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SPECIAL REPORT

JOKOWI'S INDONESIA: SHIFTING TO REFORM AND NEW GROWTH

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INTRODUCTION: A NEW STRATEGY

Indonesia is preparing to shift its economic development strategy under President Joko Widodo (popularly known as Jokowi). Amidst the continuing global slowdown, the Jokowi administration sees the need for a new approach that can lift growth rates beyond current levels and create both more and better-paying jobs for Indonesians entering the workplace.

Signs indicate that this new approach aims to move Indonesia up the value chain in global production networks, with an emphasis on industrialisation and innovation as new engines for growth. This goes beyond the traditional approach of relying on the resource and commodity sectors.

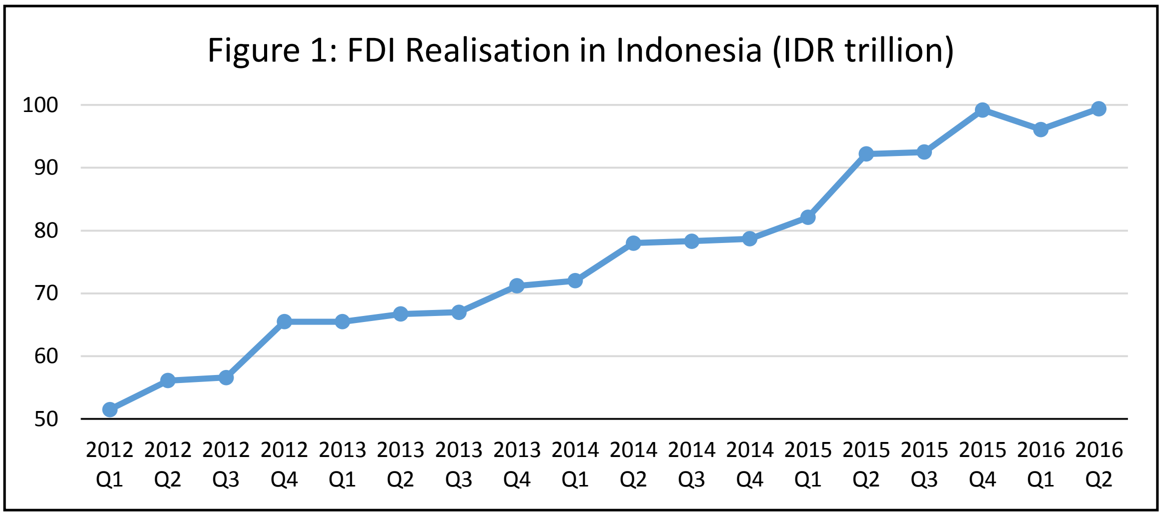
Such signs have been communicated by the President and his ministers in both public and private statements. In particular, in April 2015, Jokowi told over 700 business, government, and civil society leaders at the 24th World Economic Forum on East Asia about Indonesia's need to transform its economy. He said, "Today, we must shift from consumption back to production…to investment in our infrastructure, investment in our industry, but most importantly, investment in our human capital, the most precious resource of the 21st century."

Indonesia's aims are ambitious, and many challenging tasks lie ahead for the country. These include rolling out widespread policy changes, providing key infrastructure, reforming the bureaucracy, reforming state-owned enterprises (SOEs), improving the rule of law, and developing a work force with adequate skills and training.

Pushing ahead with such a broad slate of reforms will require the government to not only set a new regulatory direction, but also facilitate and oversee its implementation. To accomplish this, the efforts of the President and his administration will not be enough – there must also be acceptance by the broader political elites.

Another key step in the reform will be attracting foreign companies to make higher-quality investments into the country. While many foreign investors are optimistic about Indonesia, the country is increasingly competing with other economies in the region, such as Vietnam. In addition, some investors are being deterred by concerns about growing protectionist sentiments in Indonesia. These concerns must be addressed.

Time will be needed to move Indonesia in this new direction. However, a number of factors suggest that the timing is favourable to make a strong start on this shift in economic strategy.



Source: Indonesia Investment Coordinating Board[1]

Politically, signs indicate that the Jokowi administration is gaining momentum in its second year. A recent cabinet reshuffle has broadened the President's support in the country's multi-party political system. While divergent voices and policy gaps are still noticeable, there are signs of increasing cohesion in the cabinet, which will help in implementing the necessary reforms. This is considerable progress compared to Jokowi's election campaign and first year of office, when he was seen by many as an outsider to the Jakarta elites who lacked the experience to govern the nation.

Economically, Indonesia is performing well. Indonesia's Gross Domestic Product (GDP) in the second quarter of 2016 rose 5.18 percent compared to the previous year,[2] outperforming many of the world's largest economies. In a survey of multinational corporation (MNC) executives, the United Nations Conference on Trade and Development's 2015 World Investment Report found that Indonesia is among the top ten developing and transition economies in terms of investment attractiveness.[3] Fitch Ratings has also observed a marked improvement in investor confidence in Indonesia in recent months, on the back of higher public investment – especially in infrastructure projects – and wide-ranging structural reform to increase efficiency, investment, and competitiveness.[4] Other causes for investor optimism include relative improvements in macro-economic management and a concerted effort to address the government budget deficit.

