation" of contracts were introduced in 1976 with some added incentives for foreign investors and some added assurances with respects to limits on taxation, but otherwise quite similar to the second generation contracts. The timing for various phases on the project are narrowly specified, the company is obligated to pay land tax, royalties, sales taxes or import duties in addition to corporate income taxes (although some of these can be waived or reduced as part of incentive packages). An attempt is made to prevent transfer pricing, encourage local purchases or sales, and increase Indonesian participation (although most investments are joint ventures with state enterprises). Firms must also surrender all foreign exchange. This has no appreciable effect under present liberal foreign exchange policies but is a disintive because of a perceived uncertainty about future policies.

/2 Prior to 1975, foreign companies could directly hold timber concessions. With the equity sharing decrees of the mid 1970s, however, new timber developments were technically closed to foreign firms and existing firms were expected to reach 51% local ownership by 1985. These restrictions have, however, been widely evaded (see Part III below).

2.16 The policy developments with respect to (a) domestic participation in equity ownership and investment controls that have closed off significant sectors for new investment or expansion of foreign firms and that have heavily favored domestic and particularly firms in the weaker economic group; (b) requirements for phasing out use of foreign national in many high level positions; and (c) increasingly less favorable terms being offered and renegotiated with foreign firms in the natural resource-based industries reflect a significant shift away from the early "open door" policy; it is, however, too soon to clearly define the extent of this shift. The Indonesian Government has recently been more active in promotional efforts to attract foreign investment. New leadership has been installed at the BKPM in a move widely interpreted as aimed at increasing the flow of investment. Moreover, new incentives were introduced in March 1979 involving tax breaks for reinvesting retained earnings as was the permission to use inventory evaluation procedures that can reduce taxes, and the right to revalue assets due to higher replacement costs with inflation (and devaluation). Policies aimed at restricting use of foreign management and skilled labor and for meeting the equity sharing goals have been moderate and flexible by comparison to many other countries. The debate on the proper role of direct private foreign investment, therefore, still appears to be open.

3. PRIVATE FOREIGN INVESTMENT IN INDONESIA: POST-1967 DEVELOPMENTS

3.01 In this chapter, an attempt is made to identify the characteristics of private foreign investment flows into Indonesia and to evaluate its importance to the development effort. The major source of information is an extensive summary of investment approvals provided by BKPM for the 1967-79 period. This has been supplemented by data from the census of industry, from source countries, and from the Bank of Indonesia which monitors trade and financial transactions connected to direct foreign investment.

3.02 Some rough orders of magnitude of the importance of foreign (PMA) firms can be obtained from Tables 1, 2, and 3 which provide information from the 1975 industrial census (1974 data) on output, value added, and employment by foreign, government, and domestic private firms by sector. Foreign firms and public sector firms both account for about one fifth of manufacturing output compared to the three-fifths share of domestic firms. Measured in output per firm, foreign firms are on average more than twice as large as public sector firms and more than seven times as large as domestic firms. Foreign and public sector firms each contribute 23% of value added, but value added per worker in foreign firms is almost twice as high as in public sector firms and almost three times as high as in domestic firms. Employment in foreign firms accounts for about one tenth of total manufacturing employment, one half that of public sector firms and one seventh that of domestic firms.

3.03 The basic data on realized or implemented investment by PMA firms are given in Table 4 by sector for the 1967-79 period. This covers all investment except for the petroleum, banking, and insurance sectors. Almost two thirds of realized investment took place in manufacturing, with most of the rest occurring in mining and quarrying (11%) and forestry (9%). Within manufacturing, the largest share of investment occurred in textiles (23%) with most of the rest in the metal products (11.5%), chemical and rubber products (9.8%), and ferrous metals (7.8%). There is a pronounced growth in realized investment up to a 1974 peak with a declining trend thereafter, and an especially sharp decline in 1977. The post-1974 decline in realized investment is much more pronounced in real terms, as can be seen in Table 5 where realized investment is deflated by two price series indicating the inflation of dollar prices for investment goods. These figures show that while the nominal value of realized investment actually increased in the 1975-79 period, compared to the 1970-74 period, by 3%, the real value declined by 26% to 36% (depending on the choice of deflator). Despite the lack of reliability of data on investment implementation, this gives some evidence of a substantial decline in investment inflows after the policy environment became less favorable towards private foreign investment in 1974./1

/1 The world recession during this period may also have partly contributed to this decline.

Table 1: SECTORAL OUTPUT BY OWNERSHIP, 1974
(Rp billion)

	Sector	Total			Foreign			Government			Private domestic		
		N	Output	%	N	Output	%	N	Output	%	N	Output	%
311/312	Food manufacturing	1,448	298.478	100	50	41.917	14.0	180	120.686	40.4	1,218	126,875	42.5
313	Beverages	59	20.735	100	4	11.748	56.7	3	0.553	2.6	52	8.434	40.7
314	Tobacco	747	233.874	100	46	54.954	23.5	37	3.080	1.3	664	175.840	75.2
321	Textiles	1,880	209.160	100	25	39.242	18.8	49	41.268	19.7	1,806	128.650	61.5
322	Wearing apparel	60	1.333	100	2	0.140	10.5	1	0.003	0.2	57	1.190	89.3
323	Leather substitutes	24	2.966	100	2	0.025	0.8	1	0.168	5.7	21	2.773	93.5
324	Leather footwear	29	7.025	100	1	3.663	52.1	-	-	-	28	3.362	47.9
331	Wood & wood products	302	25.641	100	14	3.439	13.4	20	2.270	8.9	268	19.932	77.7
332	Furnitures (nonmetallic)	86	2.441	100	3	0.028	1.1	4	0.237	9.7	79	2.176	89.2
341	Paper & paper products	58	17.641	100	5	5.148	29.2	6	9.149	51.9	47	3.344	18.9
342	Printing & publishing	222	11.642	100	2	0.171	1.5	25	2.598	22.3	195	8.873	76.2
351	Basic chemicals	67	94.258	100	6	3.192	3.4	14	16.621	17.6	47	74.445	79.0
352	Other chemical products	218	47.332	100	27	20.300	42.9	15	2.887	6.1	176	24.145	51.0
355	Rubber	453	142.082	100	36	28.820	20.3	115	23.424	16.5	302	89.838	63.2
356	Plastic wares	129	10.933	100	7	0.990	9.1	-	-	-	122	9.943	90.9
361	Pottery, china & ware	19	0.479	100	-	-	-	1	0.018	3.8	18	0.461	96.2
362	Glass & glass products	51	9.898	100	4	6.032	60.9	2	1.712	17.3	45	2.154	21.8
363	Cement	206	23.352	100	1	1.321	5.7	17	17.571	75.2	188	4.460	19.1
364	Structural clay products	147	1.622	100	-	-	-	8	0.176	10.9	139	1.446	89.1
369	Other nonmetallic mineral products	12	0.449	100	-	-	-	1	0.158	35.2	11	0.291	64.8
371	Iron & steel	6	3.790	100	-	-	-	-	-	-	6	3.790	100.0
372	Nonferrous metal	9	14.165	100	5	11.511	81.3	-	-	-	4	2.654	18.7
381	Fabricated metal products	232	36.629	100	18	10.289	28.1	12	2.227	6.1	202	24.113	65.8
382	Machinery	66	14.386	100	5	2.512	17.5	11	7.478	52.0	50	4.396	30.5
383	Electrical machinery	60	38.162	100	9	21.366	56.0	3	0.219	0.6	48	16.577	43.4
384	Transport equipment	103	78.000	100	6	15.421	19.8	18	8.974	11.5	79	53.605	68.7
385	Measuring & optical equipment	13	0.387	100	-	-	-	-	-	-	13	0.387	100.0
390	Other manufacturing	52	3.268	100	4	1.474	45.1	4	0.507	15.5	44	1.287	39.4
	Total	6,758	1,341.1	100	282	283.7	21.2	547	261.99	19.5	5,929	795.46	59.3

Table 2: SECTORAL VALUE ADDED BY OWNERSHIP, 1974/75
(Rp billion)

	Sector	Total			Foreign			Government			Private domestic		
		N	VA	%	N	VA	%	N	VA	%	N	VA	%
311/312	Food manufacturing	1,448	115.728	100	50	13.164	11.4	180	67.307	58.1	1,218	35.257	30.5
313	Beverages	59	14.438	100	4	8.424	58.3	3	0.142	1.0	52	5.872	40.7
314	Tobacco	747	105.132	100	46	39.540	37.6	37	1.181	1.1	664	64.411	61.3
321	Textiles	1,880	68.815	100	25	16.705	24.3	49	9.968	14.5	1,806	42.142	61.2
322	Wearing apparel	60	0.460	100	2	0.035	7.6	1	0.001	0.2	57	0.424	92.2
323	Leather substitutes	24	0.644	100	2	0.008	1.2	1	0.021	3.3	21	0.615	95.5
324	Leather footwear	29	2.966	100	1	1.577	53.2	-	-	-	28	1.389	46.8
331	Wood & wood products	302	10.780	100	14	1.425	13.2	20	0.652	6.0	268	8.703	80.8
332	Furnitures (nonmetallic)	86	1.162	100	3	0.019	1.6	4	0.099	8.5	79	1.044	89.9
341	Paper & paper products	58	5.086	100	5	1.441	28.3	6	2.704	53.2	47	0.941	18.5
342	Printing & publishing	222	6.343	100	2	0.043	0.7	25	1.779	28.0	195	4.521	71.3
351	Basic chemicals	67	83.444	100	6	1.297	1.6	14	8.923	10.7	47	73.224	87.7
352	Other chemical products	218	16.969	100	27	6.813	40.1	15	1.511	8.9	176	8.645	50.9
355	Rubber	453	38.152	100	36	8.150	21.4	115	10.120	26.5	302	19.882	52.1
356	Plastic wares	129	3.057	100	7	0.327	10.7	-	-	-	122	2.730	89.3
361	Pottery, china & ware	19	0.245	100	-	-	-	1	0.006	2.4	18	0.239	97.6
362	Glass & glass products	51	4.990	100	4	3.520	70.5	2	0.484	9.7	45	0.986	19.8
363	Cement	206	12.071	100	1	0.897	7.4	17	9.461	78.4	188	1.713	14.2
364	Structural clay products	147	1.079	100	-	-	-	8	0.124	11.5	139	0.955	88.5
369	Other nonmetallic mineral products	12	0.295	100	-	-	-	1	0.098	33.2	11	0.197	66.8
371	Iron & steel	6	0.699	100	-	-	-	-	-	-	6	0.699	100.0
372	Nonferrous metal	9	3.169	100	5	2.551	80.5	-	-	-	4	0.618	19.5
381	Fabricated metal products	232	11.996	100	18	2.885	24.0	12	0.741	6.2	202	8.370	69.8
382	Machinery	66	8.383	100	5	1.204	14.4	11	5.234	62.4	50	1.945	23.2
383	Electrical machinery	60	15.722	100	9	9.235	58.7	3	0.113	0.7	48	6.374	40.6
384	Transport equipment	103	21.894	100	6	7.519	34.3	18	5.618	25.7	79	8.757	40.0
385	Measuring & optical equipment	13	0.153	100	-	-	-	-	-	-	13	0.153	100.0
390	Other manufacturing	52	1.477	100	4	0.841	56.9	4	0.194	13.2	44	0.442	29.9
	Total	6,758	555.350	100	282	127.620	23.0	547	126.480	22.8	5,929	301.240	54.2

