Decentralization, Foreign Direct Investment and Development in Indonesia

Kuswanto, K.; Hoen, Herman W.; Holzhacker, Ronald L.

Published in:
Decentralization and Governance in Indonesia

DOI:
10.1007/978-3-319-22434-3_5

Publication date:
2015

Chapter 5
Decentralization, Foreign Direct Investment and Development in Indonesia

K. Kuswanto, Herman W. Hoen and Ronald L. Holzhacker

Abstract As the role of Foreign Direct Investment (FDI) in development becomes increasingly significant, the concern of many policy makers is not only to attract FDI but also to ensure that the society and future generations gain broad benefits from the FDI. Hence, the United Nations Conference for Trade and Development (UNCTAD) developed the Investment Policy Framework for Sustainable Development (IPFSD) as guidance for countries to achieve sustainable development from FDI. Using the IPFSD, this paper examines the investment policies of Indonesia under centralized and various decentralization periods and describes the relationships among government levels in implementing the policies which guide FDI. From the examination, we found that the investment policies in Indonesia have been directed to achieve sustainable development gradually. Furthermore, the intergovernmental relationships that have changed due to the decentralization process have become crucial to the effectiveness of investment policies for the society. During the centralized period, the performance of inward FDI was good, but citizen input and participation in the policy process was weak. In the first wave of decentralization, local governments gained significant powers from the central government to guide FDI. However, the great devolution of power to local governments without

The first author is the original researcher and serves as the author for correspondence, the remaining authors are promoters and supervisors listed in alphabetical order who also have contributed to this chapter.

K. Kuswanto (✉) · R.L. Holzhacker
Faculty of Arts, Department of International Relations and International Organisations, University of Groningen, Groningen, The Netherlands
e-mail: k.kuswanto@rug.nl

R.L. Holzhacker
e-mail: r.l.holzhacker@rug.nl

H.W. Hoen
Professor International Political Economy, Faculty of Arts, Department of International Relations and International Organisations, University of Groningen, Groningen, The Netherlands
e-mail: H.W.Hoen@rug.nl

R.L. Holzhacker et al. (eds.), *Decentralization and Governance in Indonesia*, Development and Governance 2, DOI 10.1007/978-3-319-22434-3_5

clear mechanisms of intergovernmental relations and accountability led to a deterioration of the investment climate and made the policies less effective. Finally, during the second wave of decentralization, the central government has taken responsibility in the FDI management process but still provides more room for local governments to participate in the development process. Hence, cooperation between national and local government is more enhanced during this period to guide FDI.

Keywords Foreign direct investment · Decentralization · Investment climate · Sustainable development · Intergovernmental relations · Investment policy framework for sustainable development

1 Introduction

Foreign Direct Investment (FDI) may have both positive and negative impacts on development. FDI has positive impacts on economic development because it contributes to accelerating and enhancing economic growth (Blostrom and Kokko 1998). Rodriguez and Clare (1996) and Graham and Krugman (1991) also suggest that the FDI increases productivity and access to external markets, expands international production network, encourages transfer of technology, skill, and knowledge, and reduces the unemployment rate. Despite those positive impacts, FDI also brings some negative consequences to host countries such as the increase of polluting goods and local dependency on foreign capital, and the destruction of local small enterprises (OECD 2001; Pavlinek 2004). Since FDI brings both positive and negative impacts to development, the recent concerns of many policy makers is not only to attract as much FDI as possible, but also to ensure that the FDI is beneficial to the broader society and future generations.