Externally, President Jokowi has already reached out to Indonesia's key trade and investment partners, including China, the European Union (EU), Japan, South Korea and the USA. Despite the global economic slump, flows of foreign direct investment (FDI) into Indonesia have continued to increase: total foreign investment realisation in 2015 reached US $39.24 billion, up 17.8 percent from 2014 (see Figure 1). Singapore is the top investor in Indonesia with US $5.9 billion, followed by Malaysia with US $3.1 billion and Japan with US $2.9 billion. The biggest beneficiaries of FDI in

[1] (2016) Foreign direct investment (FDI) into Indonesia rises in Q1-2016, *Indonesia-Investments.com,* 25 April 2016, Available: http://www.indonesia-investments.com/news/todays-headlines/foreign-direct-investment-fdi-into-indonesia-rises-in-q1-2016/item6758 Retrieved: 15 August 2016

[2] (2016) Indonesia's GDP rises 5.18% in Q2, *The Straits Times,* Available: http://www.straitstimes.com/business/indonesias-gdp-rises-518-in-q2 Retrieved: 15 August 2016

[3] (2015) World investment report 2015, *United Nations Conference on Trade and Development,* Available: http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf Retrieved: 15 August 2016

[4] (2016) Fitch: Confidence in Indonesia improving, but challenges persist, *Flitch Ratings,* 31 March 2016, Available: https://www.fitchratings.com/site/pr/1001849 Retrieved: 15 August 2016

2015 were the mining, transportation, mineral-processing, and telecommunications sectors.

If the Jokowi administration can maintain this momentum and make a good start on the reforms needed for Indonesia's shift in economic direction, the country is well poised to attract more investments for industrialisation and innovation. This will create more jobs, increase growth, and further strengthen the country's macro-economic balance and budget.

This report considers the current and emerging factors that can support the Jokowi government's economic shift, as well as some of the key challenges that must be addressed. The first and second sections discuss Indonesia's evolving political and economic landscape, respectively. The third section focuses on Indonesia's efforts to improve its trade links. The final section discusses opportunities that may help Jokowi achieve his long term ambitions, as well as the implications of growing protectionist-nationalistic sentiments within Indonesia.

1. SHIFTING POLITICAL SUPPORT

1.1. July Cabinet Reshuffle

In July 2016, President Jokowi reshuffled his cabinet for the second time in less than a year. The move was anticipated, and indeed, many analysts had predicted it to come earlier.

The reshuffle was closely watched not only in terms of the performance and potential of the appointees, but also as an indication of the President's current standing. Jokowi's first cabinet had been seen to reflect the strong influence of the Indonesian Democratic Party of Struggle (PDI-P) and its leader, Megawati Sukarnoputri. In contrast, in this second reshuffle, Jokowi seemed to have gained the confidence to make key decisions about his own cabinet, distributing appointments to figures from Golkar and other parties who had recently joined the ruling coalition.

This signals an attempt by Jokowi to realign political actors and distance himself from Megawati's PDI-P and any single political party base. In particular, Jakarta-based sources suggest that Jokowi personally decided on the appointment of Sri Mulyani Indrawati as Finance Minister with little or no consultation with Megawati or Vice-President Jusuf Kalla, who is supported by part of the Golkar party.

Through his new appointments, Jokowi seems to be aiming to build a track record and create momentum for his re-election campaign in 2019.

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A number of other portfolios with populist appeal, such as the Head of the National Development Agency and the Minister of Villages, Development of Disadvantaged Regions and Transmigration, have been given to figures close to the President. Observers suggest that this will help anchor President Jokowi's standing as a "people's president" and prepare broad popular support for the next elections.

Another observation relates to the replacement of popular ministers, such as the former Minister of Education and Culture, Anies Baswedan.[5] Jakarta-based analysts suggest this was a pre-emptive move to prevent Baswedan from positioning himself for a vice-presidential bid in 2019 and creating

[5] Parlina, Ina and Halim, Haeril (2016) Jokowi's new Cabinet: Who's the boss now? *The Jakarta Post,* 28 July 2016, Available: http://www.thejakartapost.com/longform/2016/07/28/whos-the-boss-now.html Retrieved: 12 August 2016

possible competition with Jokowi's own re-election bid.[6]

Others replaced in the reshuffle had jeopardised the President's priority projects by publicly voicing dissenting opinions. For example, Ignasius Jonan, the former Minister of Transport, had rejected the plan to build a 142 km high-speed railway from Jakarta to Bandung.[7] Former Minister of Education Baswedan had publicly voiced misgivings about the Indonesian Smart Card programme, an education-allowance programme guaranteeing 12 years of free education and providing for students' educational needs.[8] The programme had been prioritised by Jokowi due to its popularity and vote-gaining potential.

These changes suggest that Jokowi is increasingly enforcing discipline to ensure that ministers remain in line with his agenda. This was underlined at the first cabinet meeting following the reshuffle, where Jokowi emphasised that there was "no such thing as a vision or mission of a minister (but only) the vision and mission of the President and Vice-President."[9]

Looking at those appointed, some decisions have been controversial. In particular, observers are divided over the appointment of Wiranto as Indonesia's new Coordinating Minister of Political, Legal and Security Affairs. During the election campaign, President Jokowi promised to uphold human rights, keeping in mind violations committed in the past.[10] The appointment of Wiranto, who was linked to human rights violations during his term as a military general, has raised concerns about whether this commitment still stands.

A final appointment that bears particular attention is the return of Sri Mulyani Indrawati as Finance Minister, signalling an increasing commitment to economic reforms.

The appointment of Indrawati and other experienced, reform-minded technocrats in key positions is perhaps the strongest signal of President Jokowi's increased commitment to attracting foreign investors.

Indrawati had a strong track record during her previous stint in that office, and also enjoyed international stature as one of the most senior leaders of the World Bank in the intervening years. The financial community and foreign investors greeted her appointment well, with the Jakarta Composite Index (JCI) ending its same-day trading session with a 1 percent increase.[11]

The appointment of Indrawati and other experienced, reform-minded technocrats in key positions is perhaps the strongest signal of President Jokowi's increased commitment to attracting foreign investors. Some Jakarta-based analysts and financial experts see this as Jokowi's effort to build an economic "dream team" to push through his policy and institutional reforms.