Table 3: SECTORAL EMPLOYMENT BY OWNERSHIP, 1974

	Sector	Total			Foreign			Government			Private domestic		
		N	No. of workers	%	N	No. of workers	%	N	No. of workers	%	N	No. of workers	%
311/312	Food manufacturing	1,448	141,912	100	50	6,811	4.8	180	62,663	44.2	1,218	72,438	51.0
313	Beverages	59	4,763	100	4	1,692	35.5	3	170	3.6	52	2,901	60.9
314	Tobacco	747	147,454	100	46	15,371	10.4	37	10,671	7.2	664	121,412	82.4
321	Textiles	1,880	163,863	100	25	15,448	9.4	49	21,598	13.2	1,806	126,817	77.4
322	Wearing apparel	60	2,388	100	2	54	2.3	1	23	1.0	57	2,311	96.7
323	Leather substitutes	24	1,434	100	2	48	3.3	1	137	9.6	21	1,249	87.1
324	Leather footwear	29	4,397	100	1	1,580	35.9	-	-	-	28	2,817	64.1
331	Wood & wood products	302	19,963	100	14	2,887	14.5	20	1,328	6.7	268	15,748	78.8
332	Furnitures (nonmetallic)	86	3,563	100	3	120	3.4	4	223	6.3	79	3,220	90.3
341	Paper & paper products	58	7,018	100	5	854	12.2	6	3,391	48.3	47	2,773	39.5
342	Printing & publishing	222	14,461	100	2	96	0.7	25	2,845	19.7	195	11,520	79.6
351	Basic chemicals	67	7,777	100	6	499	6.4	14	4,558	58.6	47	2,720	35.0
352	Other chemical products	218	23,802	100	27	3,724	15.6	15	2,133	9.0	176	17,945	75.4
355	Rubber	453	45,119	100	36	6,061	13.4	115	10,106	22.4	302	28,952	64.2
356	Plastic wares	129	9,389	100	7	816	8.7	-	-	-	122	8,573	91.3
361	Pottery, china & ware	19	749	100	-	-	-	1	80	10.7	18	669	89.3
362	Glass & glass products	51	6,079	100	4	1,261	20.7	2	711	11.7	45	4,107	67.6
363	Cement	206	11,653	100	1	903	7.7	17	3,769	32.3	188	6,981	60.0
364	Structural clay products	147	5,671	100	-	-	-	8	505	8.9	139	5,166	91.1
369	Other nonmetallic mineral products	12	867	100	-	-	-	1	427	49.3	11	440	50.7
371	Iron & steel	6	554	100	-	-	-	-	-	-	6	554	100.0
372	Nonferrous metal	9	1,138	100	5	754	66.3	-	-	-	4	384	33.7
381	Fabricated metal products	232	20,313	100	18	3,192	15.7	12	1,412	7.0	202	15,709	77.3
382	Machinery	66	7,262	100	5	1,194	16.4	11	2,533	34.9	50	3,535	48.7
383	Electrical machinery	60	11,889	100	9	4,864	40.9	3	468	3.9	48	6,557	55.2
384	Transport equipment	103	14,446	100	6	1,881	13.0	18	4,635	32.1	79	7,930	54.9
385	Measuring & optical equipment	13	543	100	-	-	-	-	-	-	13	543	100.0
390	Other manufacturing	52	4,803	100	4	1,003	20.9	4	766	15.9	44	3,034	63.2
	Total	6,758	683,270	100	282	71,113	10.4	547	135,152	19.8	5,929	477,005	69.8

Table 4: FOREIGN INVESTMENT IMPLEMENTATION /a BY SECTOR, 1967-79
EXCLUDING INVESTMENT IN PETROLEUM AND BANKING
(In millions of US$)

Sector	1967-69	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979/b	Total realized investment	Total no. of products	%
Agriculture	9.3	1.8	2.1	3.4	7.9	4.5	3.2	8.0	12.5	10.1	2	64.8	58	1.8
Forestry	15.0	33.0	32.8	31.2	40.9	50.3	34.4	22.7	22.1	15.0	2	299.4	78	8.7
Fishery	3.1	4.7	8.4	3.4	6.5	21.9	11.3	8.5	2.8	13.5	1	85.1	83	2.5
Mining and quarrying	11.7	42.1	61.0	50.7	6.6	44.3	40.4	42.4	20.1	57.3	9	385.6	11	11.2
Manufacturing	34.6	48.4	103.7	171.1	306.7	368.5	392.4	301.2	186.2	267.0	37	2,216.8	466	64.4
Food	9.1	13.8	16.4	15.9	34.8	21.7	13.9	10.8	11.9	14.9	1	164.2	53	4.7
Textiles and leather	2.6	11.3	44.3	77.9	149.5	157.7	181.8	91.8	27.9	31.4	14	790.2	70	22.9
Wood and wood products	-	-	3.1	0.3	0.3	1.8	10.6	4.6	1.4	0.4	-	22.5	12	0.6
Paper and paper products	0.3	0.2	0.3	6.5	5.1	1.5	0.7	3.3	9.6	11.8	1	40.3	14	1.1
Chemical and rubber	8.0	11.4	17.9	21.2	37.1	50.8	45.9	45.7	28.0	71.7	3	340.6	131	9.8
Ferrous metals	1.0	0.7	2.5	4.9	29.3	44.2	54.2	71.3	42.9	9.0	9	271.7	29	7.8
Nonmetallic minerals	}	}	}	}	11.0	17.7	43.3	30.7	27.8	37.8	-	177.4	23	5.1
Metal products	} 13.6	} 11.0	} 19.2	} 44.5	37.7	72.2	41.1	42.4	35.4	89.9	9	397.7	127	11.5
Other	}	}	}	}	1.9	0.9	0.9	0.6	1.3	0.1	-	12.2	7	0.3
Construction	1.3	0.2	0.4	2.1	1.5	16.6	7.9	4.5	3.0	1.4	-	38.9	63	1.1
Trade and hotels	1.3	4.0	6.7	4.5	17.9	19.6	8.2	17.6	6.2	17.2	3	106.2	14	3.0
Wholesale trade					8.4	-	0.1	0.2	-	0.7	-	10.8	3	0.3
Hotels					9.5	19.6	8.1	17.4	6.2	16.5	3	95.4	11	2.7
Transport and communication	4.3	1.6	0.9	0.9	0.9	1.1	2.2	4.4	2.0	4.7	14	37.0	20	1.1
Transport					0.6	0.7	1.2	4.2	1.8	1.3	-	12.8	19	0.3
Communication					0.3	0.4	1.0	0.2	0.2	3.4	14	24.2	1	0.7
Real estate and business services	2.4	2.4	2.3	3.6	4.9	24.9	23.7	12.3	3.8	14.0	3	108.3	51	6.1
Other	-	-	-	-	-	82.2	23.4	3.9	0.1	5.0	-	117.6		
Total	83.0	138.0	218.0	271.0	394.0	634.0	547.0	425.0	259.9	405.0	71	3,441.0	784	100.0

/a Implementation is the recorded disbursement on projects approved based upon cash inflows, customs data on imported capital equipment, and the conversion of foreign claims under the DICS scheme.
/b Data cover first three months of 1979 only.

Source: Bank of Indonesia.

Table 5: NOMINAL AND CONSTANT PRICE (1970) SERIES FOR FOREIGN INVESTMENT IMPLEMENTATION (1967-79)
(In millions of US$)

Year	Nominal prices	Constant prices (A) /b	Constant prices (B) /c
1970	138	138	138
1972	218	205	193
1972	271	240	213
1973	394	306	266
1974	634	443	384
1975	547	344	272
1976	425	260	197
1977	259	145	110
1978	405	197	150
1979 /a	71	32	24
1970-74	1,655	1,332	1,194
1975-79 /a	1,707	978	753

/a Data cover first three months of 1979 only.

/b Deflated by the Price Index of Machinery and Equipment published in UN Monthly Bulletin of Statistics, May 1980.

/c Deflated by the Unit Value Index for Machinery Exports from Developed to Developing Countries published in the UN Monthly Bulletin of Statistics, August 1979. Series (A) has been used for 1970 and 1979; series (B) was only available through 1977.

3.04 The data on foreign investment approvals are set out in Tables 6 to 10. Table 6 gives the official BKPM data by sector for the 1967-79 period. Total approved investment amounted to US$7.7 billion over the 1967-79 period. Thus, as of the first quarter of 1979, realized investment was only about 44% of approved investment. This appears to reflect difficulties in monitoring

investment flows,/1 long delays in implementing projects, insufficient adjustment to the official date for projects that have been shelved, and applications designed to provide leeway for future expansions. Comparison of the distribution of realized investment with approved investment shows that the implementation of planned investments in mining and quarrying and in basic metals appears to be especially low whereas implementation of approvals in textiles and metal products is especially high./2

3.05 The development of approved investment over time with its breakdown between foreign equity and debt capital is defined in Table 7. These data are not published in Indonesia but have been compiled from the summaries of 1967-79 investment approvals provided by the BKPM. The aggregate figure of US$7.3 billion is less than the official US$7.7 billion figure given above. This is probably due to the exclusion of projects that have been cancelled, but which still appear in the officially published data. The data refer to investment approvals for firms classified by years of initial approval. Thus, for example, investment approved in 1977 by a firm initially approved in 1973 is included in the 1973 data. Data on approvals by year of actual approval will be presented below.

3.06 The policy environment has the greatest impact on entry by new firms since many previously established firms become locked in either by sunken capital investments or because they can avoid changes in regulation through "grandfather clause" exemptions or well-established connections. Data for approvals by date of first application of the firm can be very useful in defining the impact of a changing policy environment. Table 7 indicates that the post-1967 experience can usefully be divided into three periods corresponding to the policy changes identified in Chapter 2 with 1967-69 a period of liberalization with the introduction of the "new economic order", 1970-74 a period of "open door" policies towards private foreign investment, and 1975-79 a period of increased control and restriction. The break between the "open door" and "control and restriction" periods is placed at the end of 1974 despite the peak of approvals for firms first entering in 1975. More than 90% of the 1975 figures results from approvals connected to one single project, the Asahan hydroelectric aluminum smelter complex, which accounted for US$1 billion of approvals in 1975 with an

---

/1 Follow-up reporting to the BKPM is not comprehensive. Information on project implementation is based on Bank Indonesia data on financial transactions and on data on clearance of investment goods and new materials through customs. The latter is particularly suspect as it is believed that firms may use the BKPM incentives for imports of investment goods to illegally clear other types of imports.

/2 The low rate of implementation is noteworthy since it is common to use data on approvals in Indonesia for comparisons with other measures of investment flows in other countries. This tends to overstate the relative importance of such inflows in Indonesia. A similar bias results from the unusual procedure of classifying any investment with any foreign equity whatsoever as foreign investment, although the practical effect is relatively minor since low foreign equity shares are rare in foreign (PMA) firms.

