Economic Policy and Investment Law in Indonesia

by

Peter Holland

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Introduction

Since independence the law on foreign direct investment in Indonesia has been determined by a political contest between four competing forces: economic rationalism, economic nationalism, collectivist ideologies and powerful vested interests. The Indonesian political system confers massive powers on the President and therefore this competition has focused on influencing President Suharto's economic policy. In the current era, following the general elections in 1992, the investment regime has become more liberal yet more uncertain as the government has attempted to balance these competing pressures. The latest liberalisation of the investment regulations in 1994 saw the debate take an unusual course, with claims that the regulations were unconstitutional or illegal and threats to take the matter to the Supreme Court.

Politics and Economic Policy in Indonesia

A key issue for developing nations today is the role of the state in the process of economic development. It is now generally accepted that export oriented industrialisation is the building block of economic success with developing countries viewing South Korea, Taiwan, Hong Kong and Singapore as models to follow. However there is significant debate over how this is to be achieved.

Neo-Classical economists believe .that the Northeast Asian states achieved success by relying on market forces and encouraging non-indigenous capital and technology. Representing this perspective, the Japanese economist Kunio Yoshihara describes capitalism in South-east Asia as imperfect or 'ersatz' capitalism: 'South-east Asian capitalism is ersatz because it is dominated by rent-seekers. What they seek is not only protection from foreign competition but also concessions, licences, monopoly rights, and government subsidies...As a result all sorts of irregularities have flourished in the economy.'[1] Neo-classical theory on economic development tends to take the position that foreign investment is wholly beneficial to the host country and that domestic and international investment law should seek to encourage it.[2] Direct foreign investment has been an important component of the growth of Southeast Asian economies which, in the 1980s, generally adopted open investment regimes as the basis of an export led industrialisation policy.[3]

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[1] Yosihara, K., *The Rise of Ersatz Capitalism in Southeast Asia,* Oxford University Press, Singapore, 1988, p. 3-4.
[2] The benefits include increased capital, improved technology, creation of employment, construction of infrastructure and transfer of skills.
[3] Japan's Ministry of International Trade and Industry estimated in 1991 that in Singapore foreign affiliates accounted for almost 90% of secondary exports, in Malaysia 60%, in the Philippines more than a third and in Indonesia more than a fifth of all exports. East Asia Analytical Unit, ***Changing Tack: Australian Investment in South-East Asia,* A.G.P.S., 1994**, p. 20.

In Indonesia the classical economic development position influences economic technocrats concentrated in the Ministry of Finance, Bappenas (the Planning Agency) and the Bank of Indonesia. However the technocrats' belief in free markets rather than govemment intervention is alien to mainstream Indonesian political thinking. As a result the influence of the technocrats in Indonesia has been greatest in difficult economic periods, especially the immediate post-Sukarno years and the period from 1984-1991.

There is also a 'revisionist' view of the success of the Northeast Asian economies. The foundation of this alternative view was made by Alice Amsden on Korea and Robert Wade on Taiwan.[4] The revisionist view has become so well accepted that even the high citadel of economic orthodoxy, the World Bank, has partially accepted it.[5] This approach holds that the government should 'pick winners' and allocate resources such as credit, foreign exchange and public investments to achieve selected goals. For investment law this view would impose significantly more controls on foreign investment. Three groups within Indonesia would seek some legitimacy from this alternative view of the success of the Northeast Asian economies: collectivists, 'rent-seekers' and economic nationalists.[6]

Traditional Indonesian economic and political thinking values collectivism rather than the free market ideology of the technocrats. The 1945 Constitution was a product of a revolution against the colonial order and therefore has an underlying ethos opposed to private property and profit The Constitution is founded on the notion of the 'integralist state', one based on collectivism rather than individual rights. In particular Article 33 envisaged a large role for the state in the economy, particularly regarding ownership and control of land and resources.' Although collectivist philosophy has not been strongly represented in government since 1965, Article 33 of the 1945 Constitution was a basis for powerful public opposition to the 1994 liberalisation of investment regulation.

'Economic nationalists' constitute a third grouping influencing economic policy. At present the most influential economic nationalist is the Minister for Research and Technology, B.J. Habibie The economic nationalists believe in active government intervention in the market place through the identification and support of target industries. The economic nationalists do not want Indonesia's economy to be dominated by foreign and ethnic Chinese enterprises. Nor do they want Indonesia to be dependent on 'footloose' low technology industries which can easily relocate to competing low-wage Asian economies. Through the influence of the economic nationalists, a feature of Indonesia's industrial policy has been a prominent role for state enterprises in strategic industries, especially in developing high-technology undertakings.

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[4] Amsden, A, *Asia's Next Giant: South Korea and Late Industrialisation,* Oxford University Press, Oxford, 1989, Wade, R, *Governing the Market,* Princeton University Press, Princeton, 1990.
[5] World Bank, *The East Asian Economic Miracle,* World Bank, Washington, 1993.
[6] See generally Hill, H., *Indonesia's New Order: The Dynamics of Socio-Economic Transformation,* Allen & Unwin, Sydney, 1994, Schwartz, A., A *Nation in Waiting: Indonesia in the 1990s,* Allen & Unwin, Sydney, 1994, Robison, R., *Indonesia: The Rise of Capital,* Allen & Unwin, Sydney, 1986, Vatikiotis, M., *Indonesian Politics under Suharto,* Routledge, London, 1993, Bresnan, J., *Managing Indonesia: The Modern Political Economy,* Columbia University Press, New York, 1993.
[7] Article 33(1) states that 'the economy shall be organised as a cooperative effort, founded upon the basis of family spirit' The Elucidation of this Article states that 'branches of production essential to the state and which govern the life of the public must be controlled by the state. If not, the reins of production will fall into the hands of powerful individuals and the public will be oppressed. Only businesses not governing the life and living of the public may be controlled by individuals.'

The final influential group in economic policy making are the 'rent-seekers' particularly military officers and leading ethnic Chinese with links to President Suharto.[8] There has also been a recent rise of Javanese in business, especially members of the president's family. The role model of the president's family is important in changing the traditional Javanese prejudice in favour of agriculture and government rather than trade.[9] However there are frequently expressed concerns about collusion and corruption, as these powerful vested interests have become extraordinarily wealthy through a system of patronage which includes import and trading monopolies, access to state contracts and credit privileges. The 'rent-seekers' are opposed to the transparent rules, impartial administration and market forces supported by the technocrats. From the viewpoint of foreign investors their influence means that it may be necessary to join with powerful domestic groups to succeed in a difficult environment.