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[6] Witular, Rendi A. (2016) News Analysis: Jokowi Leaves No Room For A 'Second Most Powerful,' 28 July 2016, Available: http://www.thejakartapost.com/news/2016/07/28/jokowi-leaves-no-room-for-a-second-most-powerful.html Retrieved: 12 August 2016

[7] Mudhoffir, Abdil Mughis (2016) Indonesia's New Cabinet Built on Political Transactions, *Jakarta Globe,* 28 July 2016, Available: http://jakartaglobe.beritasatu.com/opinion/commentary-indonesias-new-cabinet-built-political-transactions/ Retrieved: 12 August 2016

[8] (2014) New cards proof of commitment to health, education, *The Jakarta Post,* 28 June 2014, Available: http://www.thejakartapost.com/news/2014/06/28/new-cards-proof-commitment-health-education.html Retrieved: 16 August 2016

[9] Parlina, Ina and Halim, Haeril (2016) Jokowi's new Cabinet: Who's the boss now? *The Jakarta Post,* 28 July 2016, Available: http://www.thejakartapost.com/longform/2016/07/28/whos-the-boss-now.html Retrieved: 12 August 2016

[10] Suryakusuma, Julia (2016) Trumpism, denialism and our destructive selves, *The Jakarta Post,* 10 August 2016, Available: http://www.thejakartapost.com/news/2016/08/10/trumpism-denialism-and-our-destructive-selves.html Retrieved: 12 August 2016

[11] Fawnia (2016) Jokowi appoints Sri Mulyani Indrawati: What will she do next? *ASEAN Today,* 3 August 2016, Available: http://www.aseantoday.com/2016/08/jokowi-appoints-sri-mulyani-indrawati-what-will-she-do-next/ Retrieved: 11 August 2016

1.2. Parliament and Opposition

After a hard fought election and difficult first year, Jokowi's political base and credibility have strengthened. Increasingly, Jokowi has shown himself to be a pragmatic and results-oriented leader who has not only retained public confidence, but also reinforced his support in Parliament.

Jokowi's ruling coalition has been strengthened by the addition of the National Mandate Party (PAN), Golkar, and other parties that had previously been in the opposition.

The appointments increase the President's support in the Parliament and allow him more autonomy to chart his own direction for his presidency and move ahead with his reform agenda.

This realignment has been anchored by new appointments in the recent cabinet reshuffle, as noted above. Jokowi's supporters see these appointments as a necessary compromise that is being made largely on the President's terms. The appointments increase the President's support in the Parliament and allow him more autonomy to chart his own direction for his presidency and move ahead with his reform agenda.

Another notable example of Jokowi's attempt to push through reform is the recently-announced *Perppu* plan. [12] This is a series of emergency government regulations to remove legal bottlenecks obstructing economic reform. These regulations are made in lieu of law and hence can be implemented faster. In early 2016, President Jokowi used the *Perppu* plan to break an impasse of more than a decade, streamlining unfriendly laws and allowing foreigners to purchase apartments in Indonesia. [13]

Last year, Jokowi rolled out 12 economic reform packages aimed at stimulating economic growth and attracting fresh investments into Indonesia. This was followed by the announcement of his "big bang" plan in early 2016 to loosen restrictions on foreign investment in 49 sectors – the country's largest opening to international investment in 10 years.[14] With the realignment of political support for the Jokowi administration in Parliament, it is now more likely that these reforms can be ushered through with legislative backing. Failing that, the executive-led *Perppu* plan remains as an option that also serves as a reminder of Jokowi's determination to push his reforms through.

1.3. Improving Bureaucracy

Indonesia's civil service has been plagued by problems of inefficiency, ineffectiveness, and corruption, and has been seen as one of the key factors hindering progress on economic reform.

The streamlining of departments within ministries and the creation of new ministries may have some positive impact on improving the delivery of public service.

The President has taken a hard-nosed approach to this problem, with his recent announcement of plans to lay off 300,000 civil servants from 2017 to 2019. This effort to

[12] Under the Indonesian constitution, the President has the right to issue a rule in lieu of law (*Perppu*) when he determines that an emergency in the country requires it. A *Perppu* is immediately effective after the President signs it. The Parliament can either let it remain effective or let it expire within a year after the *Perppu* is issued.

[13] Witular, Rendi A. and Wirayani, Prima (2016) Govt mulls next big thing, *The Jakarta Post,* 29 June 2016, Available: http://www.thejakartapost.com/news/2016/06/29/govt-mulls-next-big-thing.html Retrieved: 15 August 2016

[14] (2016) Indonesia plans 'big bang' to woo foreign investments, *The Straits Times,* 11 February 2016, Available: http://www.straitstimes.com/asia/se-asia/indonesia-plans-big-bang-to-woo-foreign-investments Retrieved: 15 February 2016

reduce Indonesia's bureaucratic "dead wood" is expected to free up US $13.4 billion from the national budget, which the government intends to reallocate towards development spending.[15]

The streamlining of departments within ministries and the creation of new ministries may have some positive impact on improving the delivery of public service. However, the decentralised nature of Indonesia's government limits efforts to institutionalise change at the local government level.

Foreign investors point out the lack of initiative and near paralysis among the bureaucracy. Bureaucrats have reportedly been holding off approving budgets and making important decisions on major projects. [16] This has held up approved projects and reinforced perceptions of Indonesia as a difficult destination for foreign investment.

Some delays are due to lack of capacity, but in many cases they are due to corruption. Despite progress in the effort against corruption, some officials continue their rent-seeking behaviour, delaying decisions and seeking illegal payments or favours as inducements. On the opposite end of the spectrum, other officials are reportedly reluctant to make decisions for fear of being hauled up by anti-corruption authorities.