Table 6: APPROVALS OF FOREIGN INVESTMENT PROJECTS BY ECONOMIC SECTORS, 1967-79 (EXCLUDING INVESTMENT IN PETROLEUM AND BANKING)
(In millions of US$)

Sector /a	No. of projects 1967-79	Approvals /b 1967-74	1975-79	1967-79	% distribution of 1967-79 approvals
Agriculture	58	102	69	171	2.2
Forestry	78	475	132	607	7.8
Fishery	23	45	82	127	1.6
Mining and quarrying	11	547	906	1,453	18.7
Manufacturing	466	1,956	2,774	4,730	61.0
Food	53	123	187	310	4.1
Textiles and leather	70	891	314	1,205	15.5
Wood and wood products	12	16	35	51	0.6
Paper and paper products	14	16	101	117	
Chemical and rubber	131	247	578	825	10.6
Nonmetallic minerals	29	233	319	552	7.1
Basic metals	23	234	916	1,150	14.8
Metal products	127	190	319	509	6.6
Other	7	6	7	13	0.1
Construction	63	58	19	77	1.0
Trade and hotels	14	134	49	183	2.3
Wholesale trade	3	11	1	12	0.2
Hotels	11	123	48	171	2.2
Transport and communication	20	32	65	97	1.2
Transportation	19	26	21	47	0.6
Communication	1	6	44	50	0.6
Social and personal services and other	51	195	112	307	3.9
Total	784	3,544	4,208	7,752	100.0

/a Classification according to "International Standard Industrial Classification of all Economic Activities". (Statistical Office of the United Nations, Statistical Paper, series M, No. 4.)

/b Investments approved by the Foreign Investment Board (up to June 1973) and by the Capital Investment Coordinating Board thereafter. Data have been revised to exclude cancelled projects.

Source: Data provided by the Indonesian authorities.

Table 7: FOREIGN INVESTMENT APPROVALS: TOTAL INVESTMENT, FOREIGN EQUITY, INDONESIAN EQUITY, FOREIGN LOANS BY FIRMS CLASSIFIED BY INITIAL YEAR OF APPLICATION, 1967-79
(In millions of US$)

Year	Total investment /b	Foreign equity	Indonesian equity	Foreign loans	Debt/ equity ratio
1967	165	70	3	50	0.68
1968	870	69	29	85	0.72
1969	317	121	49	143	0.84
1970	462	183	84	162	0.62
1971	704	184	71	438	1.72
1972	397	140	46	209	1.12
1973	1,006	230	101	644	1.94
1974	1,356	212	203	740	1.78
1975	1,878	321	117	1,442	3.29
	(167)/a	(39)/a	(23)/a	(107)/a	(1.72)
1976	293	54	35	203	2.28
1977	134	30	17	78	1.65
1978	130	38	21	71	1.20
1979	156	39	25	92	1.44
Total	7,268	1,711	801	4,357	1.73
	(5,557)/a	(1,429)/a	(707)/a	(3,022)/a	
% of total	100	23.5	11.0	60	
1967-69	752	280	31	278	0.77
		(37%)	(11%)	(37%)	
1970-74	3,924	949	505	2,193	1.51
		(23%)	(13%)	(56%)	
1975-79	875/a	200/a	121/a	551/a	1.71
		(23%)	(14%)	(63%)	

/a Excludes Asahan hydroelectric aluminum complex (see text).

/b Total investment does not add to Foreign Equity, Indonesian Equity and Foreign Loans because some investment is financed from retained earnings and because of data omissions in some of the applications.

increase in approved investment to US$1.7 billion in 1977. This joint venture between foreign companies and the Indonesian Government represents almost a quarter of the total investment approvals in 1967-79. It is best dealt with separately in trying to define underlying trends in the investment process. Excluding Asahan, firms obtaining initial approval in the "open door" period 1970-74 have accounted for 70% of the total post-1967 investment approvals, whereas post-1974 projects account for only 16% of the total. This decline more accurately indicates the change in the investment climate than do the unrealiable data on investment implementation which indicate investment flows that reflect decisions made in the past under different conditions./1

3.07 The breakdown of total approved investment between equity and debt capital in Table 7 indicates an increase in debt-equity ratios from 1967 until the mid-1970s and then a decline in the late 1970s. Nevertheless, the debt-equity ratio for the period of increased control and restriction (excluding Asahan) is higher than in the previous periods. With little change in the ratio of foreign to Indonesian equity, this means that the decline in new foreign investment approvals is even more pronounced for foreign equity investment which is lower even in nominal terms for every year after 1974 than in any year from 1967-74 (again excluding Asahan).

3.08 The great importance of a single project (Asahan) in the data on investment approvals suggests that care should be taken in comparing periods corresponding to policy phases identified in Chapter 2 to avoid identifying trends that may result from a very limited number of projects. The data on the US$7.3 billion of approvals have, therefore, been classified into small- (less than US$10 million), medium- (between US$10 and US$40 million) and largescale projects (greater than US$40 million) in Table 8. In the five-year period 1970-74, 379 projects were first approved leading to almost US$4 billion of planned investment. Excluding Asahan, only 144 new projects were approved in the five-year period 1975-79 leading to less than US$0.9 billion of planned investment. The decline in planned investment for new projects is evident for all sizes of firms. Planned investment projects of less than US$10 million fell from 410 projects with approved investment of US$12 billion to 124 projects with approved investment of US$0.4 billion. Investment projects in the US$10 to US$40 million range fell from 62 projects with approved investment of US$0.9 billin to 17 projects with approved investment of US$0.3 billion. Large-scale investment projects (over US$40 million) declined from 18 to 3 with a corresponding fall in approved investment from US$1.7 billion to less than US$0.2 billion.

/1 The 16% of investment approvals accounted for by firms entering after 1975 can be expected to be even smaller in real terms. However, estimates of the fall in real investment approvals cannot be obtained by simply deflating these figures by indices of investment goods prices since much of the investment approvals for firms entering in earlier years took place through revision or expansion in later years. This question is discussed further with reference to Table 10 below.

3.09 The largest 14 projects account for some 45% of total investment approved in the 1967-79 period. The Asahan hydroelectric aluminum complex (US$1.7 billion) accounts for 23% of total approvals. The next 13 largest projects include 4 cement plants (US$385 million), 5 textile plants producing yarn and synthetic fiber (US$471 million), 2 steel plants (US$287 million), 1 tire plant (US$58 million) and 1 window glass plant (US$117 milllion). All of these 13 projects were first approved prior to 1975, although much of the investment was approved in subsequent revisions and expansions. Medium- and large-scale PMA firms first approved after 1974 include fishery ventures (US$55 million), wood processing plants (US$85 million), pulp and paper plants (US$65 million), chemical plants (US$88 million), motor vehicle assembly plants (US$75 million) and real estate development projects (US$55 million).

Table 8: TOTAL INVESTMENT APPROVALS BY SIZE OF FIRM BY YEAR OF FIRST APPLICATION (In millions of US$)

	< 10		10 - 40		> 40		All	
Year	No.	Value	No.	Value	No.	Value	No.	Value
1967	11	32	3	35	2	98	16	165
1968	40	97	5	106	1	67	46	270
1969	46	117	9	170	1	40	56	327
1970	11	198	9	132	2	132	122	462
1971	82	204	8	171	4	329	94	704
1972	74	164	11	193	1	40	86	397
1973	100	418	18	156	4	432	122	1,006
1974	43	249	16	267	7	839	77	1,355
1975	21	89	5	78	1	1,712	27	1,879
1976	29	86	4	81	2	126	35	293
1977	22	72	3	62	0	0	25	134
1978	35	116	1	14	0	0	36	130
1979	17	44	4	69	1	43	22	156
1967-69	97	234	17	311	4	205	118	752
1970-74	410	1,233	62	919	18	1,772	379	3,924
1975-79	124	407	17	304	4	1,881	145	2,592
					(3)/a	(164)/a	(144)/a	(875)/a
1967-79	631	1,876	96	1,534	26	3,858	642	7,268

/a Excluding the Asahan aluminum complex approved in 1975.

Source: Derived from BKPM data.

increase in approved investment to US$1.7 billion in 1977. This joint venture between foreign companies and the Indonesian Government represents almost a quarter of the total investment approvals in 1967-79. It is best dealt with separately in trying to define underlying trends in the investment process. Excluding Asahan, firms obtaining initial approval in the "open door" period 1970-74 have accounted for 70% of the total post-1967 investment approvals, whereas post-1974 projects account for only 16% of the total. This decline more accurately indicates the change in the investment climate than do the unrealiable data on investment implementation which indicate investment flows that reflect decisions made in the past under different conditions./1

3.07 The breakdown of total approved investment between equity and debt capital in Table 7 indicates an increase in debt-equity ratios from 1967 until the mid-1970s and then a decline in the late 1970s. Nevertheless, the debt-equity ratio for the period of increased control and restriction (excluding Asahan) is higher than in the previous periods. With little change in the ratio of foreign to Indonesian equity, this means that the decline in new foreign investment approvals is even more pronounced for foreign equity investment which is lower even in nominal terms for every year after 1974 than in any year from 1967-74 (again excluding Asahan).

3.08 The great importance of a single project (Asahan) in the data on investment approvals suggests that care should be taken in comparing periods corresponding to policy phases identified in Chapter 2 to avoid identifying trends that may result from a very limited number of projects. The data on the US$7.3 billion of approvals have, therefore, been classified into small- (less than US$10 million), medium- (between US$10 and US$40 million) and largescale projects (greater than US$40 million) in Table 8. In the five-year period 1970-74, 379 projects were first approved leading to almost US$4 billion of planned investment. Excluding Asahan, only 144 new projects were approved in the five-year period 1975-79 leading to less than US$0.9 billion of planned investment. The decline in planned investment for new projects is evident for all sizes of firms. Planned investment projects of less than US$10 million fell from 410 projects with approved investment of US$12 billion to 124 projects with approved investment of US$0.4 billion. Investment projects in the US$10 to US$40 million range fell from 62 projects with approved investment of US$0.9 billin to 17 projects with approved investment of US$0.3 billion. Large-scale investment projects (over US$40 million) declined from 18 to 3 with a corresponding fall in approved investment from US$1.7 billion to less than US$0.2 billion.

/1 The 16% of investment approvals accounted for by firms entering after 1975 can be expected to be even smaller in real terms. However, estimates of the fall in real investment approvals cannot be obtained by simply deflating these figures by indices of investment goods prices since much of the investment approvals for firms entering in earlier years took place through revision or expansion in later years. This question is discussed further with reference to Table 10 below.