The influence of the 'rent-seekers', the collectivists and the economic nationalists has meant that, unlike Korea and Taiwan, at the micro level Indonesia has not been a 'hard state'. Government support of firms has never been as tightly tied to performance criteria as the successful Northeast Asian models. State enterprises and enterprises associated with the president's associates are supported even when it is economically irrational to do so. Nevertheless Indonesia has succeeded in transforming itself from one of the poorest countries in the world to an emerging middle income economic power. Indeed it can be argued that Indonesia's favoured treatment of politically well-connected people has prevented it from the adopting mistakes of the Northeast Asian economies, especially adopting industrial selectivity along the South Korean lines.[10]

The classical and revisionist theories of economic development have different approaches to foreign investment regulation. The classical view would encourage investment through a variety of fiscal and non-fiscal incentives. The revisionist view would emphasise devices which screen investment to encourage entry of desirable investments and to maximise benefits for the host state. Indonesian investment law is therefore the outcome of a complex relationship between these forces.

Indonesian Investment Law: An Overview

Indonesia has seven basic investment goals which it hopes to attain simultaneously. They are increased production, improved industrial structure, new work fields, equalisation of income, utilisation of human and natural resources, promotion of exports and environmental conservation.[11] From 1967 until March 1995 over US $105.8 billion in direct foreign investment has been approved with most directed into the chemicals, paper, metal goods, hotels, electricity, basic metals and textiles industries.[12] In part because of this investment, Indonesian per capita income rose from

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[8] Such as Lim Sioe Long (Sudono Salim) of the Salim Group.

[9] There were similar aristocratic attitudes that trade was shameful in imperial Rome and industrialising Britain. For a discussion of the virtual elimination of the once flourishing Javanese middle class in the colonial period see Kahin, G., ***Nationalism and Revolution in Indonesia,*** Cornell University Press, Ithaca, 1952, ch 1.

[10] Hill, H., 'Cloves and kretek symbolise the path of progress', ***Australian Financial Review,*** 3 May 1995.

[11] Ministry of Investment/Investment Coordinating Board (BKPM), ***Investment in Indonesia.*** Jakarta, 1994, p.6.

[12] Excluding investment in oil and gas, mining and banking. Republic of Indonesia, The Investment Coordinating Board (BKPM), A ***Brief Guide for Investors,*** Jakarta, 1995, p. 4-6. This compares to US $143 billion invested by domestic firms.

US $70 in 1970 to US $920 in 1994. President Suharto, in his 1995 State of the Nation address, said Indonesia's target is per capita income of US $1,280 in 1999 and the status of a newly industrialising country.[13]

There are many types of incentives states may offer to attract foreign investment.[14] Fiscal incentives offer the investor a direct monetary gain and include tariff protection, tax holidays, accelerated depreciation, investment allowances, special tax exemptions, withholding tax and double tax agreements[15] and other tax concessions such as exemption from import duties in priority industries. In Indonesia, unlike countries such as Malaysia, limited use has been made of tax incentives since 1984. Of the non fiscal incentives, industrial estates are extensively used in Indonesia to assist regional development and to promote the manufacture of export products. Like many other countries Indonesia has investment guarantees and has sought to monitor foreign investment yet encourage it by establishing a 'one-stop' investment approval process.

Indonesia has had three main mechanisms for regulating foreign investment and to ensure that it benefits from it. First are requirements that foreign investment should be by joint venture with Indonesia firms. Although since 1994 wholly owned foreign investment generally is permitted, there are still powerful strategic reasons for prefemng to invest through joint ventures. Secondly there are certain areas in which foreign investment is not permitted or is conditionally permitted. Third investment have to be approved by the President of Indonesia after scrutiny by the Investment Coordinating Board (BKPM). The current policies and legal institutions on direct foreign investment have their foundations in Indonesia's colonial period. It is useful therefore to begin with an examination of that era to understand the dynamics of the Indonesian foreign investment regime today.

Colonialism and the 'Old Order' 1920-1965

Industrialisation has been an integral part of Indonesia's economic development and growth. The country's first period of industrial growth took place in the 1930s.[16] However the Japanese occupation in the Second World 'War devastated the economy, especially manufacturing. After independence, the 1950s saw the beginning of the fundamental division of Indonesian economic thought into two orthodoxies, the technocrats and the economic nationalists.

From independence until 1957 there was a Western-style democracy with more than 30 political parties. The technocrats were ascendant in the cabinets of Wilopo, Sumitro and Sjafruddin early in this liberal democratic period.[17] In 1951 the Economic Urgency Plan attempted, unsuccessfully, to promote foreign investment subject to a 51% Indonesian ownership requirement and the reservation of certain areas for exclusive domestic ownership. Although the attitude towards foreign investment became less enthusiastic in the mid 1950s, a favourable Foreign Capital

[13] *Jakarta Post, 18* August 1995.

[14] For a comparison of Malaysia, Thailand and Indonesia see Bishop, B., 'Regulation of Direct Foreign Investment in South East Asia', in Taylor, V., ***Australian Perspectives on Asian Legal Systems,*** Law Book Company, Sydney, forthcoming.

[15] Indonesia has double taxation avoidance agreements with 29 countries including Australia.

[16] See generally Hill, H., ***Foreign Investment and in Indonesia,*** Oxford University Press, Singapore, 1988, Ch. 1.

[17] Robison, R., ***Indonesia: The Rise of Capital, Ch.*** 2.

Investment Law was passed in **1958.** Foreign investors, however, were deterred by the discretionary powers of the administrative authorities and the political problems of the late **1950s.**

In the 'Guided Democracy' period from **1959** until **1965** President Sukarno, the army and the Communist Party competed for power. 'Guided Economy' saw a lurch towards economic nationalism. In December **1957** Dutch enterprises were nationalised and the Foreign Capital Investment Act was repealed in **1959.** The hostility of the regime to foreign investment from **1957** to **1965** caused direct foreign investment to fall to only $84 million consisting entirely of investments by foreign oil companies.[18] **As** a result of the policies of the Old Order government under Sukarno, by **1965** Indonesia was an economic disaster. Inflation had spiralled at a rate of **594%** in **1965** following rates of **135%** in **1964** and **128% in 1963.** .The population was amongst the poorest in the world with a GNP per head half that of India's.[19] Thus in **1966** the New Order inherited a devastated economy.

The 'Open Door Policy' 1966-74

President Suharto took power after an unsuccessful 'coup' in **1965** blamed on the Communists and began the economic rehabilitation of the nation. At that time governments in South and Southeast Asia were perceived as too weak to provide effective government and to take difficult economic decisions. Gunnar Myrdal believed that: 'As things look at the beginning of **1966,** there seems to be little prospect of rapid economic growth in Indonesia'.[20] The New Order period began therefore with Indonesia in an economic and political crisis. Suharto, an army general, defeated Sukarno in a gradual power struggle and secured a constitutional transfer of power. The New Order government then, through its use of military power and the destruction of its rivals, had an ability to implement policies which the Old Order lacked. The issue was what economic policy?