Silos and cliques also exist as a result of a history of political patronage. This has resulted in a lack of bureaucratic unity to support President Jokowi's agenda. A spectrum of Jakarta bureaucrats and political elites continues to believe in a state-led economy as an expression of nationalism and thus opposes market-based reforms and opening the economy. This ideological split is most clearly visible in matters pertaining to currency, labour laws, and the localisation of foreign banks.

As such, even as efforts are being made to clean up the bureaucracy, decision-making speed is not felt to have improved much. A slower, consensus-led decision-making culture is seen instead, where final decisions tend to be made at a very low common denominator and not necessarily in the country's interests.

1.4. Protectionism, Elites and State-Owned Enterprises

While there are signs of an emerging effort to reform and become more open to foreign investment, there are also contrary voices calling for protectionism and nationalism. This has confused and even concerned foreign investors in both small and large ways.

Even as the Jokowi administration moves ahead with its new economic strategy, such protectionist-nationalistic sentiments will continue to shape some industries, especially high-profile sectors considered to be in Indonesia's national interest.

The protectionist-nationalistic tendencies express themselves in various ways, ranging from delays and cumbersome processes for obtaining employment passes for foreign managers to the award of important concessions to domestic companies.

Even as the Jokowi administration moves ahead with its new economic strategy, such protectionist-nationalistic sentiments will continue to shape some industries, especially high-profile sectors considered to be in Indonesia's national interest. These may include key infrastructure, such as ports and

[15] (2016) Bureaucratic dead wood, *The Jakarta Post,* 7 June 2016, Available: http://www.thejakartapost.com/news/2016/06/07/bureaucratic-dead-wood.html Retrieved: 8 July 2016

[16] (2015) Indonesia's Widodo seeks to tame bureaucrats blocking infrastructure drive, *Reuters,* 23 July 2015, Available: http://www.cnbc.com/2015/07/23/indonesias-widodo-seeks-to-tame-bureaucrats-blocking-infrastructure-drive.html Retrieved: 8 July 2016

airports, and industries where some perceive the country's resources as being exploited, such as the fisheries and energy sectors.

These protectionist-nationalistic tendencies echo the founding state-led nationalism of the Sukarno years, which many feel has been inherited by the PDI-P party.

Nationalist pride is also broadly echoed across society and is growing as the country moves forward.

Protectionist-nationalistic sentiments has become a foundation for the positions and vested interests of many of the established Jakarta elites. Nationalist pride is also broadly echoed across society and is growing as the country moves forward.

Against this backdrop, foreign investors cannot expect that the Jokowi administration will openly disavow nationalism. However, investors will find that barriers to entry into sectors that have been earmarked for growth and investment will be considerably lower and more open to foreign participation. These sectors include infrastructure, manufacturing, and the digital economy.

Resistance to reform and foreign investors is also felt in dealings with SOEs and Jakarta's ruling elites. The majority of Indonesia's elites prioritise their vested interests and often dress this up in the guise of nationalism, given that the old economic system favoured the domestic players through protectionist measures.[17]

The elites' interests are reflected in many of Indonesia's SOEs, which represent one-fifth of the country's economy and hold assets amounting to more than US$250 billion. SOEs are especially prominent in key sectors such as energy, power, transportation, aviation, agriculture, banking, and telecommunications. Domestically, SOEs are seen as the engine of the national economy.[18]

The prominence of SOEs means that they must play a key role in Indonesia's reform by executing the country's infrastructure plans and driving growth in priority sectors. A few SOEs, such as Pertamina, Bank Mandiri, Bank Rakyat Indonesia, telecommunications company Telkom, and cement maker Semen Indonesia, have managed to stay competitive.[19] But by and large, SOEs have been criticised for being oversized, inefficient, and unable to compete regionally and globally.[20] Some SOEs are also abused for private gains by political elites.

Reforming the SOEs will therefore be a critical step forward for both infrastructure development and the reform of the economy as a whole. The Jokowi administration has announced its intention to list several SOEs on the stock market and establish holding companies for SOEs in key sectors.[21] This is important not only to limit overt political influence but to make the SOEs more competitive and profitable.

[17] The Jakarta Post-PECC Conference "Global Challenges and Regional Solutions - The Next Phase of Regional Cooperation: Engaging Stakeholders", 25 April 2016, Jakarta
[18] Amindoni, Ayomi (2016), Holding companies to manage state-owned construction firms, *Jakarta Post*, 1 March 2016, Available: http://www.thejakartapost.com/news/2016/03/01/holding-company-manage-state-owned-construction-firms.html Retrieved: 15 August 2016
[19] Bland, Ben (2014) Hopes rise that Widodo will inject new life into Indonesia reform, *The Financial Times*, 19 October 2014, Available: http://www.ft.com/intl/cms/s/0/51690c00-47b6-11e4-be7b-00144feab7de.html#axzz3sNXY4K7p Retrieved: 15 August 2016
[20] Raheja, Mukul (2014) The dire need for reform of Indonesian SOEs, *The Jakarta Post*, 26 February 2014, Available: http://www.thejakartapost.com/news/2014/02/26/the-dire-need-reform-indonesian-soes.html Retrieved: 15 August 2016
[21] The key sectors are mining, financial, renewable energy and construction.

1.5. Populism and Digital Technology

Social media and digital technology look set to change the power play among Jakarta's elites and usher in a new breed of elected leaders. This trend is being driven by pragmatic populism among everyday Indonesians who are disillusioned with the old system. The use of online social media tools such as Facebook, Twitter, blogs, and other mobile phone applications has also made elected politicians increasingly answerable to the public.[22] Many are using such platforms to criticise public policies and report corrupt officials, as well as to share and exchange political information.