3.09 The largest 14 projects account for some 45% of total investment approved in the 1967-79 period. The Asahan hydroelectric aluminum complex (US$1.7 billion) accounts for 23% of total approvals. The next 13 largest projects include 4 cement plants (US$385 million), 5 textile plants producing yarn and synthetic fiber (US$471 million), 2 steel plants (US$287 million), 1 tire plant (US$58 million) and 1 window glass plant (US$117 milllion). All of these 13 projects were first approved prior to 1975, although much of the investment was approved in subsequent revisions and expansions. Medium- and large-scale PMA firms first approved after 1974 include fishery ventures (US$55 million), wood processing plants (US$85 million), pulp and paper plants (US$65 million), chemical plants (US$88 million), motor vehicle assembly plants (US$75 million) and real estate development projects (US$55 million).

Table 8: TOTAL INVESTMENT APPROVALS BY SIZE OF FIRM BY YEAR OF FIRST APPLICATION (In millions of US$)

	< 10		10 - 40		> 40		All	
Year	No.	Value	No.	Value	No.	Value	No.	Value
1967	11	32	3	35	2	98	16	165
1968	40	97	5	106	1	67	46	270
1969	46	117	9	170	1	40	56	327
1970	11	198	9	132	2	132	122	462
1971	82	204	8	171	4	329	94	704
1972	74	164	11	193	1	40	86	397
1973	100	418	18	156	4	432	122	1,006
1974	43	249	16	267	7	839	77	1,355
1975	21	89	5	78	1	1,712	27	1,879
1976	29	86	4	81	2	126	35	293
1977	22	72	3	62	0	0	25	134
1978	35	116	1	14	0	0	36	130
1979	17	44	4	69	1	43	22	156
1967-69	97	234	17	311	4	205	118	752
1970-74	410	1,233	62	919	18	1,772	379	3,924
1975-79	124	407	17	304	4	1,881	145	2,592
					(3)/a	(164)/a	(144)/a	(875)/a
1967-79	631	1,876	96	1,534	26	3,858	642	7,268

/a Excluding the Asahan aluminum complex approved in 1975.

Source: Derived from BKPM data.

3.10 The overall fall in investment approvals of 1975-79 firms compared to 1970-74 firms of 34% (including Asahan) and of a huge 77% (excluding Asahan) is an important indication of the closing of the "open door" to private foreign investment inherent in the increased controls and restrictions of the post-1974 period. The above figures, however, are in nominal terms and define planned investment by firms first approved in these periods, rather than planned investment actually approved in these periods (regardless of when the project was first proposed and approved). It is possible to use data provided in the BKPM summaries of approvals to show planned investment by year of approval broken down between new investment and revision or expansion for previously approved project and then to account for the inflation of dollar prices of investment commodities. The results are presented in Tables 9 and 10.

3.11 A shift in importance between new investment projects and revisions or expansions of old projects between the 1970-74 period and the 1975-79 periods is clearly evident in Table 9. Over the 1970-74 period, investment approvals for new projects were almost five times greater than approvals for revised or expanded projects which had been previously approved. In the 1975-1979 period, however, revisions and expansion of previously approved projects become greater than new projects. While investment approvals for new projects fell by 28% between the two periods (by 68% if Asahan is excluded), this was offset by a substantial growth of approvals for revised or expanded projects (by 255% including Asahan and by 56% excluding Asahan). While the growing importance of investments by established firms is predictable as those firms overcome the fixed costs of initial investment, the very sharp drop in new projects receiving approval probably reflects the changing policy environment described in Chapter 2.

3.12 The inflationary period throughout the 1970's has had an important impact on the dollar value of investment over the 1967-1979 period. The unit value index for machinery export from developed to developing countries has been used to deflate the dollar value shown in Table 3 to obtain the results presented in Table 10. Despite the difficulty of defining a fully adequate deflator, this table probably gives the best overall picture of changes in private direct investment flows in the 1967-1979 period. If Asahan is included, overall investment approvals declined in real terms by 26% in the 1975-1979 period compared to 1970-1974 and by 61% if Asahan is excluded. The fall in investment approvals for new projects is even more precipitous; by more than a half if Asahan is included and by more than

Table 9: INVESTMENT APPROVALS FOR NEW PROJECTS AND CHANGES IN INVESTMENT APPROVALS FOR PREVIOUSLY APPROVED PROJECTS, 1967-1979
(millions in current US Dollars)

	Total approvals by year of approvals	New project approvals by year of approvals	Changes in previous approvals by year of change
1967	100	100	-
1968	108	108	-
1669	155	153	2
1970	220	220	-
1971	351	325	26
1972	339	299	40
1973	673	518	155
1974	1,530	1,204	326
1975	1,376 (335)/a	1,186 (145)/a	190
1976	453	261	202
1977	350	128	202
1978	375	118	857
1979	1,228 (558)/a	156	1,072 (402)/a
Total	7,268 (5,557)/a	4,780 (3,739)/a	3,488 (1,913)/a
1967-1969	363	362	2
1970-1974	3,113	2,566	547
1975-1979	3,792 (2,081)/a	1,849 (808)/a	1,943 (1,273)/a

/a Excluding Asahan Hydroelectric Aluminum Complex.

Source: Derived from data supplied by BKPM.

four-fifths if Asahan is excluded. Real investment in new projects approved in the five year period 1975-1979 is even 12% below real investment approved in new projects in the three year period 1967-1979. Only the increase in investment approvals for previously approved projects (by almost two thirds if Asahan is included, and by a quarter if it is excluded) operates to maintain real investment approvals. However, this effect probably does not offset the decline in new investment by as much as the data on overall planned investment would suggest. The reason is that the summary statistics

Table 10: INVESTMENT APPROVALS FOR NEW PROJECTS AND CHANGES IN INVESTMENT APPROVALS FOR PREVIOUSLY APPROVED PROJECTS, 1967-1979 (millions of 1970 US dollars)/a

	Total approvals by year of approval	New projects by year of approval	Changes in previous approvals by year of change
1967	103	103	-
1968	115	115	-
1669	178	175	3
1970	220	220	-
1971	310	287	23
1972	266	235	31
1973	454	350	104
1974	927	730	197
1975	684 (166)/b	590 (72)/b	94
1976	210	121	94
1977	149	54	86
1978	139	44	95
1979	423 (192)/b	54	369 (138)/b
1967-69	396	393	3
1970-74	2,177	1,822	449
1975-79	1,605 (856)/b	863 (345)/b	738 (507)/b

/a Deflated by the Unit Value Index for Machinery Exports from Developed to Developing Countries published in the UN Monthly Bulletin of Statistics, August 1977. This series has been extended to 1979 using the Price Index of Machinery and Equipment published in the UN Monthly Bulletin of Statistics, May 1980.

/b Excluding Asahan Hydroelectric Aluminum Complex.

on approvals provided by BKPM often show frequent revisions /1 of approvals without clarifying whether the revision represents an expansion or a revised valuation of a proposed project not yet initiated or completed. The frequency with which investment figures are changed, while no adjustment is made in estimated labor inputs or projected outputs would suggest that a large proportion of the investment revisions represent re-evaluation for inflationary increases in project costs after first approval, but prior to full implementation. The low rate of implementation noted earlier is consistent with this interpretation. All indicators, therefore, point to a very substantial change in the private foreign investment process in the second half of the 1970's as Government policy became more restrictive.

3.13 There is further evidence supporting the interpretation in the dat made available for 1978 and 1979 by the Investment Coordinating Board (BKPM) Some 26 applications were rejected relative to 58 applications approved in the 1978-79 period. Rejected applications include 5 projects in the real estate business, 2 projects in pulp and paper, 2 synthetic fiber projects, 4 chemical projects, 4 machinery and equipment projects, 2 electricial equipment and apparatus projects, 1 petrochemical project, 1 cement project, 1 glass project, 1 basic metals steel industry project, 1 metal products project, and 2 unclassified projects. No detail was available on proposed investment levels or on reasons for rejections, although the supply and demand monitoring underlying the DSP controls was noted as having been of importance.

3.14 Other characteristics of approved foreign investment can be briefly summarized. Projected employment of foreign workers and Indonesians is summarized in Table 11. Foreign employment accounts for less than 2 1/2% of projected employment in manufacturing and less than 2% of employment in manufacturing. The location of projected investment is summarized in Table 12. Half of approved investment and 71% of the projects were located on Java with 58% of the projects and 43% of all planned investment accounted for by West Java (including Jakarta). Sumatra accounted for 12% of the projects and 20% of total investment approvals, most of which is concentrated in North Sumatra. Kalimantan accounts for 8% of all projects and 7% of investment, most of which is accounted for by East Kalimantan. The rest is widely scattered throughout the archipelago, although the ten projects in Irian Jaya account for about 4% of approvals. The source country for private foreign investment approvals for 1967-1978 is given in Table 13. Japan accounts for 35% of overall approvals followed by the US (11%) and Hong Kong (10%). The Philippines, Australia, the Netherlands, West Germany and Switzerland all account for between 1% and 5% of total investment approvals. Except for the importance of Japan, private foreign investment in manufacturing in Indonesia appears to be widely diversified by source.

/1 Many projects are revised five or six times.

Table 11: PROJECTED EMPLOYMENT IN FOREIGN INVESTMENT PROJECTS APPROVED 1967-1979

	Total employment (1)	Foreign employment (2)	(2) or a % of (1)
Nonmanufacturing	260,711	4,698	1.8
Manufacturing	241,157	5,783	2.4
Food	46,160	660	1.4
Textiles and leather	74,028	1,366	1.8
Wood and wood products	18,284	1,077	5.8
Paper and paper products	3,862	109	2.8
Chemical and Rubber	25,811	1,028	4.8
Nonmetallic minerals	20,623	670	3.2
Basic metals	8,378	242	2.9
Metal products	42,189	611	1.4
Others	1,822	20	1.1
Total	501,868	10,481	2.1

Source: Based on data provided by BKPM.