The New Order regime in **1966** attained power without a clear economic policy. Had the leftist coup succeeded, Indonesia could have adopted a Marxist economic strategy similar to that of North Korea or China. With the military dominant after the coup, the New Order government could also have adopted an isolationist economic policy like the that of the military regime in Burma. Instead the New Order government took advice on economic policy from a small 'number of economists, the 'technocrats'. Indonesia's subsequent economic rehabilitation was therefore based on state planning and foreign capital. To stimulate investment, one of the first actions of the new government was to enact Law 1/1967 on Foreign Investment which was followed by the Domestic Investment Law in **1968.**

The **1967** Law is still the fbndamental legislation on foreign investment in Indonesia but, like all 'Basic Laws' in the Indonesian system, is implemented through a series of government, presidential and ministerial regulations. **As** economic and political policy has changed, this has permitted dramatic changes in the investment regime without any change in legislation. The initial position of the govemment, under the influence of the technocrats, was to offer foreign investors an open door.

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[18] **Hill, H.,** ***Foreign Investment and Industrialization in Indonesia,*** **p. 5. The other capital flows came mainly from the socialist bloc in the forms of loans to state owned enterprises.**
[19] ***Far East Econoniic Review,*** **13 February 1969.**
[20] **Gunnar Myrdal,** ***Asian Drama: An Inquiry into the Poverty of Nations*****, Pantheon, New York, 1968, p. 489.**

The Foreign Investment Law 1967 requires that a foreign company trading in Indonesia must be a legal entity incorporated under Indonesian law as a liited liability PMA company (Foreign Direct Investment company).[21] The major features of the Act and the regulations encouraging investment in 1967 were:

- Article 15 provided for a variety of tax concessions.
- Articles 19 and 24 provided a guarantee that profits and proceeds from the sale of shares could be repatriated and an accelerated depreciation allowance.
- There were few restrictions on the employment of foreign personnel.
- There were initially no restrictions on foreign equity such as obligations to take on local partners.
- Articles 21 and 22 provided for a 30 year guarantee to investors that there would be no nationalisation, and further that in the event of nationalisation compensation would be paid.

A new administrative apparatus was created. Foreign investment (and some domestic) was regulated by the BKPM (*Badan Koordinasi Penanaman Modal)*, the Investment Coordinating Board.[22] Real power however lay with the departments in whose jurisdiction a proposed project lay.[23]

In addition to the guarantees against nationalisation in Articles 21 and 22 of the 1967 Law, the new government began making Investment Guarantee Treaties with the USA and some European countries.[24] Further protection for potential investors was given in 1968 when Indonesia signed the multi-lateral Convention on the Settlement of Investment Disputes between States and Nationals of Other States. The Convention established the International Centre for the Settlement of Investment Disputes, an organ of the World Bank.[25] Although in its first twenty five years of existence the Centre only determined 26 disputes, it has played a useful role in promoting international investment.[26] However it is unclear to what extent such investment treaties boost investor confidence in host states. It has often been suggested that foreign investment depends more on a favourable political and economic climate rather than on the creation of a legal structure for investment protection.[27]

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[21] *Penanaman Modal Asing.*

[22] Initially foreign investment was administered by the Technical Team for Foreign Investment - *Panita Teknis Penanaman Modal.* Firms owned by Indonesians are regulated by the Domestic Investment Law No. 611968. Domestic firms seeking financial incentives had to register under the former Act as PDMA (Penanaman Modal Dalam Negeri) companies and be regulated by the BKPM. The BKPM is not responsible for oil and gas, mining and banking which are administered separately.

[23] For the licensing procedures see BKPM, *A Brief Guide for Investors.* Ch. 7.

[24] An Investment Agreement between Indonesia and Australia came into effect in 1993.

[25] The other major instrument of foreign investment law for which the World Bank has been responsible is the Multilateral Investment Guarantee Agency which creates a scheme for the insurance of foreign investment to which all states can subscribe. Indonesia is a member of the MIGA.

[26] For an analysis see Hirsh, M., *The Arbitration Mechanism of the International Centre for the Settlement of Investment Disputes*, Martinus Nijhoff, Dordrecht, 1993. In *Amco v Indonesia* (1986) *25 ILM* 1441 an ICSID tribunal ordered Indonesia to pay damages to an American company arising from a dispute over the construction and operation of a hotel.

[27] Sornarajah,, M. *The International Law in Foreign Investment*, Cambridge University Press, Cambridge, 1991, p. 235-7.

The period up to 1973 saw Indonesia's economy recover rapidly with an average annual growth of 7.7% during the first Five Year Development Plan (Repelita I).[28] By the end of the 1970s the BKPM had approved 177 proposals, of which only 37 were wholly owned foreign projects.[29] Thus even in the period when foreign investors could operate through wholly owned firms, the majority chose to use a joint venture with a domestic partner.

The growth of the Japanese presence in Indonesia in this period was particularly significant. Japanese investment started later in Indonesia than in other Southeast Asian countries. In 1967 Japan had just two investment projects valued at $6.7 million but by 1969 this had risen to seventeen projects worth $132.2 million.[30] Two thirds of this investment was in textiles which caused the failure of many Indonesian firms in the textile industry and the subsequent public hostility to foreign investment. Both the right and the left criticised the liberalisation of economic policy especially the encouragement of foreign capital which was characterised as 'selling out' to foreign capital. Thus the 'free market' strategy with its open door policy towards foreign investment was abandoned in the early 1970s.

Economic Nationalism 1974-83

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 a recent precedent in Thailand where in October 1973 mass demonstrations had forced into exile Field Marshall Thanom Kittikachorn, a long term prime minister.[31] 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.[32] Tight controls were imposed on civil society including the unions, the press, political parties, universities, Islamic institutions and business groups. The result was that by 1983 Suharto had consolidated power with no potential for opposition either from the army or civilian groups.

Following the Malari affair, the government tightened the terms of foreign investment and introduced measures to assist domestic business. The government able to do so because it had been freed from its dependency on foreign aid and investment by the oil boom of 1973-4. Economic nationalists assumed control of trade and industry policy, leaving the technocrats largely confined to macroeconomic policy.

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 a

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[28] BKPM, *Investment in Indonesia*, p.11.

[29] However a major problem was that, largely due to administrative problems, only $300 million was actually invested of almost $2 billion worth of approvals from 1967 to 1972. McCrawley, P., 'Survey of Recent Developments', (1972) 8 No. 3 *Bulletin of Indonesian Economic Studies* 1.

[30] Vatikiotis, M., *Indonesian Politics under Suharto*, p. 35.

[31] Crouch, Harold, *The Army and Politics in Indonesia*, Cornell University Press, New York, 1978, p. 311-2.

[32] A prominent example was the protracted campaign by Mochtar Lubis in his newspaper against General Sutowo.

ten years.[33] In addition to divestiture requirements there were minimum capitalisation requirements. Additional sectors were closed to new joint ventures.[34] Activities that required large amounts of capital or technology remained open while many basic industries were closed completely. Regulations relating to employment of expatriate personnel were tightened. Over and above these restrictions, foreign investment was discouraged by entry procedures which became 'opaque, complex, time consuming and costly'.[35]

Indonesia thus began to use a complex series of requirements concerning local equity, minimum capitalisation and divestiture which had the effect of discouraging new direct foreign investment. From 1967 to 1985 Malaysia received three times as much foreign investment as Indonesia and Singapore four times.[36] Most Indonesian investment was for the expansion of existing firms rather than the entry of new enterprises. The bulk of this non-oil investment was import substituting, aimed at sales in the domestic market rather than exports.''