> **As public opinion increasingly shapes the development of Indonesia's policies, there is a sense that it will also create a more accountable political administration.**

The growth of social and digital networks has not gone unnoticed by the Indonesian elites and politicians, especially Jokowi. The 2012 Jakarta gubernatorial elections and 2014 presidential polls, both of which Jokowi won, were dubbed "social media elections" for their high use of digital technology.[23] Jokowi has over 6.2 million "likes" on Facebook and regularly posts photographs documenting his Presidential duties, high-level meetings, and overseas trips.

Fuelled by rapid growth in smartphone penetration and a large educated and urban youth population, Indonesia has become one of the world's top five social media markets.[24] This means that the role played by digital technology in politics is likely to increase in the near future. As public opinion increasingly shapes the development of Indonesia's policies, there is a sense that it will create a more accountable political administration.

In this regard, the Jokowi government will do well to ensure that complex trade and investment issues, as well as the decision to deregulate Indonesia's economy, are well-communicated and properly understood by the public. This appeal to the masses will be important to drive and support reforms from the bottom-up, countering the protectionist-nationalistic forces among some of the Jakarta elites.

A generational shift is occurring in Indonesia, and it is possible that a more protectionist, older generation can be matched and outnumbered by a more open and receptive younger generation. If so, this will reinforce reform efforts to create a strong but internationally competitive and connected Indonesia.

2. ECONOMIC AND INSTITUTIONAL REFORM

In a world short of growth, Indonesia is outperforming and attracting growing interest from foreign investors. With costs rising in China, many companies are turning to Southeast Asia and by extension Indonesia, the largest economy and market in ASEAN.

In Indonesia, there is growing domestic recognition that growth rates should improve to provide better jobs for the young population entering the work force, and that strategic, higher-quality investment is key for driving higher-value sectors and creating higher-paying jobs. In other words, a window is opening up where foreign investment interest is aligning with domestic desire for such investment.

[22] SIIA-KPMG closed-door dinner dialogue with former Indonesia Minister for Trade Thomas Lembong, 26 April 2016, Jakarta

[23] Lake, Rebecca (2014) Indonesia's surprising love affair with social media, *The Jakarta Globe*, 24 February 2014, Available: http://jakartaglobe.beritasatu.com/features/indonesias-surprising-love-affair-with-social-media/ Retrieved: 10 July 2016

[24] Yang, Jennifer Hui (2014) Indonesian presidential election: will social media forecasts prove right?, *RSIS Commentaries,* 25 June 2014, Available: https://www.rsis.edu.sg/wp-content/uploads/2014/07/CO14120.pdf Retrieved: 10 July 2016

But this window may close unless the Jokowi administration implements reforms and economic development plans in a timely manner. According to a World Bank analysis, factors such as low labour productivity, high logistics and business costs, and a lack of a sound industrialisation strategy are diminishing Indonesia's attractiveness to foreign investment.[25]

Consequently, Indonesia risks finding itself overlooked and bypassed by foreign businesses and factories looking for a new home. Already, foreign companies such as Panasonic, Toshiba, and Ford have announced plans to stop or reduce their operations in Indonesia.[26] There are fears that more foreign companies will start moving operations to regional competitors such as Vietnam and Malaysia, both of which have strong fundamentals and easier access to export markets such as the EU, USA, and Japan because of free trade agreements and other arrangements.[27]

The following sections discuss the limitations and challenges that Jokowi needs to overcome in order to follow through with his economic development plans.

2.1. Increasing Government Revenues

The Indonesia government is experiencing a revenue shortfall for reasons beyond its control, such as weak commodity prices and dampened demand for Indonesian exports. This has prompted the government to revise its 2016 state budget to accommodate a larger budget deficit for development, especially infrastructural development.[28]

According to a study by the consultancy firm, McKinsey, Indonesia will need at least US$600 billion over the next 10 years to bridge critical infrastructure gaps.

The need for sizeable and readily-available capital to fund infrastructure projects will make partnerships with the private sector a top priority in the near future.

The need for sizeable and readily-available capital to fund infrastructure projects will make partnerships with the private sector a top priority in the near future. To help plug the financing gaps in the interim, public sector spending needs to play an increasing role. The government is expected to increase capital expenditure, which includes spending on infrastructure, from US $18.85 billion to US $21.06 billion.[29] Funding this expenditure will be a challenge, especially as the government aims to keep its fiscal deficit below 3 percent of GDP.[30]

Part of the increased revenue for the government to spend on infrastructure will come from savings made from lifting the fuel subsidy last year, which amounted to an estimated US$18.4 billion. This has created a considerable 53 percent boost in Indonesia's infrastructure budget – the biggest year-on-year increase in the country's history.[31] Further

[25] (2016) Resilience through reforms, *Indonesia Economic Quarterly, The World Bank,* June 2016, Available: http://www.worldbank.org/en/country/indonesia/publication/indonesia-economic-quarterly-june-2016-resilience-through-reforms Retrieved: 13 July 2016
[26] (2016) Indonesia & Free Trade Agreements: Indonesia-EU CEPA, TPP & EFTA, *Indonesia-Investments.com,* 10 February 2016, Available: http://www.indonesia-investments.com/news/news-columns/indonesia-free-trade-agreements-indonesia-eu-cepa-tpp-efta/item6484 Retrieved: 13 July 2016
[27] Ibid.
[28] Rahadiana, Rieka and Suhartono, Harry (2016) Jokowi steps up infrastructure as Indonesia budget strained, *Bloomberg,* 1 July 2016, Available: http://www.bloomberg.com/news/articles/2016-07-01/indonesia-steps-up-infrastructure-rollout-as-budget-takes-strain Retrieved: 15 July 2016
[29] (2015) The report: Indonesia 2015, *Oxford Business Group*.
[30] (2016) Significance of tax amnesty programme, *DBS Group Research,* 15 July 2016, Available: https://www.dbs.com/aics/templatedata/article/generic/data/en/GR/072016/160715_economics_significance_of_tax_amnesty_programme.xml Retrieved: 15 July 2016
[31] (2015) Indonesia's economy: Spicing up growth, *The Economist,* 9 May 2015, Available: http://www.economist.com/news/finance-and-

cuts on diesel subsidies in Indonesia's revised 2016 budget were passed by the Parliament in June. The savings from these cuts will be allocated towards programmes including healthcare and public works.

