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# Open Door Policy and Foreign Investment

by Dr Azhari Zahri, Singapore \*

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When the Suharto Cabinet was formed by Congressional Decree in July, 1966, one of the basic tasks assigned to it was the stimulation of the flow of foreign capital into Indonesia<sup>1</sup>. In January, 1967, the Cabinet submitted the draft of a Foreign Investment Law to Parliament which became Law only a few months later. Indeed, never in Indonesian history foreign investment was given such a strong support by Parliament.

However, to stimulate foreign private investment in a country which suffered from a long political turmoil and an economic setback requires more than just a favourable political atmosphere. Many preconditions necessary to encourage foreign private investment must be established and it may take a few more years before Indonesia becomes a fertile land for foreign capital.

During the period between 1967 and 1969 there were 177 projects, involving the total amount of intended investment of more than US \$1 bn, approved under the Foreign Investment Law. Another amount of about US \$700 mn has been approved by the Government during the last ten months, bringing the total planned foreign investment to the amount of US \$1,700 mn. Looking at these figures one could get the impression that the campaign for foreign investment is really paying off.

An official report, however, indicates that only approximately 10 p.c. of this total planned investment has actually been implemented and most of this in the mining sector<sup>2</sup>. It was also reported that some foreign investors have withdrawn their applications for various reasons. This gloomy picture shows that unless the obstacles are removed Indonesia's open door policy can hardly achieve a successful result and hence a new policy must be found to develop the country's natural resources.

Some of the obstacles which have handicapped the smooth flow of foreign capital into this country are deeply rooted in the Indonesian political and economic system. The period of independence from 1950 up to date has seen a long struggle between two opposing opinions on how the Indonesian potential wealth must be developed.

## Political and Psychological Barriers

The first open door policy was adopted under the Dutch Rule when the struggle between the Dutch conservatives and the liberals ended eventually with the victory of the latter, and when the Agrarian Law was enacted in 1870, followed by the enactment of the Mining Law in 1899. Although the liberals, no less than the conservatives, regarded the colony as an enterprise, their policies were different, for, while the conservatives favoured the role of state exploitation the liberals preferred private exploitation<sup>3</sup>.

While the provision of the Agrarian Law made it possible for Western plantation enterprises to obtain land either from Government for periods up to 75 years or from the natives for a short period, the promulgation of the Mining Law led to a rapid growth of foreign mining enterprises in the Netherlands India<sup>4</sup>.

However, these legal provisions were not the only steps taken by the Dutch Colonial Government to stimulate foreign investment in the colony. The construction of communication and transport services, irrigation, harbours, and various infrastructures were also intensified to facilitate the development of colonial resources. This was followed by the growth of financial institutions to help finance plantations and other Western undertakings.

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<sup>1</sup> For detailed discussion, see Dr Azhari Zahri, *Indonesia: Public Control and Economic Planning* (Singapore: MPH Publication Ltd., 1969), Chapter IX.

<sup>2</sup> Cf. *Kompas*, Djakarta, June 25, 1970.

<sup>3</sup> Cf. Bernard H. M. Vlekké, *Geschiedenis van den Indischen Archipel* (J. J. Romen & Zonen Uitgevers, Roermond-Maastricht, 1947), pp. 348-353. See also J. S. Furnivall, *Netherlands India: A Study of Plural Economy* (New York: The Macmillan Co., 1944), Ch. VII.

<sup>4</sup> Azhari Zahri, *op. cit.*, pp. 5-12, and Alex L. ter Braake, *Mining in the Netherlands East Indies* (N. York: The Institute of Pacific Relations, 1944), pp. 21-25.

The dominance of foreign private enterprises in the Indonesian economy and the colonialism, which were associated with the Liberal system, later became a target of attack by both the Indonesian nationalists and some Dutch scholars. Indeed, the whole ideological foundation of the Indonesian nationalist movement itself had been based on anti-colonialism and anti-liberalism.