The return to dominance of the economic nationalists in the 1970s saw emphasis placed on state enterprises rather than private investment. The national oil company, Pertamina, became the focus of the economic nationalists' drive for a high-tech modernisation of Indonesia.[38] However by 1981 the nation was dangerously dependent on oil revenues. In that year exports of oil and gas constituted 80% of exports and oil revenues constituted 71% of the government's budget receipts.[39] The economic technocrats, particularly the World Bank, were critical of this direction in Indonesian economic policy. The government did not accept such criticism until the second oil boom led in 1983 to recession in the industrial economies and a collapse in oil prices in 1986 with disastrous consequences for oil exporting nations.[40]

With the collapse of the government's revenue base, the technocrats regained ascendancy in economic policy. From the mid 1980s the economy was progressively deregulated and liberalised. including a return to a policy of encouraging foreign investment. The fundamental target of the technocrats was to change from a policy of high-cost, import-substituting industrialisation to an export-driven market economy utilising Indonesia's comparative advantages of plentiful labour and abundant natural resources.

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[33] See Arndt, H., 'Survey of Recent Developments', (1975) 11 No. 2 ***Bulletin of Indonesian Econoniic Studies 1*** and Hill, H., 'Survey of Recent Developments', (1981) 20 No. 2 ***Bulletin of Indonesian Economic Studies 1.***

[34] Even before the Malari incident in the early 1970s certain fields had been closed to foreign investors such as weaving mills located on Java and selling to the domestic market.

[35] Hill, H., 'The Economy', in Hill, H., ***Indonesia's New Order,*** p. 68.

[36] Hill, H., ***Foreign Investnient and Industrialization in Indonesia,*** p. 47.

[37] BKPM, ***Indonesian Investment News,*** 1991, Vol. 13, No. 1, p. 2.

[38] However in 1976 through mismanagement and corruption. it was unable to meet payments on its debt of $ 10.5 billion, approximately 30% of Indonesia's GNP at the time. This debt included $2.5 billion for civil works and commercial credits, $1.9 billion for projects involving liquefied natural gas, fertiliser projects and gas pipelines, $2.1 billion for a steel plant, $156 million for telecommunications, $3.3 billion for purchase and hire of oil tankers and other contracts worth $700 million. Bresnan, J., ***Managing Indonesia: The Modern Political Economy,*** p. 167.

[39] Schwartz, A., A ***Nation in Waiting,*** p. 55.

[40] Among the populous oil-rich countries, no government has been more successful than Indonesia in dealing with this reversal of fortune. Comparisons can be drawn with Iran, Nigeria and Mexico. Little, R W., 'Indonesia is Indonesia', in Young, K. & Tanter, R. (eds), ***The Politics of the Middle Class in Indonesia.*** Centre for Southeast Asian Studies, Monash University, Melbourne, 1990.

Deregulation 1984-92

In the period fiom 1974 following the Malari affair, Suharto had built up a system of authoritarian power concentrated on the presidency. Domestic opposition had been mollified by restrictions on foreign investment which thereby favoured the economic nationalists and the 'rent-seekers' However in the period after 1984 Suharto used his unchallengeable power to impose on the Indonesian economy a deregulation and devaluation program designed by the economic technocrats. This use of authoritarian power to liberalise industrial protection followed the Korean and Taiwanese precedents. In contrast the government in the more open system in the Philippines was unable to resist the powerful vested interests and a heavily protected economy continued to serve the interests of a privileged few industrialists.[41] Nevertheless the Indonesian deregulation strategy confronted powerful opposition. Therefore reform was concentrated on the financial sector rather than the real sector where monopolies controlled by the associates of the President continued to flourish.

The government introduced deregulation measures to diversify the economy, encourage foreign investment and promote the private sector. It took a gradualist approach to deregulation beginning with bank reforms in 1983, tax reform in 1984, devaluation of the rupiah in 1986, trade reforms in May 1986, October 1986, January 1987, and December 1987. In 1988, 1992, 1993 and 1994 reforms in investment regulation were implemented in order to encourage capital inflow.

One of the features of the foreign investment regulations in this period was the use of performance standards targeted for export production and regional development. The shift of emphasis fiom import substitution to export production led to efforts to encourage investment by multinational corporations in export production by conferring dispensations fiom local participation and divestiture requirements. The introduction of the 'Negative List' ***(Daftar Negatif)*** helped to clarify regulatory provisions. Presidential Decree No 211989 replaced an Investment Priority List with the Negative List which listed the sectors which were closed to foreign investment. The Negative list was reviewed and reduced in 1991, July 1992, June 1993, July 1994 and in May 1995. The 1995 Negative List reduced the number of sectors closed to foreign companies to 15 (such as taxi transport, retail trade and sawmills) and the number closed to all companies to 11 (such as casinos and marijuana cultivation).[42]

Under the pressure of international oil prices and unfavourable exchange rates, Indonesia achieved a major restructuring of the economy between the mid 1980s and the elections in 1992.[43] GDP growth had fallen to **2%** in 1985 but rose to 4.9% in 1987, 5.8% in 1988, 7.5% in 1989, 7.4% in 1990 and ***6.6%*** in 1991. Foreign investment approvals rose from $1.46 billion in 1987 to $8.78 billion in 1991. **A** significant result of the private investment was to fiee the economy of its dependence on oil. Non-oil exports trebled from $5.87 billion in 1985 to $18.23 billion in 1991, **mainly** fiom a diversified base of manufactured goods. In 1969 at the beginning of the First Five Year Plan manufacturing contributed only 9.2% of GDP but this had risen to 21.1% by the end of 1991. The source of foreign investment also changed significantly in this period. Japan had long been the major investor in Indonesia. However in the latter part of the 1980s investment fiom the

[41] **Bresnan,** J., *Managing Indonesia: The Modern Political Economy,* **p.292.**
[42] **Presidential Decree No** 31/1995.
[43] **For the statistics in this paragraph see BKPM,** *Investment* **in** ***Indonesia,*** **p. 12-14.**

four Asian NICs, Hong Kong, South Korea, Singapore and Taiwan, rose rapidly as their labour intensive industries relocated to lower cost economies.[44]

A Time of Uncertainty 1992-

The current period can appropriately be labelled the period of uncertainty. In the political sphere the uncertainty is focused on the succession to the presidency, in particular the conflict between Suharto and the armed forces (ABRI).[45] In the economic sphere the uncertainty is focused on the resurgence of the economic interventionists including conflicting directions for policy on foreign investment. While the technocrats have no political base, the economic nationalists have significant political and religious influence. The most prominent economic nationalist, the Minister for Research and Technology, B.J. Habibie, was a leading contender for vice-president in 1993 and is a possible successor to Suharto as president. In 1990 Suharto placed Habibie at the head of the newly formed ICMI, the Association of Muslim Intellectuals. The alliance with Muslim leaders, who have traditionally been focused on social justice rather than economic development, is potentially very significant.