Another key effort to boost the country's coffers involves increasing tax revenues and broadening the taxpayer base. The planned driver for this is a new tax amnesty programme that aims to convince Indonesians to voluntarily declare and pay taxes on income being held overseas. The government hopes to collect as much as US $42.64 billion worth of tax revenues through the scheme.[32]

This is not the first time that Indonesia has launched a tax amnesty programme. The country's first tax amnesty programme in 1964 failed after the 1965 30 September Movement resulted in the fall of the country's first president, Sukarno. A second programme in 1984 was launched under the Suharto government but also failed to take off.[33]

As such, some remain doubtful as to whether the current amnesty programme will substantially support the big-ticket infrastructure plans. Concerns also extend beyond the amnesty itself to the overall tax system, which many see as a murky area in need of reform. Despite reassurances that data will be kept confidential, Indonesian businessmen may be concerned about how their financial data will be used and if they will be targeted should there be a change in government policy in the future.

Some commentators feel that should results fall short from what is expected, public confidence in the Jokowi administration could take a hit.[34] It is true that a smaller-than-expected haul could slow infrastructure development plans. It is notable that one of the first efforts by the newly appointed Minister of Finance, Sri Mulyani Indrawati, has been to reduce pressure on the tax amnesty's performance by proposing funding cuts to several ministries to help reduce the government deficit.[35]

Jokowi and his government will need to consider other ways beside the tax amnesty to ensure a sustainable increase in the budget and consistent funding for their priority plans.

On the other hand, supporters of the tax amnesty programme point out that it is fundamentally necessary but will need time to gain traction. They also observe a rising trend of young Indonesian businessmen who are willing to repatriate wealth back to Indonesia, as they recognise the potentially high investment returns and wish to play an active role in the country's development.

Jokowi and his government will need to consider other ways beside the tax amnesty to ensure a sustainable increase in the budget and consistent funding for their priority plans. Steps that should be considered include increasing excises on fuel, tobacco and vehicles, as well as a comprehensive strategy to reform the country's tax policy and

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economics/21650586-bad-policy-much-bad-infrastructure-holding-indonesia-back-spicing-up Retrieved: 1 November 2015

[32] (2016) Indonesia expands tax amnesty to draw funds, *The Straits Times,* 12 August 2016, Available: http://www.straitstimes.com/business/indonesia-expands-tax-amnesty-to-draw-funds Retrieved: 15 August 2016

[33] Supriadi, Agust (2016) Prioritaskan UU tax amnesty pemerintah belajar dari masa lalu, *CNN Indonesia,* 29 April 2016, Available: http://www.cnnindonesia.com/ekonomi/20160429141442-78-127559/prioritaskan-uu-tax-amnesty-pemerintah-belajar-dari-masa-lalu/ Retrieved: 15 July 2016

[34] Wirayani, Prima (2016) Revised state budget passed without objections, *The Jakarta Post,* 29 June 2016, Available: http://www.thejakartapost.com/news/2016/06/29/revised-state-budget-passed-without-objections.html Retrieved: 15 July 2016

[35] Sawitri, Angelina Anjar (2016) Tax amnesty target remains unchanged: Minister Sri Mulyani, *Tempo.co,* 5 August 2016, Available: http://en.tempo.co/read/news/2016/08/05/056793633/Tax-Amnesty-Target-Remains-Unchanged-Minister-Sri-Mulyani Retrieved: 15 August 2016

administration. Indonesia has a relatively low tax revenue in relation to its overall GDP, meaning that there is scope to increase these general taxes without unduly burdening the economy. [36]

2.2. Managing Decentralisation

Indonesia's decentralisation policy has empowered local government leaders at the provincial and city levels. The considerable benefits of this policy can be seen today in the rapid growth of many areas and cities outside Jakarta.

However, decentralisation also poses challenges. One downside has been an increase in corruption over land procurement processes. Others include a lack of capacity at the local government level and difficulty in coordinating with Jakarta-based agencies.

As a result, some investors face long-drawn-out processes, such as the need to seek permission from local governments who often have no experience in project development. This is cited by investors as a strong disincentive.[37] Investors also highlight the need for central agencies and government leaders to engage more with the local authorities in order to garner bottom-up support for the country's overall long-term development plans.

2.3. Corruption and Lack of Legal Certainty

Corruption is a long-standing and widespread problem. Despite the leadership of President Jokowi and the development of institutions such as the Corruption Eradication Commission (KPK), much remains to be done to address it.

In measuring the rule of law based on the experiences and perceptions of the general public and in-country experts, the 2015 World Justice Report ranked Indonesia 52 out of 102 countries. This was a drop of six places from 2014, suggesting that upholding the rule of law remains a serious challenge in the country.[38] The report also revealed that corruption is still rampant among the nation's judiciary and law enforcers, and that civil justice is not effectively executed.

As the Jokowi administration woos higher-quality investments, there is a need to provide foreign investors with greater assurance through clearer and fairer dispute settlement mechanisms.

As the Jokowi administration woos higher-quality investments, there is a need to provide foreign investors with greater assurance through clearer and fairer dispute settlement mechanisms. This relates to investor-state relations, as well as disputes between foreign investors and Indonesian companies or individuals with political connections.