### Policy of Isolation

The same as in other emerging countries in Asia and Africa, the Indonesian nationalists argued that the people's standard of living in a colonial territory could only be raised if this territory achieve the condition of independence or political self-government<sup>5</sup>. But this is only the first step, because experience shows that the attainment of political self-government does not necessarily result in the exclusion of all foreign influence. Hence, people tend to believe that only if the independent nations succeed in eliminating all foreign economic influence or achieve independence could the people of free nations raise their economic welfare.

For almost two decades after independence Indonesia adopted this inward-looking policy and was obsessed by the fear that if the foreign enterprises were allowed to re-establish themselves in the country, they would regain their old "strangle hold" on the Indonesian economy.

Nowadays, after a decade of "guided" economic system of the former President Sukarno, Indonesia, as was the case one hundred years ago, feels the need of foreign private investment and hence has adopted another policy. But a shift in economic policy resulting from a political change has not yet been accompanied by either a noticeable change in the structure of government administration or a change in bureaucratic attitudes. The government administration set up originally to carry out the socialist economic policies of the old order and the bureaucrats empowered to exercise public control over the nation's economy have not experienced a major change.

### Administrative Handicap

In January, 1967, when the Foreign Investment Law was completed, the Suharto Cabinet set up a Foreign Investment Council comprising the chairman of the Cabinet Presidium and Ministers concerned with economic and financial affairs and the chairman of the National Development Planning Bureau<sup>6</sup>. The Council, whose day-to-day work is performed by the Foreign Investment Board, is responsible for the implementation of foreign investment policy. Logically, the Council

or the Board must be the highest decision making body in the foreign investment administration. But this is not the case because in practice many other government departments and even regional administrations concerned with foreign investment projects are also holding authority to approve projects.

The administrative complexity inherent in the economic system of the old regime is aggravated by the vagueness of the government regulation on the establishment of the Council and the Board<sup>7</sup>. Article 2 of the regulation states that "the Foreign Investment Council is in charge of submitting recommendations to the Government . . ., concerning:

- ☐ formulation of implementing the Foreign Investment Law;
- ☐ recommendations for approval or rejection of applications for foreign investment; and
- ☐ advice on matters related to the granting of permits concerning taxation, transfer and changes of the status of foreign enterprises and the like."

From this it becomes obvious that the Council or the Board is nothing more than an advisory body which would pass on the applications to the Indonesian Government essentially consisting of many departments, agencies, regional administration and the like.

### Difficult Administrative Procedure

Indeed, a major source of delays and frustration to foreign investors is the division of functions and authority between the Council or the Board and the many other departments and agencies concerned with foreign investment projects<sup>8</sup>. The complexity of this administrative procedure has led to the intensified corrupt practices in the government bureaucracy dealing with foreign investment projects. The Vice Chairman of the Indonesian Congress, H. M. Subchan, recently charged that the flow of foreign investment is not smooth because investors have to make numerous payoffs through unofficial channels which hold the authority to approve projects<sup>9</sup>.

The establishment of a single body with real executive authority is certainly needed and would

<sup>5</sup> See also, Hla Myint, "The Inward and Outward Looking Countries of Southeast Asia and the Economic Future of the Region", in: *Japan's Future in Southeast Asia* (Kyoto University, 1966).

<sup>6</sup> "Decision of the Cabinet Presidium No. 17 (Ek. Kep. I), 1967", in: *Indonesian Government, Investment: Policies, Procedures, Field of Investment and Progress Report* (Jakarta; 1969), pp. 130-132.

<sup>7</sup> *Ibid.*, Articles 2-4.

<sup>8</sup> M. Clapham, "Difficulties of Foreign Investors in Indonesia", *Bulletin of Indonesian Economic Studies*, Vol. VI, No. 1 (March, 1970), and see also *Harian Kompas*, Jakarta, June 24, 1970.