As the concept of sustainable development and FDI has become a hot topic recently, a study about FDI policy is very relevant especially for developing countries. Sustainable development is a development that meets both the needs of present people and the needs of future generations (WCED 1987). Among middle-income developing countries, Indonesia is an interesting country to study FDI. With abundant natural resources, low labour costs, a large population base, and good economic conditions, Indonesia has been considered one of the most attractive countries for investment in Asia, receiving $18.85 billion in FDI in 2013 (UNCTAD 2013). Regardless of the good performance of inward FDI in Indonesia, the contribution of this FDI to development in Indonesia remains unclear. Some studies found that the FDI has positive contributions to development in Indonesia (Parjiono 2003; Lipsey and Sjolhom 2002). For instance, Parjiono (2003) found that inward FDI contributes to an acceleration in economic growth, and Lipsey and Sjolhom (2002) found that foreign companies paid higher salaries than domestic ones. On the other hand, some studies found that the inward FDI has made little contribution to regional development in Indonesia (Effendi and Soemantri 2003; Sodik and Nuryadin 2005). Likewise, Thee (2001) found that Indonesia was not successfully taking advantage of FDI projects to promote development. Departing

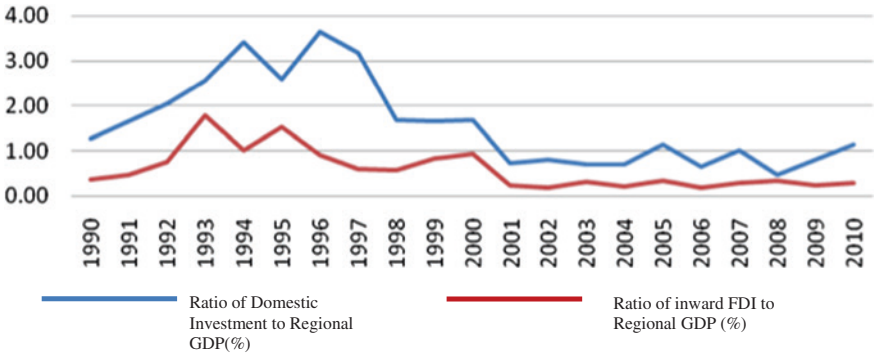

Fig. 1 Trend of inward FDI and domestic investment in Indonesia, 1990–2010. *Source* KADIN (2012)

from those empirical studies, we are interested in examining the FDI policy in Indonesia in relation to the concept of sustainable development.

This study also attempts to analyse the impact of the governance system on the implementation of investment policy. It follows the fact that Indonesia has been implementing decentralization since 2001 and some surprising facts related to FDI have arisen. Decentralization aims to reduce regional inequality and to improve local economic performance by increasing the role of local government in economic development, including managing FDI. However, some institutional problems such as corruption, overlapping regulation, over-taxation, and policy fragmentation have become more prominent during the decentralization era (LPEM UI[1] 2002a; World Bank 2005; Kuncoro 2006). Data from KADIN[2] (2012) illustrates that despite the increase of inflow FDI to Indonesia during the decentralization era, the contribution of inward FDI to regional development remains low. While the total amount of inward FDI going to regions has increased, the ratio of total amount inward FDI to regional GDP has decreased (see Fig. 1). Moreover, data from the BKPM[3] (2013) shows that the distribution of FDI project is concentrated in the Java and Bali regions, despite the decentralized system.

Departing from this situation, here we present an empirical study on how the inward FDI is managed in Indonesia under different types of governance system. More specifically, it describes the policy changes in Indonesia under the centralized and decentralized systems and the changed relationship between local and

[1]LPEM UI is the University of Indonesian Research Center for Economic and Social Development in Indonesia; information can be seen in http://www.lpem.org/?page_id=35.

[2]KADIN is Indonesian Chambers of Commerce and Industry, an umbrella organization of the Indonesian business chambers and associations, information can be seen in http://www.bsd-kadin.org/about/kadin.

[3]BKPM is the National Investment Coordinating Board of the Republic of Indonesia which is responsible for coordinating domestic and foreign direct investment in Indonesia. Information is available at http://www4.bkpm.go.id/contents/general/2/about-us#.VFdiQ6NgW70.

central government. This study is unique because many other studies on FDI and decentralization focus on statistical analysis and emphasize economic aspects of FDI. For instance, Yong (2008), Kalamova (2008), and Kessing et al. (2007) examine the relationship between decentralization and FDI using econometric models and only consider the overall quantity of inward FDI. Different from those studies, this study explains the policy development and relationship between stakeholders in formulating and implementing policy under different governance systems. Hence, we not only emphasize the quantity of inward FDI, but also consider the impact of FDI on the welfare of citizens and the fate of future generations.