This sentiment is echoed by international investors. Many foreign investors lack confidence in Indonesia's legal system and have often stated that seeking arbitration in Indonesia is a very complicated, tedious and time-consuming process.

The lack of trust in Indonesia's legal system has prompted foreign investors to settle disputes outside of Indonesia. Yet, opinion in Indonesia remains against international investment settlement mechanisms such as the International Convention on the Settlement of Investment Disputes (ICSID), which are felt to

[36] (2016) Indonesia: Staff report for the 2015 Article IV consultation, *International Monetary Fund,* 8 February 2016, Available: https://www.imf.org/external/pubs/cat/longres.aspx?sk=43787.0 Retrieved: 22 July 2016

[37] (2015) Towards a sustainable financial system in Indonesia, *United Nations Environment Programme,* April 2015, Available: https://www.die-gdi.de/uploads/media/Towards_a_Sustainable_Financial_System_in_Indonesia.pdf Retrieved: 22 July 2016

[38] (2015) Rule of law index, *World Justice Project*, Available: http://worldjusticeproject.org/sites/default/files/roli_2015_0.pdf, Retrieved: 2 August 2016

be biased against Indonesia and developing countries.

In 2012, the previous administration limited access to the ICSID, so that a foreign investor can only use the ICSID if the central government is at fault, not a local government.[39] This decree is allowed within the framework of the Convention.[40] However, it leaves investors without legal recourse when there are disputes concerning the local government, and given the decentralisation of authority in the country, this can have a considerable impact on investor confidence.

The Jokowi government needs to find ways to balance domestic sentiment against the concerns of foreign investors. One way is to allow investors to access private remedies. For example, when Singapore-based investors collaborate with local partners in Indonesia, the standard Memorandum of Understanding (MoU) may stipulate that disputes will be settled in Singapore – through arbitration or the courts, as agreed by the parties – or in a third country.

In the longer term, legal reform is essential, and the Jokowi government can initiate this as a signal of its intentions. President Jokowi recently instructed the newly-appointed Coordinating Minister for Political, Legal, and Security Affairs, Wiranto, to carry out legal reform of national and local legislation. The progress of this reform needs to be monitored and communicated to the business community.

2.4. Workforce and Productivity

While Indonesia's workforce numbers are high, finding sufficiently-skilled workers in Indonesia has been a challenge for investors. Inadequate language and mathematical skills cause miscommunication and ignorance, creating errors that result in ineffectiveness and inefficiency. This is especially true for the manufacturing and construction sectors, and will likely result in greater problems as Indonesia attracts higher-quality investments that require more advanced skills.

Foreign firms will therefore need to allocate larger budgets towards skills and language training for their local employees to avoid decreased productivity.

This lack of skilled labour is exacerbated by tightened labour laws that require a 1:10 ratio of expatriates to Indonesian hires, up from the previous ratio of between 1:3 and 1:5. Foreign firms will therefore need to allocate larger budgets towards skills and language training for their local employees to avoid decreased productivity.

While Indonesia has the lowest wage cost in US dollar terms in Asia, this advantage needs to be adjusted for lower labour productivity.[41] If Indonesia is keen on regaining its competitiveness in the manufacturing sector, it will need to raise its cost competitiveness in this area or risk losing out to other countries.

2.5. Developing an Industrial Strategy

Last year, Jokowi announced plans to establish seven more Special Economic Zones (SEZs) in the next five years as a way to boost

[39] (2012) Indonesia limits the jurisdiction of the ICSID, Available: http://aksetlaw.com/news-event/newsflash/indonesia-limits-the-jurisdiction-of-the-icsid/ Retrieved: 2 August 2016

[40] (2013) Churchill Mining PLC v. Republic of Indonesia (ICSID Case No. ARB/12/14) Procedural Order No.2, Request for Joinder, *International Centre for Settle of Investment Disputes,* Available: https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC2952_En&caseId=C2261 Retrieved: 1 August 2016

[41] (2016) Resilience through reforms, *Indonesia Economic Quarterly, The World Bank,* June 2016, Available: http://www.worldbank.org/en/country/indonesia/publication/indonesia-economic-quarterly-june-2016-resilience-through-reforms Retrieved: 13 July 2016

development and growth, and called on foreign investors to build and manage these zones in Indonesia.[42] This is in addition to the nine existing SEZs, which include one in Batam, Bintan and Karimun (BBK); one in Palu, Central Sulawesi, housing nickel mining companies and cocoa processing plants; and one in Simalungun, North Sumatra, housing oil palm plantation companies and logistics firms.[43]

SEZs can be established as "favourable micro-climates" that have the potential to attract significant investments by offering incentives to foreign investors. The use of SEZs has been particularly effective in countries such as China, where industrial clusters within SEZs have helped to support industrial development in coastal areas.[44]

However, SEZs can also raise the cost of business if mismanaged or planned poorly. The BBK SEZ is one such example. The lessons drawn from BBK should be kept in mind when planning the development of future SEZs.

BBK, which began as the Batam Industrial Park in 1971, was part of a plan to jumpstart value-added manufacturing in Indonesia. However, BBK has so far failed to fulfil its full potential due to a range of problems.

Firstly, as part of decentralisation, each of BBK's provinces were made autonomous. This meant that investors had to deal with increasingly complex regulations involving provincial and sub-provincial levels of government.[45] The authorities at different levels reflected different vested interests. This created confusion, delayed projects, and impacted profit margins.

Adding to this were problems related to labour. A shortage of labour caused workers from Java and other provinces to be imported into BBK. There was inadequate infrastructure to cope with this increase, leading to social problems and frequent worker protests. This disrupted work and caused companies to lose profits.