<sup>9</sup> Quoted in *The Singapore Herald*, September 26, 1970, p. 10.

simplify the administrative procedure for foreign investment. However, under the present state of government bureaucracy the establishment of a single organisation with highest authority will hardly be supported by the departments or regional administrators since any single authority could be interpreted by them as a monopolisation of corruption. Unless a serious action is taken to abolish or reduce corruption and to improve bureaucratic efficiency the public administration continues to handicap a smooth flow of foreign capital into the country.

### Legal Impediments

Equally serious obstacles to the implementation of approved foreign investment projects are to be found in the existing laws concerning enterprises, labour, land, taxation and trade. The Indonesian commercial law relating to limited liability companies is inherited from the Commercial Code laid down by the Dutch in 1847. A shareholder, according to this Code, is not permitted to have more than 6 votes regardless of the number of shares he or she holds. Foreign investors, except for banks and mining companies, are required to incorporate a local company.

These clauses constitute a handicap to both foreign investment and the development of a domestic capital market. A shareholder with 90 p.c. of the number of shares could be defeated in voting by two plotting shareholders with respectively 5 p.c. of shares each<sup>10</sup>. If this regulation of voting right is intended to avoid foreign domination and control over the management of joint ventures other devices could be worked out by the Government to safeguard the national interest. The Government could, as it had done in 1951, determine types of mixed enterprises in which Indonesians would hold the majority of stock and control the board of directors<sup>11</sup>. Only recently, the Government has submitted a proposal for the amendment of the article in the Commercial Code which limits the voting right of a shareholder. This move has already been followed by an immediate unfavourable reaction of the public and, therefore, the amendment will not be passed easily by Parliament for political reasons.

Another aspect of legal problems facing foreign investment is labour legislation. Under present legislation the employer is required to obtain a permit from the Department of Manpower before

he can dismiss his worker. To obtain a dismissal permit a long arbitration procedure is normally involved. In 1964 a labour regulation was issued by the Government which requires an agreement from both parties (employer and employee) before a dismissal could come into effect. This regulation remains effective up to the present time. Regulations governing wages, strikes and others are also considered barriers to foreign investment. In the past when the world of Indonesian Trade Unions was dominated by the communist elements the labour legislation was abused to weaken the employer's position. Under present circumstances destructive action by Trade Unions and wild strikes could hardly take place but in the long run, if no attempt is made to improve the labour legislation and arbitration procedure, foreign investment would be discouraged. An attempt must be made to establish a sound Labour Arbitration Court to safeguard the interest of both employer and employee.

### Problems of the Land Law

Land Law is also a source of legal difficulties about which many domestic and foreign investors complain. The domestic investors undertaking plantation enterprises voiced their complaints about the 25 year limit to the right for using land<sup>12</sup>. This limit, according to them, does not permit plantation enterprises to make sufficient profit because of heavy overhead cost incurred in the production. To foreign investors the 30 year limit to the right of using land is a reasonable enough period, but the problem is the lack of clarity concerning the rights of the user.

The Indonesian Land Law classifies the right of ownership, the right of exploitation, the right of land for premises, and the right of use. The Foreign Investment Law offers foreign investors only the right of building, the right of exploitation and the right of use<sup>13</sup>. Since the right of ownership is a hereditary right, it can only be possessed by Indonesian citizen. To some foreign investors it is not clear whether a mortgage can be raised on real property which has been assigned to them and for which a concessional price has been paid<sup>14</sup>.

### Tariff Protection

Article 15 of the Foreign Investment Law provides import duty concessions to foreign investors especially for the imports of capital goods (equipment, machinery or working tools) into Indonesian

<sup>10</sup> See also Professor Mohd. Sadii, *Foreign Capital and Growth of National Enterprises, Indonesian Perspectives*, August, 1970, p. 14, and his article in *Kompas*, June 4, 1970.

<sup>11</sup> *The Industrialization of Indonesia*, *Indonesian Review*, Vol. I (1951), pp. 184-186.

<sup>12</sup> *Kompas*, June 24, 1970, p. II.

<sup>13</sup> *Foreign Investment Law*, Article 14.