Table 12: APPROVED FOREIGN INVESTMENT BY LOCATION 1967-1978

Location	Number of projects	Total investment (million US$)	Percentage of total investment
Java	475	3,625.8	51.0
Special territory Jakarta	309	1,357.7	19.1
West Java	162	1,702.0	23.9
Middle Java	19	212.3	3.0
Special Territory Yogyakarta	4	3.3	0.1
East Java	80	350.5	4.9
Sumatera	94	1,375.4	19.2
Special Territory Aceh	5	15.5	.2
North Sumatera	45	1,077.1	15.1
West Sumatera	5	37.7	0.5
Riau	17	81.7	1.1
Jambi	3	9.9	0.1
Bengkulu	-	-	-
Lampung	7	85.0	1.2
South Sumatera	12	68.5	1.0
Kalimantan	63	491.0	6.9
West Kalemantan	13	17.7	0.2
East Kalemantan	23	321.3	4.5
Middle Kalemantan	19	76.5	1.1
South Kalemantan	8	75.5	1.1
Sulewesi	25	235.7	3.4
North Sulawesi	3	81.9	1.2
Middle Sulawesi	6	11.4	0.2
Southeast Sulewesi	3	28.2	0.4
South Sulawesi	10	114.2	1.6
Malaku	10	109.2	1.5
Bali	4	24.2	0.3
West Nasatenggarra	1	2.0	0.03
East Nasatenggarora	2	33.8	0.5
Irian Jaya	10	265.8	3.7
East Timor	-	-	-
Combined Regions	25	960.7	13.5
Total	805	7,123.6	100.0

Source: BKPM, cited in Soedeyono, Indriyo Gitsudarmo, Ameruddin Ardani, and Sokadji Ranuwihardjo "Mattenational Corporations and Host Country Technology; A Case Study of Indonesia" Council for Asian Manpower Studies, Project No. 78-3-04, 1980

Table 13: APPROVED FOREIGN INVESTMENT ACCORDING TO COUNTRY OF ORIGIN 1967 - DECEMBER 1978

Country of origin	Number of projects	Total investment in Million US$	Percentage to total investment
1. USA	105	800.5	11.237
2. Canada	4	84.9	1.192
3. Panama	6	34.2	0.480
4. Bahamas	3	11.4	0.160
5. Belgium	13	78.7	1.105
6. Denmark	2	8.7	0.122
7. France	9	28.9	0.405
8. Italy	3	7.3	0.102
9. Netherlands	49	230.5	3.236
10. Norway	1	9.4	0.132
11. West Germany	30	205.6	2.886
12. United Kingdom	43	101.3	1.422
13. Switzerland	17	160.7	2.256
14. Poland	1	3.0	0.042
15. Lichtenstein	2	2.3	0.032
16. Netherland Antilen	1	9.7	0.136
17. Japan	203	2,534.0	35.572
18. South Korea	18	80.8	1.134
19. Hong Kong	118	722.2	10.138
20. Taiwan	5	105.8	1.485
21. Singapore	40	130.9	1.837
22. Malaysia	27	53.7	0.753
23. Brunai	3	6.5	0.091
24. Thailand	9	25.9	0.363
25. Philippines	20	311.4	4.371
26. India	11	76.0	1.067
27. Australia	43	217.2	3.049
28 New Zealand	1	0.4	0.006
29. Combined Countries	18	1,080.9	15.173
Total	805	7,123.6	100.000

Source: BKPM.

Table 14: POPULATION, GROWTH RATES, TOTAL AND PER CAPITA STOCK OF PRIVATE FOREIGN INVESTMENT IN ASEAN COUNTRIES

	GNP per capita (1977) US$	GNP growth rate 1970-1977	End of 1976 stock of private foreign investment (US$billion)	Population 1977 (million)	End of 1976 stock of private for investment per capita
Indonesia	300	7.0	5.1	133	38
Malaysia	930	7.5	2.4	13	184
Philippines	450	6.5	1.4	44.5	31
Thailand	410	7.0	.35	44	8
Singapore	2,890	8.4	1.33	2.3	578
Total			10.58	236.8	45

Source: OECD Development Review, 1978.

3.15 An international perspective on the importance of private foreign investment in Indonesia is given in Table 14 where a comparison is drawn between the ASEAN economies based on data from source countries. While almost half of the total stock of private foreign capital in ASEAN was invested in Indonesia as of 1976, Indonesia (with 56% of ASEAN population) was still below the average in foreign capital per capita with one fifth the per capita foreign capital of Malaysia (one fiftenth the per capita foreign capital of Singapore).

4. IMPLICATIONS OF POLICY REFORM FOR PRIVATE FOREIGN INVESTMENT

4.01 This chapter outlines a set of specific policy reforms that is intended to facilitate the flow of foreign investment into Indonesia. These recommendations are not intended to be instituted over night; rather, it is suggested that they be implemented over a ten-year period, or as it becomes politically feasible to do so. A specific time-frame is outlined in the main report. The intent of these reforms is to ensure a reasonably close correspondence between private profitability and the net benefit to the society at large from investment or production decisions by private sector firms. Within the context of such a reform, it becomes possible to work towards a system in which the Government's objective is to increase aggregate investment, with neutrality in policy between foreign and domestic investment in the manufacturing sector, while using limited interventions specifically designed for narrow arreas of market failure and to achieve noneconomic objectives.

Investment Restrictions and Controls

4.02 The DSP (Investment Priorities List) system could over the long run be significantly amended and no prohibitions should be placed on any properly registered domestic or foreign firm entering or expanding any business activity producing legal commodities or services. This recommendation has been made in Annex 3, but it is repeated here because all foreign firms are subject to BKPM controls. This recommendation clearly cannot be fully implemented in the short-run. It, nevertheless, defines an appropriate guideline for a longer run shift in industrial policy. It is in the interest of this majority that all investment projects be capable of producing commodities or services at lower cost than alternative ways of obtaining these goods and that competitive pressure transfer the benefits of efficient production to consumers through lower prices, to workers through higher wages and increased opportunities for acquiring skills, to households through high returns to saving that is channelled through financial institutions to business investment, and to other sectors of the economy through lower priced supplies of intermediate goods or increased demand and higher prices for inputs.

4.03 The Government should also work towards a system of pricing for natural resources that is aimed at maximizing the present value of the return to these resources. Restrictions or controls on investment in these areas should not be based on ownership characteristics of the firm. This is an area in which the Government, as the trustee and managers of most of the nation's natural resources, is inevitably involved with the terms at which these resources are made available to the private sector investor, both domestic and foreign. The interest of society, at large, as opposed to particular individuals with ownership rights in particular firms, is to have these resources managed in the most efficient way so as to obtain the highest returns possible in terms of the resources generated through royalties or taxes levied on firms with concessions to exploit these resources.

Tax Incentives for Foreign Investments

4.04 As price distortions are gradually eliminated, the present BKPM incentive system based on significant differentiation between sectors should be eliminated and replaced by a general incentive to all foreign investment; this may be carried out through a reduction in corporate income taxes. This recommendation is consistent with that made in Annex 3. There is little reason to favor or discriminate against sectors if the private returns to those sectors do not include hidden taxes or subsidies based on extensive trade restrictions and price interventions. A move toward unrestricted trade would not only undermine the rationale for many high cost incentives currently offered to foreign firms, but would also greatly reduce its value as, for instance, with the highly complex system of rebates aimed at offsetting the costs of trade restrictions on raw materials.

4.05 In many countries, there is little evidence that tax incentive systems have much effect on the level of foreign investment. This is indicated by surveys on factors important in investment decisions /1 and, perhaps more convincingly, by the extent to which investors bypass applying for incentives in countries where they have the option. For example, it is estimated that over two thirds of foreign investment in Thailand is carried out without references to the Board of Investment that administers a special tax incentive program similar to the one administered by the BKPM in Indonesia./2 The reason for this may be that there is limited value from various tax breaks or holidays over the early years of operation, or because firms can take tax credits in source countries for tax payments in host countries, or because various costs of obtaining incentives are high relative to the benefits provided. On the basis of extensive discussions with foreign investors in Indonesia, it appears that special incentives systems are a relatively minor factor in the investment decision in Indonesia as well.

4.06 This recommended elimination of special incentives could be carried out in conjunction with the elimination of extensive restrictions on foreign investment. These policies tend to work at cross purposes and reflect a basic ambiguity towards private foreign investment which, in turn, reflect doubts about the net domestic benefits of private foreign investment. There is a legitimate basis for such doubts when investment takes place in highly subsidized or protected sectors since the costs of

---

/1 See the discussion of the impact of special incentives on the foreign investment process in K. Billerbeck and Y. Yasugi, Private Direct Foreign Investment in Developing Countries, World Bank Working Paper No. 348, July 1979.

/2 For a discussion of this evidence, see the Asian Wall Street Journal, Tuesday, April 29, 1980.

subsidies or protection is borne by other groups in the economy, but are not reflected in the decision-making process of the investor; currently many foreign firms are attracted to Indonesia by the tariff protection afforded to them. The private profitability of such firms greatly exceeds their social benefits to Indonesia. Once the price distortions that can lead to net losses to the Indonesian economy from privately profitable investment are eliminated, there is no compelling reason to either restrict or differentiate the incentives to any type of investment.

4.07 As part of a move towards eliminating or reducing the use of special incentives of the type adminstered by the BKPM, the Government of Indonesia should propose an agreement within ASEAN aimed at both moderating and creating more uniformity in incentives systems for foreign investment. It is to the disadvantage of the ASEAN economies to bid up the cost of foreign investment to each other and this is one area of economic policy where mutual cooperation would be both feasible and beneficial. Since complete elimination of special incentives is tied in important ways to the elimination of price distortion, the agreement would probably have to take the form of upper limits on the types of incentives that would be permitted since a multilateral move within ASEAN towards unrestricted international trade may not be politically feasible.

4.08 If it proves to be impossible to closely approximate a 'first best' system within Indonesia, special incentive programs designed to account for price distortions should be made optional. This would open up an option to foreign investment that is presently already available to domestic investment through the BRO process of bypassing the incentives (and restrictions) administered by the BKPM. While all foreign investment applications should be processed by BKPM, this could be routinely done as a way of assisting foreign firms in quickly satisfying various registration requirements in a matter of days or weeks, while allowing firms the option of bypassing an evaluation process tied to the provision of special incentives that would reasonably be expected to take several months and which in the past has taken much longer periods of time.

4.09 This would provide some mechanism for eliminating incentives that are very costly for Indonesia, but which may be of relatively minor importance for foreign firms. Many of the benefits to foreign firms are presently whittled away by time delays and other costs imposed on them. Allowing firms the option of bypassing these procedures would be sound policy in automatically eliminating special incentives that have only marginal benefits (and, therefore, negligible impact on investment decisions), and saving resources where the incentives are redundant due to source country tax policies, and by improving the administration of incentives, since this would now be a test of the usefulness of the agency providing this service.

4.10 This recommendation does, however, imply, in combination with the suggested changes in investment controls, that no attempt be made to block

foreign investment in areas where protection and subsidies through market interventions and trade restrictions are still maintained. There are three justifications for this approach. First, ruling out controls or regulations restricting such investment will increase pressure for a first best policy of eliminating these indirect subsidies. Second, the cost in resources, time delays, and increased uncertainty in evaluating investment projects to identify such cases are likely to exceed the benefits of blocking such investment. Third, restricting foreign investment in these areas would automatically divert investment by domestic firms into sectors where Indonesia is not competitive, where production increases may have to be controlled to avoid growth of costly direct and indirect subsidies, where growth would decline as soon as the import-substitution process was completed, and where the viability of the (foreign) investment project would be undermined by a move towards a more open economic policy.

4.11 Special incentives designed to account for price distortions should be used only when the indirect taxes borne by the firm - through the effects of market interventions that raise input prices or lower output prices - exceed the indirect subsidies through market interventions that lower input prices or raise prices for outputs. The effect of this restriction on the provision of special tax incentives would be to rule out the subsidies for virtually all import substituting production of final consumers goods. Special incentives would still be available for sectors subject to discrimination (mainly export processing, agricultural projects, and intermediate or capital goods production) where the effective rate of protection /1 would be less than zero - a group of activities that accounts for a very small proportion of industrial investment at present in Indonesia and that would become progressively smaller as the policy reform outlined earlier is carried out./2

4.12 This guideline would represent an alternative to the proposal under consideration at present to carry out detailed project appraisals of all investment applications submitted to the BKPM with the intention of defining maximum levels of incentives that could be provided, while still

---

/1 The effective rate of protection measures the degree of distortion due to trade restrictions or other market intervention to value added. Under this proposal, no adjustment would be made for alleged distortion to primary factor costs.