2 Research Questions

This chapter answers the following research question: **How have the investment policies and intergovernmental relations changed over time in Indonesia?** Moreover, it answers two major sub-questions:

1. How have the policies related to FDI changed under the centralized and decentralized eras in term of sustainable development?
2. How have the intergovernmental relationships between the national and local governments changed under the centralized and decentralized eras?

3 Social and Scientific Significance

This research aims to make a positive contribution both socially and scientifically to the existing literature on FDI. Scientifically, it contributes to the debate about the impact of decentralization on FDI. Some political scientists argue that decentralization brings positive impacts to FDI because it increases citizens' participation, social accountability, and public spending effectiveness, and reduces the monopolistic behaviour of national governments (Barry 1995; Tiebout 1956). On the other hand, some economists suggest that decentralization leads to coordination failure, over-taxation, and fragmented policies among levels of government (Kessing et al. 2007; Kalamova 2008). This paper contributes to provide empirical evidence on how decentralization has had an impact on the FDI in both direct and indirect ways. While decentralization may cause coordination failure, over-taxation, and fragmentation policy, clearer intergovernmental relation mechanisms can assist in solving these problems. Therefore, this paper contributes to the application of the multi-level governance literature to Indonesia.

In terms of the social significance of this research, it will support policy makers in gaining a better understanding of the political economy aspects of FDI. This paper analyses how central and local government interact to achieve more sustainable development from FDI. It will also scrutinize some policies from the aspect of sustainable development in Indonesia.

4 Research Design and Methodology

This paper provides an empirical analysis of the investment policy changes under different types of governance systems and the change of relationships between local and central government over time in Indonesia. In order to do this, the qualitative research methodology is employed through a literature review and policy document analysis. We use the Investment Policy Framework for Sustainable Development (IPFSD) developed by the United Nations Conference for Trade and Development (UNCTAD) to analyse the investment policies over time. In addition, we use intergovernmental theory to analyse the relationship between the local and central government over time. We analyse the relationship between governments by examining the interest of each level of government, the role of each level, and the legal coordination mechanism between levels in the multi-level system.

The paper is organized into seven sections. Section 2 described the research questions; Sect. 3 explained the social and scientific significance of the paper; Sect. 4 reviewed the research design and methodology; and now Sect. 5 will review the literature and theoretical framework; Sect. 6 will explain the discussion and analysis; and finally, Sect. 7 will conclude this study.

5 Literature Review

This section provides a theoretical framework on the relationship between FDI and sustainable development. Furthermore, it also provides an overview of the concept of decentralization, sustainable development and intergovernmental relations and how those concepts are interrelated to each other.

5.1 Foreign Direct Investment and Sustainable Development

FDI has many different meanings. FDI is an investment by foreign enterprises in one economy in order to obtain lasting interest in another country (OECD 2008). Another definition from the International Monetary Fund (1997) is "*the FDI is an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise*" (p 86). Based on these definitions, we generalize the FDI which is an investment made by foreign entities to another country which involves the ability to control the management of the enterprises

Nowadays, the concept of sustainable development has become an important topic in development. The World Commission on Environment and Development (1987) defines sustainable development as a development that meets not only the

needs of the people today but also the needs of future generations. FDI has strong relationships with three parts of sustainable development: the economy, the environment, and the social development (OECD 2001). Currently, many countries have intensified their investment promotion, liberalized their economy, and provided financial incentives to attract FDI. In line with these efforts, it is necessary to protect the citizens and future generation from negative consequences of the increase in FDI. The United Nations has provided guidance by issuing the IPFSD.[4] Below is description of the concept of FDI and sustainable development and the necessary intervention polices to achieve sustainable development.

