INDONESIAN INVESTMENT LAW

Peter Holland, Swinburne University of Technology,
PO Box 218 Hawthorn, Australia 3122
(03) 9214-8097, pholland@swin.edu.au

ABSTRACT

This paper examines the evolution of the law on foreign investment in Indonesia. The paper focuses on the conflict between the forces advocating an open door policy for foreign investment and those advocating controls and restrictions. It also focuses on periods of economic and social crisis, which have been the key turning points in foreign investment policy in Indonesia.

Introduction

On 29 May 1998, just days after his accession to the presidency, B.J. Habibie announced a liberalisation of foreign investment law in Indonesia. In turning to foreign investors in response to an economic crisis, the government was following precedents set in 1932, 1951, 1967, 1986 and 1994. The purpose of this paper is to examine the historical context of Indonesian investment law with a focus on the response to economic crises.

The Great Depression and Indonesian Investment Law

In the colonial period Dutch plantation interests had vigorously opposed industrialisation. This opposition faltered in the Depression of the 1930s. The Crisis Import Ordinance of 1933 stimulated Indonesia's first period of industrialisation, one dominated by foreign firms. This was the first example of an economic crisis provoking a liberalisation of foreign investment law.

Independence 1945-1965

The post-independence period was the second period when an economic crisis resulted in a policy to attract foreign investment. The War had devastated the economy. Therefore the Economic Urgency Plan in 1951 and the Foreign Capital Investment Law of 1958 were enacted to encourage foreign investment. However this policy was not successful due to the enormous discretionary powers conferred on the administrative agencies. Foreign investors were also deterred by the growing political problems in the 1950s.

The 'Guided Democracy' period began in 1957 when regional military coups led to the resignation of cabinet and the proclamation of martial law. Economic policy in this period saw a lurch towards economic nationalism under President Sukarno. The Foreign Capital Investment Law was repealed in 1959. Any prospect of significant new foreign investment disappeared with the nationalisation of Dutch and other foreign assets. Foreign direct investment fell to only $84 million from 1956 to 1965 consisting entirely of investments by foreign oil companies. Inflation had spiralled at a rate of 594% in 1965 following rates of 135% in 1964 and 128% in 1963.

The 'New Order' and the Open Door Policy 1966-1973

President Suharto took power after an unsuccessful 'coup' in 1965 blamed on the Communists. The new government followed the advice of a small number of economists, the 'technocrats', in resolving the economic crisis. Indonesia's economic rehabilitation was based on state planning and foreign capital.

The Foreign Investment Law of 1967 opened Indonesia to foreign investment for about six years. The Law contained guarantees against nationalisation, guaranteed repatriation of profits and offered generous investment inducements with minimal conditions attached. There were initially no restrictions on foreign equity such as obligations to take on local partners. The growth of the Japanese presence in Indonesia in this period was particularly significant. The result was a rapid recovery of the economy with an average annual growth of 7.7% during the first Five Year Plan.
Economic Nationalism 1973-86

The turning point in economic and political policy came with the Malari affair in January 1974. This began with student demonstrations against the Japanese Prime Minister, Tanaka, and developed into mass riots and conflict within the governing elite. The government was conscious of developments in Thailand where in 1973 mass demonstrations had forced into exile Field Marshall Thanom Kittikachorn, a long term prime minister. To avoid such a possibility, the Indonesian system of government, which had previously been relatively open and pluralistic, became closed and authoritarian after the Malari affair.

Following the Malari affair, the government restricted foreign investment and introduced measures to assist domestic business. The government was able to do this because it had been freed from its dependency on foreign aid and investment by the oil boom of 1973-4. The new limitations on foreign investment from 1974 required foreign investors to undertake joint ventures with an Indonesian partner. The Indonesian equity was to be increased to 51% within ten years. In addition to divestiture requirements there were minimum capitalisation requirements. Additional sectors were closed to new foreign investment. Regulations relating to employment of expatriate personnel were tightened. Over and above these restrictions, foreign investment was discouraged by opaque and costly entry procedures. The effect of these post-Malari measures was to discourage any significant foreign investment.

The Oil Crisis 1986

A collapse in oil prices in 1986 had disastrous consequences for the Indonesian government’s revenue base. The technocrats thus regained ascendancy in economic policy and from the mid-1980s the economy was progressively deregulated. The fundamental aim of the technocrats was to change from a high-cost, import-substituting industrialisation to an export-driven market economy utilising Indonesia’s comparative advantages of plentiful labour and natural resources. The principal feature of the foreign investment law was the use of performance standards targeted for export production and regional development. Foreign investors satisfying these standards had dispensations from the onerous local equity requirements.

The government’s deregulation strategy confronted powerful opposition within Indonesia from the economic nationalists. Therefore reform was concentrated on the financial sector rather than the real sector where monopolies controlled by cronies of the President continued to flourish. Nevertheless Indonesia achieved a major restructuring of the economy between the mid-1980s and the elections in 1992. Foreign investment approvals rose from $1.46 billion in 1987 to $8.78 billion in 1991. A significant result of the private investment in industry was to free the economy of its dependence on oil.