The Jokowi administration needs to have a sound industrial strategy that goes beyond tax incentives to demonstrate a strong and continuing commitment to the development of SEZs.

Although Indonesia's government has now placed BBK under a Regional Council reporting to Jakarta, and a thorough audit of the Batam Authority is being carried out, [46] clarity in articulating the vision and comparative advantage of the new BBK is still required to win back investors. Investors have expressed uncertainty and wariness about the SEZ's investment prospects, and some companies have chosen to close their operations in BBK and move to other countries.

Moving forward, the Jokowi administration needs to have a sound industrial strategy that goes beyond tax incentives to demonstrate a strong and continuing commitment to the development of SEZs. It should set out clear objectives for each SEZ, including targets for employment, revenues and FDI generation. Such expectations will help direct and discipline the authorities in charge of these SEZs and improve accountability.

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[42] Soeriaatmadja, Wahyudi (2015) Indonesia seeking investors to build SEZs, *The Straits Times,* 5 November 2016, Available: http://www.straitstimes.com/asia/indonesia-seeking-investors-to-build-sezs Retrieved: 22 July 2016

[43] Ibid.

[44] (2016) Resilience through reforms, *Indonesia Economic Quarterly, The World Bank,* June 2016, Available: http://www.worldbank.org/en/country/indonesia/publication/indonesia-economic-quarterly-june-2016-resilience-through-reforms Retrieved: 13 July 2016

[45] Choi, Nankyung (2007) The SEZ plan for Batam, Bintan, and Karimun: Looking back and ahead, *S. Rajaratnam School of International Studies, Nanyang Technological University,* 16 July 2007, Available: https://www.rsis.edu.sg/rsis-publication/idss/956-the-sez-plan-for-batambintan/ Retrieved: 5 August 2016

[46] (2016) What does the future hold for Batam?, *Indonesia Business Insight,* 15 March 2016, Available: http://www.indonesiabusinessinsight.com/article/read/what-does-the-future-hold-for-batam Retrieved: 5 August 2016

3. EXPLORING INDONESIA'S NEW TRADE LINKAGES

Policymakers increasingly believe that Indonesia must engage with regional and other trade and economic integration arrangements so as not to lose out to its neighbours in terms of trade connectivity.

During a closed-door meeting organised by the SIIA, an Indonesian cabinet minister shared his view that Indonesia must step up efforts to improve its free trade networks with key export markets. The minister also announced Indonesia's commitment to move ahead with the ASEAN Economic Community (AEC) and speed up negotiations on Comprehensive Economic Partnership Agreements (CEPAs) with the EU, the European Free Trade Association, and Australia.[47]

CEPAs and other bilateral free trade agreements are lower hanging fruit that can provide foreign investors with the assurance that they will continue to have free or easy access to key export markets in the short to medium term.

These efforts will anchor Indonesia's ongoing domestic economic reforms. The development of the AEC and free trade deals is expected to lower the country's tariffs to become on par with the rest of the region, making Indonesia more competitive.

In the meantime, CEPAs and other bilateral free trade agreements are lower - hanging fruit that can provide foreign investors with the assurance that they will continue to have free or easy access to key export markets in the short to medium term.

Being bound by trade agreements with external partners also provides an impetus for the Indonesian government to modernise and improve existing trade regulations by liberalising the economy.

This will help lay the groundwork to participate in more forward-looking trade agreements, such as the Trans-Pacific Partnership (TPP), which includes the USA and Japan. Jokowi has mentioned interest in joining the TPP, but the trade pact's high standards currently make it difficult for Indonesia to participate on a level playing field. As such, Jokowi's statement about the TPP can be seen as a long-term objective, giving direction for further reforms in Indonesia.

4. CONCLUSION: NEW OPPORTUNITIES

In the past, Indonesia has leveraged on its abundant natural resources and large consumer base as the foundation for economic growth. However, there is an increasing effort from Jokowi's administration to shift from consumption-led to investment-led growth. These efforts are targeted at establishing opportunities in new sectors through infrastructural development, industrialisation, and innovation.

Indonesia's manufacturing sector is expected to grow, especially with the government's renewed emphasis on attracting manufacturing investment to emerge as a cost-competitive manufacturing hub, linked to both regional and global production networks.[48]

The first steps are already being taken to realise this aim. In August 2016, the 2,700-hectare Kendal Industrial Park in Semarang will be launched. Led by Singapore's Sembcorp, Kendal will be the first Singapore-Indonesia collaborative industrial park on the main island of Java. Such integrated industrial estates will support Indonesia's industrialisation efforts

[47] SIIA-KPMG closed-door dinner dialogue with former Indonesia Minister for Trade Thomas Lembong, 26 April 2016, Jakarta

and enhance Indonesia's ability to attract high-quality foreign investors.

The lure of port cities outside of Jakarta, such as Surabaya and Semarang, where labour costs are lower, will likely see more foreign companies opening operations there.

Other key sectoral opportunities include those in infrastructure, power and utilities, and information and communications technology (ICT). The Jokowi administration has committed to channelling more of the government's 2016 budget towards developing these sectors. All these shifts should open up new kinds of opportunities for investors.

Investors should note that protectionist-nationalistic sentiments are likely to continue. The Jokowi administration cannot ignore or openly defy such rhetoric, as these sentiments enjoy broad public support at present.

Nevertheless, the emerging signs surveyed in this report do suggest a concerted, if less obvious, effort to push for reforms and create more openness and new investment opportunities. Jokowi is targeting foreign investors who can create jobs and advance the infrastructure, digital economy, and manufacturing sectors, either on their own or in partnership with Indonesian companies. If investors can successfully interpret the government's signals and navigate Indonesia's complexities, they stand to reap significant rewards by supporting Indonesia's new economic shift.

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