By the early 1990s the success of the deregulation measures meant that there was little sense of economic crisis to prompt President Suharto to adopt further economic reforms propounded by the technocrats. The rapid economic growth had also produced widespread concerns about the technocrats' program including concerns about economic inequality, interest rates and bank failures. Following the 1992 election, the president appointed a new cabinet and dismissed the three leading technocrats.[46] It is however uncertain whether in doing this Suharto intended only to defuse domestic criticism or fundamentally to change the nation's basic economic policy away from the market based industrialisation program of the technocrats towards'the high-technology vision of the economic nationalists led by B.J. Habibie.

The economic nationalists believe that Indonesia's industrialisation should not be dependent primarily on attracting foreign private capital into labour-intensive, low-technology industries. They believe in state enterprises and state planning, in particular the committing of more government resources to high technology undertakings. The drive behind the long term strategy of the economic nationalists is the fear that Indonesia is being left behind by its regional competitors in the race to develop medium and high technology exports as shown in the table below.

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[44] See discussion in Tie Kian Wie, 'The Surge of Asian NIC Investment into Indonesia, (1991) 27 *Bulletin of Indonesian Economic Studies* 55.

[45] See for example Lane, M., *Openness, Political Discontent and Succession in Indonesia.* Australia-Asia Paper No. 56, Griffith University, Queensland, 1991.

[46] The Coordinating Minister for the Economy, Radius Prawiro, the Finance Minister, Johannes Sumarlin, and the Governor of the Central Bank, Adrianus Mooy. However they were replaced by other technocrats, Saleh Afiff, Mar'ie Muhammed and Soedrajad Djiwandono.

Index of Technology Composition - Manufacturing Exports[47]

	1970	1993
Singapore	0.47	1.79
Malaysia	0.24	1.72
Japan	0.80	1.30
Taiwan	0.57	1.19
Korea	0.37	1.07
Philippines	0.10	0.95
Thailand	0.15	0.92
China	0.22	0.58
Indonesia	0.19	0.34

The index of technology composition of exports developed by the Centre for Strategic Studies in Melbourne shows that over the past two decades Indonesia has lagged behind countries such as Malaysia and Singapore in moving into knowledge and R&D based exports.[48] Indonesia's index of technology composition is much lower than the Asian average. The state-led industrialisation policy of the 1970s and early 1980s boosted Indonesia's higher technology exports but under the market-led program from the mid 1980s, the successful industries have been labour intensive and low technology industries using Indonesia's low cost labour and abundant raw materials. Both the technocrats and the economic nationalists agree that, given the likelihood of increased competition from countries such as China in the export of labour intensive, low technology products, Indonesia has to move up the technology ladder but they disagree on the appropriate roles of the state and the market in this process.

In Indonesia the centrepiece of the economic nationalist program has been the decision by Suharto in 1989 to place ten 'strategic industries' under a Strategic Industry Administration Board headed by Habibie. This included enterprises manufacturing steel, railroad stock, telecommunications, electronics and aircraft.[49] There have been some notable achievements such as the successful development of an aerospace industry.[50] However the technocrats, led by the World Bank, have criticised the 'technology leapfrogging' strategy. Successful nations like South Korea and Taiwan have taken a more gradual approach with clear criteria governing the industries and firms to be supported. All of the ten strategic enterprises are thought to be unprofitable, accounting for almost half of all the loses reported by Indonesia's state owned enterprises.[51] The issue is whether, in the short and medium term, Indonesia can afford the program of the economic nationalists.[52]

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[47] Source: Centre for Strategic Economic Studies. See Ray, D., 'RI left behind in hi-tech exports', *Jakarta Post,* 26 August 1995. As a comparison, the 1993 index value for the EEC7 was 0.96, for USA 1.52, for Canada 0.86, for Australia 0.57 and for New Zealand 0.21.

[48] An index value less than one indicates a concentration in industries with little R&D such as wood, paper and textiles rather than industries such as aerospace, computers and electronics.

[49] The first moves towards the strategic targeting of high-tech industries was made in 1984. See Arndt, H., 'Survey of Recent Developments', (1984) 20 No. 2 *Bulletin of Indonesian Economic Studies 1.*

[50] For example August 1995 saw the test flight of the N-250, the country's first domestically designed medium range commuter aircraft.

[51] World Bank. *Indonesia: Sustaining Development,* World Bank, Washington, 1993.

[52] The limited revenues available to the government has led it to finance the high tech thrusts through private capital, including foreign investment. For example the state owned aircraft manufacturer, IPTN, will establish a joint venture company to fund its development of the N-2130 passenger jet and

The most powerful political constraint on the high-tech vision of the economic nationalists is the need to maintain economic growth to provide jobs and reduce poverty. It has been estimated that 320,000 fewer jobs would be created if the growth of non-oil GDP fell by 1% yet Indonesia needs to provide jobs for 2.3 million new entrants to the labour forcer each year and to raise the living standards of the 30 million people still living below the poverty line.[53] It is the low-tech labour-intensive industries which can create the new jobs to satisfy these needs.

As the economic nationalists rose to power from 1991, 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.[54] Thus the technocrats in 1993 and 1994 were able to persuade Suharto to agree to two deregulation packages by using the threat of competition from other host countries for foreign capital. In 1993 a limited package drew criticism from the investment community and in 1994 a more comprehensive reform drew more hostile criticism from the economic nationalists and the collectivists. Therefore, despite their domestic weakness since the 1992 elections, the technocrats were able to persuade President Suharto in 1994 to promulgate 'perhaps the most liberal measure ever taken regarding the treatment of foreign investors'.[55]

Government Regulation 20/1994

The 1994 regulation represented a significant victory for' the technocrats over the economic nationalists.[56] The key features of PP20/1994 were the permitting of full foreign ownership, reduction of divestment requirements, reduction in the levels of minimum Indonesian equity and the opening up of strategic sectors, especially infrastructure, to foreign investment. This was a dramatic reversal of a long history of requirements concerning minimum capital, local participation and divestiture dating back to 1974.

The economic imperative behind the new measure was the realisation that other countries had developed .more attractive investment climates. State Secretary Moerdiono said in announcing the new regulation that Indonesia needs $305 billion (Rp 660 trillion) in new investment in the current Five Year Plan (*Repilita VI*) of which 73% was to come from private investment.[57] Indonesians were aware that as the global flow of FDI rose from $79 billion in 1986 to $204 billion in 1990 only $1 billion extra flowed into Indonesia.[58] Industry Minister Tunky Ariwibowo said that 'we are now facing keener competition from such countries as China, Vietnam India and other Asian countries in attracting foreign investment.'[59] The BKPM said that the domestic equity requirements

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existing projects such as the state-owned steel company, Krakatau Steel, will restructure and make a public offering to raise funds for expansion.