/2 See Annex 2 for the group of activities with negative effective protection.

maintaining net benefits to the Indonesian economy./1 The high cost in time, resources and uncertainty of such detailed project evaluations and the unreliability of exercises that are often based on arbitrary assumption underlying estimates of appropriate shadow factor prices and shadow foreign exchange rates suggest that more limited procedures should be used. Restricting incentives to foreign and domestic firms that can effectively show that their profits understate benefits to society because of well-defined distortions to products or inputs caused by Government intervention is the most effective way of providing incentives, while at the same time identifying significant price distortions that might be eliminated directly.

4.13 In cases in which the BKPM extends special incentives to investors in accord with recommendations made earlier (paras. 4.08 and 4.10), the BKPM should be required to calculate the projected costs of these incentives and to provide subsequent reports on actual costs once projects are undertaken. Under the present system, costs of special incentives are reflected in foregone tax income that is effectively hidden in a complex system tax exemptions and rebates. Estimates of the costs of these incentives are not available at the BKPM and attempts to generate some estimates proved unsuccessful because of difficulties in obtaining the required data especially on corporate tax payments lost because of tax holidays. The following recommendation made below would greatly simplify an accounting of the costs of such subsidies.

4.14 These special incentives designed to account for a distorted price system should take the form of tax credits that could be used by the firm in settling corporate tax payments, tax payments for any imports subject to duty or for utility charges levied by Government agencies. This recommendation is aimed at simplifying the incentive system. In the limited cases in which firms would be in a position to apply for these special incentives, independent calculations should be carried out to confirm that the estimates provided by the firm in its applications are designed to offset price distortions that cause private profits to understate net social benefits. This could be done by using information on price distortions and estimates of input-output proportions consistent with efficient production. The subsidy payments to firms would then be paid to offset the loss in the firm's profits. The tax credits would be recorded once evidence was furnished on the level of domestic sales or exports; these would have to be consistent with documentation from the tax and customs departments which should carry out a check on the claimed credits. Credits could be carried over from year to year, possibly earning an interest rate consistent with

---

/1 This approach is being considered by BKPM with the assistance of consultants from the W.D. Scott Company.

short term yields. This system would eliminate the present complex system of rebates based on ´master lists´ that are difficult to forecast, change, and administer /1 and which require detailed negotiation with Government agencies which expands on the scope for arbitrary decision making and creates opportunities for corruption.

4.15 The proposed system would be an efficient mechanism of intervention if the problem was a price distortion for an output or if the input-output coefficient for inputs subject to price distortions were fixed. If this were not the case, it could conceivably be better to attach the subsidy to the level of use of an input with a price distortion./2 Within the small subset of projects eligible for this type of subsidy program, the smaller subset for which this problem is significant may be so small as to be negligible. If not, it can easily be handled within the context of this proposal by attaching the subsidy to the use of the imported input in which case it becomes equivalent to an import duty rebate as under the present system.

The Commercial Infrastructure

4.16 The Government has an important role to play in the improvement of the commercial infrastructure that should also be carried out. Improving the commercial infrastructure so as to reduce excessive costs and uncertainties of doing business in Indonesia should have higher priority than the system of control and incentives for foreign investment. The following comments reflect the nature of some of the problems and indicate some steps that should be taken. A more comprehensive survey should be carried out to provide the basis for an overall reform in this area.

/1 There is reason to suspect that many imports brought in with reduced tax or tax exempt status under the ´master list´ system are diverted to other cases and that the investment application may have been simply a cover to obtain duty-free status. Data from the customs department by project showing high imports of raw materials but negligible imports of capital equipment suggest this is a especially severe problem for domestic investment projects.

/2 The nature of the problem results when a domestic input is substituted for an imported input subject to a tariff. The Government loss of tariff revenue should be reflected in the loss of the subsidy if there are not offsetting gains generated by domestic production of the substitute.

4.17 The perception of many foreign firms is that arbitrary decision-making and uncertainty with respect to taxation is a serious obstacle to good business practices in Indonesia and has, according to these firms, a significant detrimental effect on foreign investment. There is a long back log in tax collection. Tax liabilities settled in early 1980 by foreign firms, for instance, related predominantly for the 1974-75 period. Tax assessments are reported to be frequently adjusted upwards, a problem felt to be especially common for joint ventures. These problems have, however, abated after the March 1979 reforms and, with other efforts made by the tax authorities, the situation appears to be improving. There is, however, no effective way of having tax disputes settled through the court system - any appeals must be made through the tax collecting agencies. Rebates on prepayments for corporate income tax collected through the MPO tax on various transactions that frequently exceed corporate tax obligations are often refunded with a four or five year delay. Problems with administration are also pervasive in the customs department. Heavy costs are imposed on foreign firms in having raw materials and spare parts tied up for weeks until complex clearance procedures requiring a dozen or more signatures are worked out.

4.18 The legal system also remains weak. There is a constant need for bargaining and consultation to protect rights established with the Government. Appropriate legal framework for various types of business activity, such as for leasing equipment, reportedly does not exist. There is no patent law as of the present time./1 Contracts, especially between foreign-owned firms and Indonesian firms or nationals, often cannot be successfully defended in the courts. Contract law exists but there is not a well-developed body of corporate law cases that can provide guidelines in business arrangements./2 The Indonesian Chamber of Commerce has established the 'National Board of Arbitration', but this mechanism has rarely been used in practice. Corporate law is outdated and remains based on Dutch colonial law. While a new corporate law is being considered, this has been the case for years.

4.19 The policy making process is characterized by considerable uncertainty. There is no systematic process of collecting, coding or for identifying and resolving inconsistencies or ambiguities in industrial regulations or laws. A successful reform along the lines outlined above could greatly contribute to resolving this problem by restricting potential areas of intervention. A more disciplined approach to policy formulation is also required. Regulations or announcements are often made without clarifying

---

/1 A patent application process does exist and reportedly implies priority rights once a patent law is passed, but concerns remain about the ability to defend these rights in the courts.

/2 Indonesian courts typicaly do not provide written opinions.

their legal status, without clearly defining their applicability across firms that entered at different time periods under different sets of regulations, without clearly spelling out previous regulations that are being superseded by new regulations, or without defining the consequences of being in violation of the regulations.

4.20 All of these problems have more extensively discussed in other work on the commercial system in Indonesia and in Annex 3. A common misinterpretation of the consequences of this problem deserves to be noted. The added costs and inefficiencies resulting from poor information flows and high levels of uncertaintly are often treated as costs imposed on foreign firms. However, the costs are almost totally borne by the Indonesian worker and consumer and the system may well benefit established firms. Foreign investors must obtain a rate of return in excess of the normal risk of the supply price of capital to cover these extra costs of uncertainty. Competitive pressure will not drive this rate of return down as in the normal process that transfers benefits to consumers or workers. Established firms lose relative to a system in which competitive investment is blocked and the commercial infrastructure is improved, but they may well be better off then with an improvement in the commercial infrastructure and no restrictions on competitive investment. Established firms are better off because over time they develop expertise in reducing the uncertainties and avoiding the costs of an underdeveloped commercial infrastructure that is not available to new entrants - expertise on which the established firms can capture monopoly rents.

4.21 The Government should work together with the foreign and domestic business community in lowering the costs of doing business through a thorough reform of the commercial infrastructure. It should also work towards minimizing all barriers to entry and towards open import competition to assure that the benefits accrue to the Indonesian consumer and worker - a process in which it cannot expect the full cooperation of the established business community.

Labor Training and Technology Transfer

4.22 The main areas where external economies generate net benefits that are greater than private profitability relate to nonfirm specific training and technology transfer. There is a theoretical justification for subsidies linked to nonfirm specific training and technology transfer if the full costs cannot be imposed on workers or the full benefits cannot be recouped by the firm. Such subsidies, which should take the form of credits of the type discussed earlier (para. 4.13) linked to the levels of training or technology transfer, should, however, be used to only a very limited degree.

4.23 Such subsidies have the substantial advantage of keeping their costs highly visible and forcing proponents to justify this use of resources in terms of the alleged benefits of the program. However, the difficulty

with accurately estimating external benefits, the difficulty of establishing an effective link between subsidy payment and this type of activity, and avoiding excessive subsidies suggests that such a program should be used only rarely in practice.

4.24 As a more cooperative relationship is developed between private sector foreign and domestic firms and the Government, joint efforts to augment educational and training programs should be introduced. Many other countries have been able to achieve substantial benefits from public sector activity to stimulate labor training in the industrial sector. Public sector financial support for vocational and business oriented educational institutions could be augmented by programs to share costs with firms in programs aimed at providing training or assisting in the transfer of technology. This might take the form of a fellowship programs for business studies, financing programs in which industrial or business experts are brought to Indonesia, and financial support for well defined training program carried out by foreign firms. A section concerned with training and technology transfer would be established within the BKPM that would solicit aid from single firms or from associations of firms. It is very costly for firms (both foreign and domestic) to meet high skill personnel requirements by bringing in foreign nationals. This is done for only a very small percent of the labor force, but this is highly concentrated at top level positions. A good response from the private sector to a well run cooperative program aimed at increasing the supply of skilled labor in Indonesia can be expected. The Government may also wish to consider providing firms with tax incentives to encourage them to undertake specific training of Indonesian workers.

4.25 Restrictions on the use of foreign workers should also not be increased from their present levels. As part of an overall policy reform, restrictions in several areas could be relaxed. For example, restrictions may be relaxed for those specific skills which are in short supply in Indonesia and are expected to remain so in the medium-term. While foreign firms may rely on foreign workers to fill high level positions, this is a relatively high cost decision for these firms. This cost provides sufficient incentives to firms to minimize the use of such high level personnel from abroad and there is little to be gained by placing restrictions on their use. This would aid in achieving efficiency in production that may lower returns to Indonesians in executive positions, but which is to the advantage of the Indonesian consumer and worker. The Government should, instead, concentrate its efforts on increasing the domestic supply of the required skills.

4.26 A clear policy of unrestricted access to high level personnel with specific skills from abroad, combined with a cooperative effort to replace such workers by Government policies aimed at increasing the supply of skilled workers, would eliminate the high costs of uncertainty in the investment process. A few key personnel can make the difference between success or failure and any uncertainty created by Government restrictions on hiring practices of the firms will be reflected in a larger risk premium attached to the normal supply price of capital. This is a cost imposed on workers and/or consumers who are harmed by an artificial barrier to entry of competitive investment, and this may well result in gains to established firms.

4.27 There are several areas in which present regulations could be streamlined to reduce costs and time delays associated with the process of using foreign nationals. For example, multiple entry visas for foreign nationals are issued subject to conditions related to the number of trips carried out in the recent past. The process of applying for entry documents creates needless costs and time delays. These can be easily eliminated by providing multiple entry visas simultaneously with the issue of work permits to foreign nationals. Although changes of this type are relatively minor, streamlining such procedures could help build a spirit conducive to cooperative efforts by Government and business to increase the employment of Indonesian nationals through training projects designed to ease the demand for highly skilled labor.