Resurgence of Economic Nationalism 1992

The period after the 1992 elections in Indonesia was one of political uncertainty. In the economic sphere the uncertainty was focused on the resurgence of the economic nationalists. The economic nationalists, led by the Minister for Research and Technology, B.J. Habibie, believed that Indonesia’s industrialisation should not be dependent primarily on attracting foreign private capital into labour-intensive, low-technology industries. They believed in state enterprises and state planning, in particular the committing of more government resources to high technology undertakings. However as the economic nationalists rose to power, Indonesia began to confront new economic difficulties. Economic growth fell from 7.4% in 1990 to 6.6% in 1991 and 5.4% in 1992. Thus the technocrats were able to persuade Suharto of the need for a radical liberalisation of the investment regime.

The 1994 Liberalisation of Investment Laws

Government Regulation No. 20/1994 represented a significant victory for the technocrats over the economic nationalists. The economic imperative behind the new measure was the realisation that other countries had developed more attractive climates for foreign investment. Indonesians were aware that as the global flow of foreign direct investment rose from $79 billion in 1986 to $204 billion in 1990 only $1 billion extra had flowed into Indonesia. The 1994 regulation was a dramatic reversal of a long history of requirements concerning minimum capital, local participation and divestiture dating back to the Malari crisis of 1974. It permitted foreign investors to operate wholly owned firms except in infrastructure where they could own 95% of a joint venture vehicle.
For three years until the Asian economic crisis the liberalised investment regime established by the 1994 regulation was successful in boosting foreign investment and restructuring the economy. In 1983 the manufacturing sector had contributed only 12.7% of GDP but by 1994 this had risen to 22.3%. Indonesia by 1997 seemed to have established a sound foundation for its transformation into a modern industrial economy.

The Asian Financial Crisis

With the Asian financial crisis in 1997 the political constellation shifted. Indonesia faced its most severe economic crisis in three decades. The economic downturn produced a political crisis, with distinct echoes of the 1973 Malari riots. In May 1998 President Suharto was forced to resign and a transitional government under President B.J. Habibie took office. In June 1999 Indonesia had its first democratic election in 44 years which resulted in a potentially unstable Parliament with no political party or coalition dominant. In October 1999 Abdurrahman Wahid was elected president of Indonesia.

As a result of the 1997 financial crisis, foreign direct investment fell dramatically. On 31 October 1997 the Indonesian government concluded an agreement with the IMF on measures to deal with the crisis. The IMF agreements require complex and important reforms, particularly in the core areas of bank and corporate restructuring. Pursuant to these agreements significant reforms in investment law were introduced from 1997 to 2000.

On 29 May 1998 the government announced a significant liberalisation of foreign direct investment in an attempt to recover investors' confidence. The 1998 package provided for sweeping changes to investment procedures to cut bureaucracy and increase transparency. It also promised that the system of tax incentives would be made transparent. Another significant liberalisation of investment law was the reduction in the number of sectors closed to foreign investment. In 1998 restrictions on the retailing and domestic distribution operations of foreign investors were lifted. In July and August 2000 further sectors were opened up for foreign investment. Foreign investment in the banking sector was permitted for the first time in 1988.

The Impact of the 1997-2000 Liberalisation of Investment Law

Liberalisation of foreign investment law has been the traditional Indonesian response to economic crises. It was therefore hoped that the measures adopted under the IMF-supported reforms would restore investor confidence. However liberalisation measures in 1997-2000 have not had the success of their predecessors. Foreign investment in Indonesia fell by 60% to US $13.6 billion in 1998 and continued to fall in 1999 and 2000. Foreign investment is primarily determined by the political environment, the economic climate and the general legal system rather than by specific investment laws. Surveys of foreign investors consistently report that these factors rank above investment laws in determining the attractiveness of a host country. The Indonesian experience is testimony to the limitations on investment law reform to attract foreign investment. Despite significant reforms to the investment regime, political instability, an unsatisfactory legal regime and the plummeting Indonesian rupiah have deterred foreign investment.

The crisis of 1997 arguably was not inevitable. The nation had overcome similar problems after the collapse in oil prices in 1986. The major factor in 1997 responsible for wiping out thirty years of development was domestic policy mismanagement of the regional crisis. From November 1997 until May 1998 Suharto made a series of decisions which destroyed domestic and international confidence in Indonesia.

Suharto's successors in Indonesia face crises on many fronts without the power and economic legitimacy that Suharto had enjoyed for almost thirty years. Unlike the position in 1967 when Indonesia surmounted an economic crisis of a similar magnitude, there is today no clear centre of power. As in the 1950s there is competition between the President and the Vice-President, the military is factionalised and disdainful of the civilian politicians, there is significant regional conflict, and the Parliament consists of an unstable array of political parties and interest groups. Furthermore key figures from the old regime especially Suharto and Wiranto continue to exercise great power. Indonesia thus presents to foreign investors a picture of paralysis and civil disorder. The issue is whether a new political order can be constructed which will restore the credibility of the nation for domestic and foreign investors.