[53] BKPM, *Indonesian Investment News,* 1994, Vol. 13, No. 1, p. 4.

[54] BKPM, *Investment in Indonesia,* p. 14.

[55] *Jakarta Post, 4* June 1994.

[56] Peraturan Pemerintah (Government Regulation) 2011994 on Investment. There is also an implementation decree, Decree of the Minister for Investment No. 15/SK/1994.

[57] *Jakarta Post,* 3 June 1994. In August 1995 this figure was raised to Rp 815 trillion (US $360 billion).

[58] *Jakarta Post,* 8 June 1994.

[59] *Jakarta Post,* 3 June 1991. Indonesia has certain advantages over such rivals. It has a free foreign-currency regime, a proven regulatory framework and perhaps less concerns about political succession than China.

had to be relaxed and that 'faced with the fact that the world's investment funds are limited and competition with other developing countries in attracting FDI is strong, the degree of this ownership relaxation must be compatible or even better than that of those competitor countries'.[60]

Article 2(1)(b) of PP 2011994 therefore permitted foreign investors to wholly own their companies, except in the infrastructure sector. The 1994 regulations also contained no minimum capital requirements. Previously, under PP 5011993, wholly owned projects were only permitted in limited circumstances and, in general, there was a minimum amount of investment of US $1 million. The new regulations therefore removed the problems associated with finding a domestic partner and forcing substantial divestment on foreign investors which had, for example, discouraged the transfer of the latest technology and the entry of small and medium sized investors with specialised knowledge.[61]

The right to operate wholly owned subsidiaries was subject only to an obligation in Article 7 for companies to 'sell part of their shares to Indonesian citizens' within fifteen years from the start of commercial production. Foreign investors are therefore under an uncertain obligation as the regulations do not specify the extent of divestiture required. This unsatisfactory provision was the result of compromises in the drafting process in which the technocrats lacked the political strength to push through a package permitting permanent 100% foreign ownership.[62] However the divestiture requirements may only be symbolic. The responsible Minister has said that companies may be required to divest as little as 1%.[63]

Another uncertainty is the application of the new provisions to existing firms with divestiture obligations. The regulation itself made vague provision for these[64] and at the time the regulations were announced, officials said that 'the spirit of the new package should apply to existing contracts but it was up to particular parties to reach a new agreement.'[65]

A second significant feature of the 1994 package was the expansion of areas in which foreign joint ventures could invest. Since 1989 there has been a steady reduction in the negative list of areas closed or restricted for foreign investment. Nevertheless the strategic nature of infrastructure industries was always given as a reason to exclude foreigners from infrastructure investment However Article 5 of PP 2011994 permitted joint ventures to operate in nine key infiastructure sectors: 'ports, generation and transmission as well as the distribution of energy to the public, telecommunications, shipping, airlines, drinking water supply, public railways, atomic energy reactors and mass media'.[66] This was a surprising provision which was clearly designed to harness foreign capital in the task of building up Indonesia's infrastructure which, although good for a

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[60] BKPM, *Indonesian Investment News,* 1991, Vol. 13, No. 1, p. 5.

[61] Mari Pangestu and Iwan Jaya Azis, 'Survey of Recent Developments', (1994) 30 No. 2 *Bulletin of Indonesian Economic Studies* 3.

[62] BKPM spokesperson, Personal Communication, July 1995.

[63] Asialine - A Newsletter for Business, 1991, Vol. 2 No. 5.

[64] Article 12 provided 'Companies established under foreign capital investments which have been set up or engaged in commercial production before the enforcement of this government regulation, based on agreements reached by shareholders can make adjustments to the provisions in this government regulation.'

[65] *Australian Financial Review,* April 1995.

[66] However foreign investment had already taken place in some of these sectors such as telecommunications (GE in the Paiton project) so that to an extent the 1994 regulation only ratified what had already been already practised. Mari Pangestu and Iwan Jaya Azis, 'Survey of Recent Developments', (1994) 30 No. 2 *Bulletin of Indonesian Economic Studies* 3.

developing country because of government spending in the 1970s, still needs significant expenditure to keep pace with development. With the reduction in oil revenues and limits to the amounts Indonesia can prudently borrow, there is a need for increased private investment.[67] Therefore President Suharto called for private sector companies to finance most of over $50 billion infrastructure investment in the coming five years including cities, toll roads, power plants, telecommunications, harbours and airports.[68]

The 1994 regulation also relaxed the equity requirements for joint ventures. Under the 1993 regulations at least 20% of the venture were to be held by Indonesians with an obligation to divest after 20 years of operation so that Indonesians held at least 51%. In contrast PP20/1994 provided that joint ventures were compulsory only for infrastructure projects and Article *6* reduced the minimum equity for Indonesian partners in such joint ventures to 5% with no further obligation on the foreign investor to divest.

PP20/1994 therefore represented a significant loosening of domestic equity requirements and protection for domestic producers. Foreign investors were permitted to operate through wholly owned firms except in infrastructure where they could own 95% of the joint venture vehicle. The new regulations gave foreigners the choice of whether to have a domestic partner, what the composition of foreign-domestic ownership should be and whether 'and how much to divest to domestic entities.

Economic nationalism in developing countries often has led to requirements for local equity participation with foreign investors.[69] There are obvious advantages in divestiture and local equity requirements. Aside from mollifying domestic political opposition to foreigners, these advantages include ensuring that less profits are repatriated abroad, permitting greater state control and the development of a local entrepreneurial class. The empirical evidence however is that local partners are often simply 'sleeping partners' who play no important role in control.[70] Also local equity does not necessarily mean local control as foreign firms can avoid requirements by raising the debt-equity ratio and maintaining control through long-term licensing and management contracts. A further problem with local equity requirements is the possible development of an elite group of local businesses supporting repression of social development and human rights abuses. The ultimate difficulty with joint venture arrangements is the disincentive to foreign investment if other countries permit use of wholly owned vehicles. In Indonesia in 1994 the imposition of local equity controls was largely abandoned because it had deterred foreign investment with consequences for economic growth and thus, ultimately, for political stability.

The new requirements in PP 20/1994 have therefore significantly reduced domestic ownership protection and support.[71] The subsequent public battle between the economic technocrats, who formulated the package, and the economic nationalists took an unusual course for Indonesia: it focused on the legality of the measures. As subordinate legislation PP20/1994 ought not conflict

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[67] **In 1995 the Indonesian foreign debt reached $88 billion with a uncomfortably high debt service ratio of 32%.**

[68] ***Jakarta Post,* 18 October 1994.**

[69] **On requirements relating to local equity generally see Somarajah,, M. *The International Law in Foreign Investment,* p. 111-3.**

[70] **Hill, H., *Foreign Investment and Industrialization in Indonesia,* Ch. *7*.**

[71] **Other important innovations in the 1991 regulation permitted an existing PMA company to form a new PMA company, permitted existing PMA companies to acquire shares in domestic companies and provided certainty for PMA companies' tenure and extension of tenure.**

with the Constitution or legislation enacted by the parliament (DPR). Critics, motivated by collectivist ideals or economic nationalism, argued that this had occurred.