4.28 If it is felt that Government/business efforts on the supply side of the market are insufficient to lower the demand for foreign personnel, then an annual fee should be charged for working permits available to locally-registered firms in Indonesia. Such a process would allow market processes to efficiently allocate these positions and would minimize uncertainty for the firms. The fee for such permits could be varied in light of labor market conditions to increase or decrease the incentive for foreign workers.

Ownership Restrictions

4.29 As part of a general reform, current ownership restrictions or differential treatment related to ownership characteristic of firms should be carefully reviewed. Ownership restrictions have become a central element in the system of controls on foreign and nonethnic Indonesian domestic firms; they were introduced and increased during the 1970s. The objective behind minimum requirements for local equity suggested in a recent UN report is to "exercise local control, to develop entrepreneurship, and frequently

to increase the host country's share of profits."/1 This seems to accord with the generally accepted position in Indonesia. There is little evidence to suggest that current ownership regulations are effective in any of these areas.

4.30 Control of private sector firms, both domestic and foreign, is based on the legal system and Government regulation. There is little reason to expect that domestic-owned or foreign-owned firms, attempting to maximize profits, would behave differently in ways that make control of undesirable activities on the part of foreign firms more difficult than control of domestic firms. There are grounds for belief that, in fact, foreign firms operate closer to the legal norms with respect to tax payments and business operations in general than do domestic firms. This partly reflects the higher visibility of foreign firms in a country where there is considerable sentiment against foreign business, the tax advantages provided and legal restraints imposed by source countries for compliance with the formal legal system of the host economy,/2 and a relative disadvantage in finding ways of avoiding various tax and legal obligations.

4.31 Ownership restrictions to foster entrepreneurship can and have been avoided by using local firms or individuals as fronts. Equity sharing restrictions can be satisfied by allowing local partners to purchase shares on the basis of a loan from the foreign partners with all shareholders rights held by the foreign partner until the indefinite term loan is repayed. Another mechanism is for the foreign partner to surrender equity, but to maintain full control via long term management contracts. These policies frequently end up as a way of generating rents for local partners as a return for their ability to satisfy ownership regulations./3

/1 U.N. Center for Transactional Corporations, Policy Toward Recent Foreign Investment and Technology in Thailand, December 1979, p. 12.

/2 An example would be the U.S. Concept Practices Act.

/3 Richard Robinson, "Capitalism and the Bureaucratic State in Indonesia, 1965-1975," University of Sydney Doctoral Thesis, 1977.

4.32 An example of this that also reflects the nature of the costs to the Government of such interventions is given by the timber industry in Indonesia. New timber developments were technically closed to foreign firms in the mid-1970s and existing firms were expected to reach 51% local ownership by 1985. However, the intentions of these decrees have been effectively side-stepped since concessions issued to local companies have, in turn, been assigned over to a joint venture which typically starts with 70-80% foreign control. Although this is scheduled to be reduced to 49% in 1985, these companies are so highly leveraged that much of the debt capital is actually risk capital that has been provided by the foreign partner or foreign purchaser. Long-term management or supply contracts are used to maintain control of the company and the local participation represents little more than a payment to a local company for acting as a front to obtain the concession. While the contracts make provision for royalty payments, the actual collection is low as politically influential holders of concession licenses have been able to evade these payments. Thus, the ownership restrictions have, in fact, tended to divert the rent due to the Indonesia Government for the use of these resources into the hands of narrow interest groups./1

4.33 The returns to the Indonesian economy may, therefore, not be increased because added costs created by the ownership restrictions are shifted to consumers or workers and because reduced equity shares may distort incentives for foreign partners. For example, if the foreign partner's share is low, higher profits may be made in overpricing capital equipment or technology transferred to the firm or by supplying low quality inputs. The profits made in the supply of inputs to the joint venture can more than compensate for the losses recorded for the joint venture that is saddled with overpriced or inappropriate technology. For example, the share of before tax profits for foreign interests is reduced to 27% in a firm with 51% local ownership paying a 45% corporate income tax. Since the parent company's return on before tax profits is likely to be higher than this, transfer pricing for technology, goods, and services may become a problem.

/1 A more detailed analysis of the timber industry is available in C. Manning, "The Timber Boom" Bulletin of Indonesian Economic Studies Vol. 7, Nov. 1971, p. 35.

4.34 These restrictions have a substantial impact on the flow of foreign investment. The modern theory of private foreign investment identifies one of the advantages of private foreign investment in exploiting various technology advantages that are protected by commercial secrecy. Firms that are protecting production or management secrets will not invest in areas where their control of this knowledge is threatened by forcing controlling ownership shares to be transferred to local firms or individuals. Such restrictions will also restrict investment in very competitive export-oriented firms where the added costs cannot be passed on to consumers whose access to competing imports is effectively blocked by trade restrictions./1

Financial Policies

4.35 All restrictions on the operation of foreign firms in domestic markets for credit could also be given serious consideration by the Government with a view to eventually reforming them. As discussed in detail in Annex 4, current foreign investors in Indonesia do not have access to domestic investment credits. This reflects a belief that net returns in Indonesia increase significantly with the transfer of investment resources from abroad or are significantly reduced if such projects compete for domestic resources. However, an inflow of debt (on equity) capital involves a commitment for a future transfer in the opposite direction and there is little grounds for believing that domestic interests receive exceptional gains in these transactions or incur exceptional losses in alternative transactions based on domestic financial markets.

4.36 The importance of private foreign investment is in its contribution to the economic efficiency based on advantages in the transfer and application of technical and managerial know how. In countries with severe constraints on potential domestic saving, both financial and technological transfers are profitable and can be expected to occur simultaneously. However, in a country such as Indonesia where the central problem is the efficient use rather than the mobilization of resources, there is little justification for imposing restrictions on financing that limit the process of private foreign investment. Removal of these credit restrictions would

---

/1 This factor has led to discussions within the Government of the need to relax these restrictions for export-oriented firms. While passing the costs on to consumers in import-competing sectors does remove this "need", it doesn't affect the wisdom of removing these restrictions from all sectors.

also work to eliminate the investment of resources abroad which are then in effect, brought back through off-shore borrowing with increased costs of financial intermediation and restricted development of domestic financial institutions.

4.37 The use of tax incentives by the Government to encourage foreign firms to go public on the Jakarta stock exchange are explained mainly by the ownership issue. There was little enthusiasm in some fifteen reports touching on the potential for a stock market written during the 1960s and 1970s./1 However, the creation of a stock market provided a mechanism in which ownership could not only be transferred to Indonesian nationals, but the number of beneficiaries could be greatly increased. Concerns about the effectiveness of such policies are based on the high costs of the subsidies used to encourage firms to go public, on the risks imposed on unsophisticated investors on the potential for further losses in Government revenue that may be required to protect these groups from capital losses, on the possibility of stock manipulation and fraud in an economy with poorly developed accounting practices, on limited capital market expertise, and weak legal traditions and systems.

4.38 While some countries have forced sale of shares to the public at prices well below reasonable market value, this has severe effects on future foreign investment if not offset by increased (often hidden) subsidies and Indonesia correctly seems intent on avoiding this. However, the tax incentives used as an alternative are very costly, although this cost is well hidden. For instance, based on incentives available until March 1979, a firm with an after tax profit rate of 22% for the next five years and with a debt/equity ratio of 0.75 would have a present value of tax savings (calculated at an 8% discount rate) in excess of the value of the equity transferred to the public./2 This is a heavy cost to incur for policies that still only benefit upper income groups.

/1 References and a discussion of these reports is available in a forthcoming book on capital markets and foreign investment being prepared by Sumantaro and R. Dickie.

/2 Say the investment is $100 million, equity capital is $57 million, and debt capital is $43 million. The corporate income tax with the 22% after tax return would be 18 million at the 45% tax rate but 14 million at the 35% tax rate for firms selling 30% of equity to the public. The present value of the $4 million tax loss for five years discounted at 8% is $17.2 million. To obtain this tax saving, the firm must sell at a market price of $17.1 million (30% of $57 million).

4.41 If Government interventions in stock prices is minimal, there is a danger of extensive losses by investors due to stock manipulation or fraud, where manipulation of company accounts to evade taxes is already evasive, and where expertise in appraising companies' financial positions and prospects are limited. This is especially serious as Danareksa (the Government agency promoting the stock market) has encouraged sales of stocks to very unsophisticated investors who should not hold high risk portfolios. A collapse of an unsound market could greatly impede the development of the financial system and this would have strong negative implications for new foreign investment.

4.42 The political pressures operating to prevent losses in the stock market are more likely to lead to significant further use of Government resources in future support of the market. The costs will then be borne in foregone Government revenues that could have been available to support public sector development programs with higher returns and better income distributional effects. Given that a market has been instituted, the sensible policy on the part of the Government now is to greatly limit the incentives it is providing to firms to go public, to withdraw from excessive intervention in the market and to concentrate on the improvement of the legal and commercial infrastructure required for a sound financial system in which the stock market may eventually play an important role.

4.43 Finally the restrictions on joint ventures issuing corporate debt instruments in Indonesia should be abolished. The logic of this recommendation is similar to that suggesting that restrictions in short-term credit markets should be abolished. A corporate debt market would also be a useful precursor for the natural development of the stock market, since the expertise developed in the marketing and appraising debt instruments would provide a sound basis for the operation of the more complex share markets.

FOREIGN INVESTMENT PROBLEMS: THE VIEW OF FOREIGN FIRMS

Introduction

As discussed earlier, foreign firms in Indonesia have been operating under favorable economic conditions since the liberalization policies of the late 1960s. The Government in its attempt to attract foreign direct investment into the manufacturing and agro-industrial sectors has allowed foreign firms in Indonesia (a) to own fully their equity, (b) to employ rather freely foreign personnel at the managerial and technical levels, and (c) to transfer internationally capital, without obstacles, for profit and amortization payment as well as for purposes of borrowing. Furthermore, foreign firms have been operating within an open foreign exchange regime seldom found in countries at Indonesia's stage of development and the Government's prohibition of labor strikes and the strict enforcement of this law has afforded foreign, as well as Indonesian managers, the security of planning future production without the worry associated with the labor unrest. In spite of all these highly attractive features, there have been over the last few years, indications that foreign investment has been declining. Much of the explanation can be found in some of the specific features of the 1974 policies and regulations of the Indonesian economy discussed in Chapter 2.

As the effects of trade and other economic policies are pursued elsewhere, this chapter is focused on the major factors that, in the eyes of foreign investors, appear to have restrained the flow of foreign direct investments to Indonesia, particularly, in the manufacturing sector. For purposes of discussion, the factors affecting established foreign firms are presented first, followed by a discussion of the factors affecting expansion or entirely new projects. The discussion in other words attempts to present, on the one hand, the difficulties with the daily operation of the firms and on the other the hurdles foreign investors must negotiate in investing in Indonesia. This appendix, therefore, briefly discusses some of the major problems of foreign investment policies as viewed or interpreted by the foreign firms themselves. It should be emphasized that the views presented here are not necessarily shared by the World Bank. They, merely, represent opinions of foreign investors as expressed to the mission. Their views are important in that they express perceptions - regardless of their validity - that affect the behavior of foreign firms and, therefore, need to be addressed.