5.1.1 FDI and Economic Development

FDI can enhance economic growth of host countries when Multinational Companies (MNCs) spill-over their productivity to domestic enterprises which comes from technology transfers, knowledge transfers, and other MNCs—domestic enterprises linkages (Rodriguez-Clare 1996; Caves 1971; Blostroom and Kokko 1998). The productivity spill-over mechanism can be explained as follows: (1) the MNCs possess a superior technology and management which local firms can capture from knowledge sharing and technical/management training undertaken by the MNCs. Therefore, it can increase the value added of workers and productivity of local firms; (2) the MNCs possess international networks so that local firms are able to expand their business networks. Hence, productivity of local firms will also grow; (3) the existence of MNCs in host country increases local industrial competitiveness so that it can improve local firms' productivity; and (4) the existence of foreign firms decreases the dependency of local firms on government budgets because the FDI provides external financial sources for development (Blostroom and Kokko 1998).

However, without any proper policies, the FDI can harm local community and domestic enterprises because it increases local dependency to foreign capital and destroys small and medium enterprises (Pavlinek 2004). In order to minimize negative consequences of the FDI, a strong institutional framework and good investment climate are necessary to create an institutional setting that enables local citizens to participate in the investment policy development process and create better development (UNCTAD 2012). More specifically, UNCTAD (2012) mentioned that "investment policy should be developed involving all stakeholders and embedded in an institutional framework based on the rule of law that adheres to high standards of public governance and ensure predictable, efficient and transparent procedures for investors" (UNCTAD 2012, p 11). In addition, the government shall determine the criteria for approving FDI projects based on the potential of the jobs which can be created, the technology which can be transferred, the infrastructure which can be developed, and the business linkages which can be

[4]The IPFSD is the Investment Policy Framework for Sustainable Development, a framework developed by the United Nation Conference on Trade and Development.

generated (UNCTAD 2012). In fact, despite high amounts of inward FDI, many developing countries are not successfully receiving the full benefits from FDI because of weak institutions (OECD 2001).

5.1.2 FDI and Social Development

FDI has significant impacts on social development. Many studies confirm that FDI may reduce unemployment, increase the Human Development Index (HDI), and raise wages of host country citizens (Moran 2011; Colen et al. 2008). Baghirzade (2012) argues that the FDI in the twelve Commonwealth of Independent States (CIS) can promote social development especially by increasing the human development in those countries. Colen et al. (2008) found that FDI significantly contributes to reducing income inequality and poverty. The OECD (2001) determines that the social effects of foreign investment can be examined in two areas: FDI can create employment and FDI can exacerbate differences in income distribution and equality. Therefore, the existence of a proper labour regulation in a country is very significant.

Although FDI has positive impacts on social development, some studies found that FDI also harms poor people, increases income inequality, creates human and labour rights violation by MNCs, and reduces wage standards because the MNCs may lobby the government to lower labour standards (Mosley and Uno 2007; Letnes 2002; Galagher and Andres 2008). The negative impact of FDI on social development arises from the weak labour standard regulation or enforcement in a country.

Since FDI has both positive and negative impacts on social development, policy interventions are necessary through appropriate investment policies and other related policies which are coherent with the goal of sustainable development (UNCTAD 2012). There are two related policies that are important and will lead to coherence of the investment policy: the labour market regulation and the corporate social responsibility regulation. According to the IPFSD, the labour market regulations shall meet some criteria as follows: (1) the labour market regulation should support job creation objectives of investment policy, but the employees' rights should also be protected; (2) international labour standards should be adopted by the country; (3) the transfer of skills should be encouraged; and (4) regulations should give priority to increase the productive capacity of the labour force by FDI (UNCTAD 2012). Another related policy that is important is the corporate social responsibility obligation embedded in the investment process. In order to achieve sustainable development, the government should encourage compliance with high standards of responsible investment (UNCTAD 2012). Collen et al. (2008) argue that government should do more to regulate MNCs' responsibilities for social development (i.e. regulations on labour wage, corporate social responsibilities and protection of human rights law, etc.).

5.1.3 FDI and Environmental Protection

FDI may have significant impacts on the environment. The OECD (2001) argued that while FDI may lead to increased pollution due to industrial activities, it may improve structural efficiencies for environmental investment when it is paired with a strong environmental regulatory framework. Cole et al. (2006) found that FDI has a positive relationship to environmental regulation in a host country. Some studies found that some MNCs have a lower impact on pollution compared to domestic firms, but some others have a higher impact (Galagher and Zarkhy 2007).