One attack on PP 2011994 was based on the spirit of the 1945 Constitution. For example the Central Executive Board of the PDI (Democratic Party of Indonesia) called on the government to withdraw the regulation. It said 'we feel that the intention and the spirit of Article 33 of the 1945 Constitution obliges the state to control all branches of production that are vital to the state and affect the livelihood of many people'.[72] Similar criticisms based on the Constitution were raised by the Indonesian Legal Aid Foundation (LBH) with well known human rights lawyer Todung Mulya Lubis offering to act for anyone who was prepared to apply for judicial review to the Supreine Court.[73]

Critics such as economist Kwik Kian Gie also claimed that the regulation contradicted the 1967 Law on Foreign Investment and the 1968 Law on Domestic Investment. It is argued that Article 6 of the 1967 Law prohibits full foreign ownership of strategic sectors such as the mass media.'' It was also claimed that the new measures violated other Acts. The BKPM's approval of four private oil refineries with a combined investment of $7.2 billion in Aceh, East Java and South Sulawesi was claimed by a number of legislators to violate Law 4411960 and Law 8/1971. These Laws require an investor to set up in cooperation with Pertamina to construct and operate oil refineries.[75]

The most interesting challenge concerned opening up the media to foreign investment which resulted in a victory for the economic nationalists. The Minister of Information (and key Suharto supporter in intra-elite conflicts) Harmoko, stated that he had not been consulted on the measures. He said that there were barriers in media laws which were constructed to deter unwanted foreign values from penetrating the national culture as well as preventing Indonesian publication from being taken over by foreigners. Opposition to opening the media to foreign ownership was also loudly voiced in the DPR by legislators such as Aisyah Aminy who heads House Commission 1 overseeing information.[76]

It was argued that the 1994 regulation should be revised because foreign investment in the mass media is prohibited by law. Article 13 of the Press Act 1982 states that 'the capital of a Press Corporation shall be wholly national, whereby all its founders and board members shall be Indonesian citizens'. Furthermore Article 15 of the Ministry of Information Regulation Concerning Press Publication Operating Permits states 'press companieslpublishers and their respective publications are not permitted to give or to receive aid in the form of capital or any other contributions in whatever form to/from other parties, including other press companies/publishers which openly or in a disguised form will cause a shift in ownership/management of the press companies/publishers concerned, to the party of the donor'. Aid and contributions are allowed only with the approval of the Minister of Information acting in consultation with the Press Council.

[72] *Jakarta Post,* 7 June 1991.
[73] *Jakarta Post.* 16 June *1994.*
[74] *Jakarta Post,* 8 June 1994.
[75] *Jakarta Post.* 29 September 1994. However the BKPM argued that approval was valid because 100% of the raw materials would be imported from the Middle East.
[76] *Jakarta Post, 4* June 1994. Others. such as Depari a spokesperson for the privately owned television company, RCTI, however felt that the deregulation measures were a public relations ploy as no one would be willing to invest substantial amounts since licences could be revoked at any moment for publishing 'wrong information'.

The Supreme Court indicated that it could exercise its new powers to review the legality of PP20/1994. In keeping with its civil law tradition, Indonesian courts historically have had very little power of judicial review. There is no provision for judicial review of the validity of legislation. However in June 1993 Chief Justice Purwoto issued a new regulation giving those who wish to contest the legality of a government regulation two alternatives: contesting it in the lower courts and then on appeal to the Supreme Court or filing for a judicial review directly with the Supreme Court. In the first twelve months however the few cases brought before the Supreme Court have failed.[77] In an unusual development, Chief Justice Purwoto publicly stated that the Court would act if presented with a formal application for judicial review of the 1994 investment regulations. He said 'we will review if, for example, the Indonesian Press Association (PW) asks us to make a judicial review because it harms the association in several ways...But the final review must still be carried out by the government'.[78]

The issue however did not reach the courts. After a meeting with Suharto days after the new regulations were announced, Harmoko stated that the President would not allow foreigners to own equity in the local media.[79] Subsequently the 1995 Negative List included private television and radio broadcasting as one of the six sectors absolutely closed for foreign investment.[80] This was therefore a significant victory for the economic nationalists.

The Impact of PP 2011994

The liberalised investment regime established by PP 2011994 has been successful in boosting investment: Foreign investments surged 194% to a record high of US $23.7 billion in 1994 while domestic investment also rose 34.9% to $24.2 billion.[81] This reversed the poor figure in 1993 when only $8.1 billion in foreign investment was recorded. The trend continued in 1995 with foreign investment reaching $29.4 billion by the end of July and the State Minister of Investment predicted that foreign investment approvals by the BKPM would surpass domestic for the first time.[82] In 1994 there were 449 foreign investment projects approved which will employ 316,809 Indonesians and 6,804 foreigners. Of the projects almost 64% plan to export their products with annual foreign exchange earnings estimated at $13 billion.[83] Despite the provisions of PP20/1994 permitting 100% owned investment vehicles, much investment continued to be through joint ventures to take advantage of the domestic political contacts of Indonesian partners in an environment where the economic nationalists and vested interests were still influential.

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[77] The first was brought by media publisher Surya Paloh to contest the Ministry of Information's power to revoke the press publishing licence which he claimed contravened the 1982 Press Law. His application was rejected. There is also since 1991 an Administrative Court which has begun to make some important decisions on the legality of government actions such as the closure of the ***Tempo*** periodical. However the jurisdiction of the Administrative Court is limited to written rulings which are 'concrete, individual, and final'. Law 511986, Article 1.

[78] ***Jakarta Post,*** 10 June 1991.

[79] ***Jakarta Post.*** *7* June 1991.

[80] Presidential Decree 3111995.

[81] Actual funds invested average only 52% of approvals. ***Far Eastern Economic Review,*** 1 September 1991. This is expected to rise to 60% in 1995. *Jakarta Post,* 21 August 1995. These rates are thought satisfactory, being superior to China's. BKPM spokesperson, personal communication, July 1995.

[82] ***Jakarta Post,*** 21 August 1995.

[83] ***Jakarta Posr,*** 23 December 1991. This included six large projects including three oil refineries, two power plants and an integrated steel mill with investments of about $ 8 billion.