Problems Related to Established Firms

Managers of foreign firms already in operation in Indonesia have been concerned, in general, with the problems associated with governmental institutions, with the myriad of controls and regulations, and with the related issues of illegal payments. To amplify on the perception of foreign managers about the business environment of Indonesia, it will be helpful to present some of the common aspects and effects of institutions, control and regulations, and corruption as the foreign managers themselves see them.

Customs

Foreign firms have repeatedly expressed two major complaints about customs procedures: (i) the delays in ports; and (ii) the bureaucratic process. One manager, for example, noted that goods shipped by air can be cleared in two days in Singapore, but in Jakarta it would require two to three weeks. For goods imported by ship, the required time for customs clearance in Jakarta is anywhere from three to four weeks which is three to four times as long as in Singapore. All foreign managers agreed that the reasons for these delays are related to: (i) the extensive reclassification of imports in order to avoid high tariff rates, or to utilize low check-list prices, or both; (ii) efforts for funding the people to whom illegal payments must be paid in order to provide favorable tariff treatment and to expedite the clearing process; and (iii) the long list of procedures that have to be followed for getting things through customs./1 The improper functioning of the customs department, according to these managers, has imposed high costs on the firms not only in the form of illegal payments, but also, in the form of larger than otherwise inventories of raw materials and final goods and in the form of resources spent by the firms in obtaining privileged treatment, in other words, in their attempt to seek rents. A foreign manager, referring to the system of check-list prices, said that arguing for his company's claims on international price movements to those responsible for adjusting the check-list prices has been extremely time-consuming. As a result, he has decided to lobby in favor of specific rather than ad valorem duties.

In dealing with the intricacies of the business of clearing goods through customs, most foreign managers said that they have retained the services of specialized firms which deal directly with the customs departments. These firms, expediters or forwarding agents, seem to serve the market in that they help small firms lacking their own specialized staff with their expertise about customs.

Many firms raised the problems related to the inability of customs' officials, at the lower levels of the echelon, to handle complex transactions involving tariff classification and the corresponding tariff assessment. Consequently, firms make illegal payments either to reduce the waiting time and get ahead of the queue, or to affect a favorable tariff treatment on either legitimate or illegitimate grounds. The firms claim that the senior supervisors at customs are aware of these problems, but their solution further aggravates the situation. They have introduced more

---

/1 Annex 3 presents the various steps required to clear imported goods through customs.

complicated ways for policing corruption and for streamlining customs procedures; the customs supervisors do not opt to reduce the length of the formalities and, in particular, the discretionary power of the staff.

Problems with Tax Authorities

The tax office has been another target of specific and widespread criticisms among foreign managers. Most managers indicated that the lack of a legal framework for taxation, the presence of several tax rulings, and the complicate procedure for tax assessment makes illegal payments the most efficient way to expedite tax affairs. At the same time, however, they expressed the hope that specific problem areas of taxation could be improved. To begin with, many managers complained about the MPO tax. As they understood it, this tax serves the purpose of withholding corporate taxes. But, as it takes the form of a specific tax on various traded commodities, it bears no relation to the expected corporate tax liabilities of the various firms involved. It is applied in an ad hoc manner to some, but not all sales and goods, and also to firms on the BKPM's tax holiday regime as well as to firms which are fully subject to corporate income tax. In addition, the managers stated that if the amount of MPO collection in a given fiscal year was in excess of the corresponding official corporate tax liability of the firm for that year, it has only been refunded two to three years hence rather than been credited against the firm's other tax obligations such as sales taxes or import duties. For some of the firms, the accumulated balances of MPO taxes over the years have been considerable and the managers would very much like to see them converted to credits against any other current tax liabilities that they may have. In particular, foreign firms under the tax holiday regime would like to see their accumulated MPO balance specifically converted to credit for indirect taxes, such as sales taxes and/or import duties.

Finally, most managers were, on the whole, pessimistic about the effectivenss of recent legislation on accounting procedures and tax rate discounts. This new legislation provides tax incentive to firms which go public and/or have their books audited by reputable accounting firms. The incentives are in the form of permanent reduction on applicable corporate tax rates up to one half the normal rate. While most managers were complementary about the objectives, many stated that the implementation of this law had not yet been tested. Their pessimism was based on previous government actions meant to reduce corruption and streamline bureaucratic procedures which they claim have accomplished little. In addition, these managers claimed that the accounts of their books, by necessity of the multinational nature of their firms, have always been kept according to the best accounting practices available, but this has not precluded the three ongoing problems with tax authorities.

Indonesianization of Equity

In its effort to increase Indonesian ownership in the economy, the Government has issued regulations, applying to new and expansion projects undertaken by foreign investors, requiring that a certain percentage of the project's equity be owned by Indonesian nationals. But according to various managers, as with other rules, controls and regulations, the specifics of this policy's implementation have been vague, ad hoc, and therefore, inconsistent. Thus, for example, foreign managers have perceived that the share of Indonesian equity needs to be anywhere from 10-20% at the start of the project, to 30-60% at the end of some specified period of time. Although this time period has usually been ten years, the exact moment from which the law would become effective has varied from project to project. In some cases, the BKPM had stipulated the ten year period to start from the moment it has approved the investment application, while in other cases, from the moment the capital goods have cleared customs, and still in others, from the moment commercial production has started.

Therefore, as the time between an investment approval and the start of commercial production has often been about 5 years, according to many foreign firms, some projects received considerable more time than others as to where they are expected to have the Indonesian equity share increased to the required amount. Moreover, the foreign managers were unclear in understanding the specific implications of this policy for expansion projects. For example, does the regulation regarding Indonesian ownership apply only on the expansion part or on the total amount of the foreign equity? Can they, in other words, keep expanding and postponing forever Indonesian majority ownership of their firm? Most of the foreign managers interviewed were sympathetic to the participation of Indonesians in the manufacturing sector's capital equity. But they see problems if authorities pursue the Indonesianization of equity in an accelerated way. Currently, foreign managers feel that the most notable problems appear to be the vagueness of the policy, the inadequacy of the local capital market to absorb the financial requirements of this policy, and, finally, the lack of institutions, such as accounting firms and stock markets, at both the national and regional level which will help with the transition.

According to several managers interviewed, the BKPM's ruling on the Indonesianization foreign investment in agriculture has added to the usual high risks of plantation investments; the BKPM has ruled that the ten year period starts at the time the investment has been approved. For many large agro-industrial projects, the first year of positive cash flow usually comes between the sixth and tenth years from the planting time. To require, therefore, that foreign investors relinquish majority ownership at that time acts as a major disincentive to new investments in the field.

Foreign investors have, therefore, adopted two alternative ways in coping with the requirements of Indonesian equity. One is to offer the required percentage of shares to the public at large through the newly formed Indonesian stock exchange. This procedure has usually been followed by established large foreign firms during periods of expansion. But, "going public" has not been without problems, the most serious of which have to do with the small size of the stock exchange, and with the exclusion of private insurance firms and private banks from participating. Private insurance firms, because they are well-managed firms in general, are in a position to invest considerable cash in the stock market, increase its competitiveness and improve the quality of transactions. For new foreign investment projects in general, the method preferred by the foreign investors has been to recruit a local Indonesian(s) as their partner. In many cases, the local shareholders selected for the equity requirements either have strong connections with Indonesians with power or are members of that group.

Distribution

Another issue of concern to foreign managers was the regulation prohibiting foreign manufacturer from distributing products because it has been reserved for Indonesians. It seems this regulation has been widely applied with very few exceptions. One such exception has been made for the pharmaceutical industry where foreign manufacturers have been allowed to undertake all or part of the distribution of the drugs they have been producing locally. Another industry where foreign firms have been allowed some form of trading are the tire manufacturers. They have been allowed to import tires from their foreign affiliates which they do not produce locally, but they are not permitted from distributing these or the locally manufactured tires at the retail level. Nor are they allowed to import and distribute auxiliary products that their overseas affiliates produce. Consequently, retail distribution of such a company's products is not well coordinated as this company is responsible for the import of tires and Indonesians unrelated to his firm, are responsible for the related auxiliary products.

According to many foreign firm managers, it appears that prohibiting foreign firms from distribution activities has affected Indonesians adversely in two distinct ways. First, as many indigenous distribution firms are relatively high cost operations - a point on which all foreign and most Indonesian managers agreed - the Indonesian consumer pays a high price for the product of the retail level and for this kind of experimentation in developing local entrepreneurship. Second, and probably more important, the absence of foreign distribution firms has prevented the Indonesians from obtaining the best training opportunity for developing the required skills. All managers agreed that there are no better ways for learning the ins and outs of distribution other than working under experienced management, which foreign firms can usually supply. The discussions, however, did not reveal whether this was a problem which arose from the domestic nature of the firms or whether it encompassed the broader problems associated with regulations related to distribution and transportation.

Issues Related to New Foreign Investments

All foreign managers claimed that the most important difficulties a new foreign investor faces in Indonesia relate to the BKPM procedures and the many unresolved issues associated with the Indonesianization of equity which have already been discussed. The BKPM was an important target of complaints among many foreign managers. Purported to cut through the red tape and to assist investors, the BKPM has, in their view, added to the existing bureaucracy one more layer of problems and difficulties. Some of the managers referred to the illegal payments paid to BKPM officials by investors to obtain quick service and favorable treatment with respect to fiscal incentives.

From the foreign firms' point of view, a troublesome BKPM item is the master list. This is a list duty-free imports of capital goods granted to investors as part of their incentives facilities./1 As considerable time elapses between the BKPM's approval of duty-free imports, as identified in the master list, and their actual importation, changes of items on this list are inevitable. Such changes usually occur, according to the managers, for reasons of availability, of unexpected price changes and of simple changes in original intent as a result of new and better information. The time required to get approval for the substitution of the major item in the master list is about one year. In this case, some investors have decided to clear the new item through customs, pay the duties and then have the duties reimbursed. But most of the managers found this to be a risky procedure because, they claimed, once duties have been paid and the item imported, the investors have little or no bargaining power to force the BKPM to approve the replacement. Thus, they try to settle the issue of duty payment prior to customs clearance, and this has, on occasion, taken up to a year to accomplish.

All of the managers agreed that the main reason for the BKPM's ineffectiveness is that it is not an independent government agency; its staff are on loan from the various government agencies and departments. Thus, the BKPM acts as a hub in which the various ministries are represented with officials who have not been delegated adequate authority to decide on the investment proposals. These officials simply act as messengers for the proposals to their respective ministries which ultimately decide on them. All of the managers preferred the old system of personally carrying the investment application from office to office for approval. They felt that this was a fast and easy way to locate the troublesome spots of the approval's procedure and do something about it. It is not surprising, comfortable with the recent decision of the Government that foreign investors, regardless whether they seek incentives or not, must submit their investment proposals only through BKPM.

/1 Certainly, the master list problem pre-dates BKPM, as it has always been connected with the investment incentive packages in Indonesia.