<sup>14</sup> Cf. M. C I a p h a m, *op. cit.*, pp. 77.

territory. In his instruction issued in August, 1967, the Minister of Finance specified the types of goods to be exempted from import-duties ranging from machines, tools, raw materials, semi-finished and finished goods, all kinds of transport to office equipment and building materials for constructing factories, offices, houses and other infrastructures for foreign enterprises personnel. Also included in the list are consumer goods needed by foreign personnel whose value is not to exceed an amount of US \$ 50 per person or of US \$ 100 per family.

Despite this liberal provision many foreign investors remain unsatisfied, not so much because of the lack of definition or uncertainties of interpretation of the Minister's of Finance instructions to the Director General of Customs but because of difficulties in dealing with customs officers. This government special regulation has already given rise to strong protest from domestic investors who do not qualify for this provision. More liberal policies, therefore, would undoubtedly cause only hostility of domestic enterprises and more difficulties to foreign investors themselves in dealing with customs officers who have benefitted from the trade control system for so many years.

Tariff protection of finished goods is also established for foreign investors through the imposition of duties on imports as a part of the Indonesian foreign exchange control. However, since both legal and illegal smuggling has not been wiped out, foreign enterprises producing consumer or finished goods are deprived of that tariff protection. Smuggling also causes a great difficulty for the Indonesian importers because the smuggled goods retail cheaper than legally imported commodities.

#### **Tax Exemptions**

Foreign investors are also granted relief of taxes for a period of time depending on the amount of capital invested. Foreign investors investing a minimum of US \$ 2.5 mn during the first two years, whose investment is undertaken in enterprises which either increase foreign exchange earnings or save foreign exchange for imports, are granted corporation and dividend tax exemptions for three years. If that minimum of US \$ 2.5 mn is invested in undertakings which neither increase foreign exchange earnings nor save foreign exchange for imports the exemptions are limited to two years. However, if foreign investors invest in the islands outside Java an additional exemption of another year is granted from both corporate and dividend taxes. Foreign enterprises investing a minimum of US \$ 15 mn within the first two years are granted tax exemptions for five years.

Whilst the provision for tax exemption may be considered one of the most encouraging aspects of the government open door policy, many foreign companies have also expressed anxiety as to what will happen after expiration of the tax exemptions<sup>15</sup>. The reason for this anxiety is the Indonesian tax system which is regarded as being too heavy to enable business to grow in a normal and healthy way. Corporation taxes averaged about 50 to 60 p.c. and Indonesia has few double taxation agreements. Foreign employees, too, are often subject to double taxation. Apart from this, a regional tax is another aspect of the tax system which discourages foreign investors. A regional tax on export of timber, for instance, must be paid by foreign investors undertaking forestry enterprises. This tax is not included in tax exemption.

It has been announced by the Government that a tax reform will be carried out which would encourage the growth of foreign as well as domestic enterprises.

A lack of infrastructures necessary for industrial development is another factor responsible for the slow flow of foreign capital. It has impeded the foreign investment projects in Indonesia. The present Five-Year Development Plan has allocated roughly 30 p.c. of its total investment budget to infrastructures such as industrial site, roads, electricity, water supply, communications and others, but it will take a few years before they are completed.

#### **Competition for Foreign Capital**

Recent international monetary crises and the restrictions imposed on capital outflow by developed countries suffering from balance of payments deficits seem to be other obstacles which tend to limit the flow of foreign capital into Indonesia. With its more developed neighbours such as Singapore and Malaysia, Indonesia is forced to compete keenly for foreign investment.

The American private investment in Singapore during the last three years, for instance, amounts to well over US \$ 250 mn compared to only less than US \$ 100 mn in Indonesia for the same period. With its highly developed infrastructure and industrial site and with its incentive investment law, Singapore has been considered one of the most tempting locations for foreign investors not only in Southeast Asia but also in the world. This is, in effect, a factor to be reckoned with in Indonesia's effort to attract foreign investment.

<sup>15</sup> Cf. PIBA — Investment Promotion Council, From Sydney to Jakarta (A Report), Jakarta, 1969.