There **was** also a change in the source of investment. The chairman of the BKPM Sanyoto announced that Hong Kong emerged as the largest foreign investor with investments in 1994 of $6.04 billion followed by Britain with $2.95 billion, Taiwan with $2.48 billion, South Korea with $1.88 billion, Japan with $1.53 billion and the United States with $1.52 billion.[84] Japan however is still the largest total investor in Indonesia in the period 1967-March 1995 with Australia in ninth place as shown in the table below.[85]

Country	Total Investment Value to March **1995** (US $)
1. Japan	$19.31 billion
2. Hong Kong	$14.96 billion
3. UK	$11.16 billion
4. USA	$10.66 billion
5. Taiwan	$ 7.67 billion
6. Singapore	$ 7.39 billion
7. Netherlands	$ 7.32 billion
8. South Korea	$ 5.82 billion
9. Australia	$ 5.44 billion
10. Germany	$ 4.59 billion

The flood of foreign investment led to increases in economic growth. In 1994 GNP rose 8.3% and was expected to grow by 7.7% in 1995.[86] Reflecting the change in the structure of the economy, and the emergence of Indonesia as a NIC, there was a significant increase in the contribution of manufacturing to GDP with a corresponding decline in the relative share of agriculture and oil and mining, as shown below.

	1983	**1994**
Agriculture	22.9	17.9
Mining	20.8	9.6
Manufacturing	12.7	22.3
Trading & Hotels	14.7	16.8
Financial	5.3	7.0

On its face therefore PP 2011994 represented a significant victory for the technocrats which has contributed to the desired increases in capital inflow and GNP. However foreign investment still must be approved **and** it can be expected that the Indonesian government will attach qualifying conditions to foreign investment in various industries.[87] This administrative discretion presents an ongoing opportunity for influence by the economic nationalists and powerful vested interests. The State Minister of Investment, Sanyoto Sastrowardoyo has stated that domestic investors should enter labour-intensive sectors while foreign investors are 'guided' towards entering capital-

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[84] ***Jakarta Post,*** 23 December 1991. Fears of political uncertainty in China have influenced Hong Kong and Taiwan with the latter adopting a 'southern policy' to wean investors away from China.

[85] BKPM, A ***Brief Guide for Investors,*** p.5.

[86] ***Jakarta Post,*** 21 August 1995.

[87] In contrast for example in Thailand there is no approval required unless the investor is caught by the Alien Business Law.

intensive industries." For example foreign investors with expertise have been invited by Habibie for the $38.8 billion dollar gas liquefaction project in Natuna, Riau, which he heads.[89]

The Future of Investment Regulation

The government has stated that it will introduce a new law on foreign investment. One consideration is the problem of regulating investment through decree rather than legislation. A second is the influence of obligations arising from APEC or GATT.

Since 1967 the changes in foreign investment regime in Indonesia have been implemented through presidential and ministerial decree under the 1967 Act, not through legislation. Part of the explanation is the cumbersome legislative process in Indonesia. However it may also be the need to appease or circumvent opponents of economic liberalisation. Suharto in the mid 1980s and in 1994 was able to use his political power, including his ability to issue decrees, to impose economic liberalisation measures developed by the technocrats against opposition from the economic nationalists, the collectivists and vested interests and without any need to secure parliamentary approval. However this flexibility in rule making creates an uncertain investment climate. For example, 1989 World Bank annual report said that Indonesia's legal system fell well short of a 'well fbnctioning legal system that is an important prerequisite if the shift towards a less government-regulated environment for the private sector is to be successful'.[90] The poiitical, economic and legal uncertainties of rule by decree could be averted if the investment measures were found in new legislation replacing the 1967 Act.

New legislation is also required to implement Indonesia's international obligations. One influence is APEC,[91] but more important is the GATT. In Law 7 of 1994 the Indonesian government ratified the establishment of the World Trade Organisation. The Minister for Investment, Sanyoto Sastrowardoyo, has said that the government is planning to replace the existing laws on investment. the 1967 law on foreign investment and the 1968 law on domestic investment, with a new bill drafted to suit the requirements of the new General Agreement on Tariffs and Trade.[92] The existing laws contradict the new GATT provisions which do not permit the differential treatment of domestic and foreign investment.[93]

The future may also see the reintroduction of significant tax concessions in Indonesia. In the past the main method of promoting investment in underdeveloped regions was to offer concessions regarding domestic equity requirements. With the changes in the 1994 package however, there appears to be little incentive for most investors, other than in natural resources, to locate in underdeveloped regions. New tax laws in 1994 empower the government to provide tax

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[88] *Jakarta Post,* 21 August 1995.
[89] *Jakarta Post* 27 July 1995.
[90] World Bank, *Indonesia, Country Report,* World Bank, Washington, 1990.
[91] In the Bogor forum. APEC adopted a non binding principle on investment covering national treatment, performance requirements and repatriation and convertibility. The US opposed the investment code as too weak. The code was designed to encourage investment in the region by advancing a set of principles that economies could adhere to on a voluntary basis.
[92] *Jakarta Post,* 9 December 1994.
[93] One of the major issues will be whether retail distribution is opened up to foreign retailers.

incentives[94] and the Investment Minister has said that incentives may be required to attract investors to its Eastern provinces and to certain parts of Western Indonesia.[95]

Conclusion

The link between economic policy, the law and politics is a complicated one in any society. In Indonesia the technocrats have attained primacy in economic policy-making in the difficult economic times of the mid 1960s and mid 1980s. However their free market ideology is opposed to dominant Indonesian political and economic thought. They have been constrained by the collectivist ethos in Indonesia, by the economic nationalists and by powerful vested interests.

The technocrats and the economic nationalists have competed for the ear of the president in economic policy making. However the technocrats have failed to develop their own political constituency. The technocrats depend on Suharto's support to liberalise the economy. At times Suharto has been able to use the immense personal power he has developed in an authoritarian system to force through the policies of the technocrats. However Suharto is wary of a rapid economic liberalisation which could produce a political backlash similar to that which threatened the regime in the Malari affair in 1974. On the other hand, the regime's legitimacy depends upon sustained economic growth which, in turn, still requires significant inflows of foreign capital. Suharto therefore has 'allowed his ministers to liberalise just enough to guarantee annual infusions of foreign aid and investment'.[96]

Economic technocrats within Indonesia and outsiders, particularly the World Bank, have urged the government to reduce restrictions on foreign investment, to limit the role of state enterprises, to lower taxation and to allow more competition by abolishing many monopolies and protectionist measures. The current investment regulations (PP20/1994) were drafted by the economic technocrats and were imposed by Presidential authority against strident domestic opposition Although partial and ambiguous, PP20/1994 has resulted in a dramatic increase in foreign investment in Indonesia. Despite the reservations of the President and important components of the political elite, it is likely that the liberalisation of investment regulation will continue with the enactment of a new Basic Law on foreign investment to further promote the 'globalisation' of the economy.

[94] The incentives currently available were provided in December 1994 (effective January 1995) are limited to allowing companies in remote areas to carry forward losses for up to 10 years, to reduction in the withholding tax and to accelerated depreciation.

[95] Reuter News Service, 23 January 1995.

[96] Vatikiotis, M., *Indonesian Politics under Suharto*, p. 174.

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