As the FDI brings both positive and negative impacts to the environment, a strong environmental regulation framework must exist to reduce negative impacts of inward FDI. The OECD (2001) explains that the implementation and enforcement of adequate environmental regulations are very important in limiting environmental damage. Furthermore, the OECD (2001) also states that consistent law enforcement of environmental regulations is more preferable for investors than the relaxation of environmental standards. According to the IPFSD, in order to minimize negative effects of FDI toward environmental quality, environmental impact assessment should be part of investment policies; environmental norms should be transparent, non-discriminatory, predictable, and stable; and foreign enterprises should be encouraged to adhere to international standards (UNCTAD 2012).

After discussing the impact of FDI on sustainable development and some necessary intervention policies which should be in place, we focus on the circumstance when the governance is more decentralized. In a centralized system, the central government can easily execute the policy and plan, but in a decentralized system when local governments gain larger authority to manage investment locally, additional governance issues arise. Later, we discuss how decentralization can influence FDI and sustainable development.

5.2 Decentralization, FDI and Sustainable Development

Before we discuss decentralization and FDI, we need to understand what the definition is of decentralization. We use the definition of decentralization developed by Cheema and Rondinelli (2007), who argue that decentralization is a set of policies regarding the transfer of power, authority, and responsibilities within the government and within society. In this study, we use administrative and political decentralization as the model of our analysis. Administrative decentralization is the distribution of authority and responsibility from the national to local governments or semiautonomous public agencies through a twinning arrangement across the national border (Cheema and Rondinelli 2007). Furthermore, political decentralization is devolution of powers and authority to the local unit of government

by allowing participation of civil society organizations in the public decision making process and in selecting the political representative (Cheema and Rondinelli 2007).

In relation to FDI, the implementation of a decentralized system can enhance FDI on the one hand, but on the other hand, it may decrease FDI in that country. The horizontal aspect of decentralization, the increased regional competition to win investment, has positive impacts on FDI (Kessing et al. 2007). Due to the regional competition under the decentralized system, the regional governments are encouraged to provide incentives and a good investment climate in order to attract foreign capital, which is necessary for development (Kessing et al. 2007). Furthermore, the decentralization reduces the probability of government misbehaviour because the government becomes more accountable under decentralization system and public spending becomes more efficient (Tiebout 1956). The decentralization also increases citizen participation in the development process so that the policy result becomes more sustainable and conflicts will be reduced.

However, the vertical aspect of decentralization may reduce the inward FDI because it creates vertical disintegration in the decision making process, increases rivalry between the different tiers, and creates coordination failures. Furthermore, it may cause over-taxation, and moral hazards problems from joint accountability (Kessing et al. 2007). Furthermore, Kalamova (2008) argues that the increased number of government tiers under decentralization system leads to excessive bureaucracy and over-regulation. Political decentralization can hamper the implementation of investment project because coordination between different independent government levels is more difficult and the voting power at the local level takes more time (Kalamova 2008). These negative effects of decentralization on the FDI are mainly caused by the coordination problems between levels of government. Therefore, the discussion about the intergovernmental relations mechanism is crucial to minimize these problems.

5.3 Intergovernmental Relations

The clear mechanism of intergovernmental relations can help to overcome some possible deficiencies of decentralization. In order to minimize negative consequences of decentralization on FDI, Kessing et al. (2007) suggest that the number of government layers should not be overly expanded and a clear coordination mechanism should be developed (Kessing et al. 2007). Furthermore, Kalamova (2008) suggests that the remedy for coordination failure, over-taxation, and over-regulation in decentralization is the reduction of hierarchical structure of government and the improvement of intergovernmental relations by assigning clear and separate responsibility to each specific layer.

Intergovernmental relations are processes of which governments within a political system interact (Phillimore 2013). Wright (1988) defines intergovernmental relations as an interacting network of institutions at the national and the

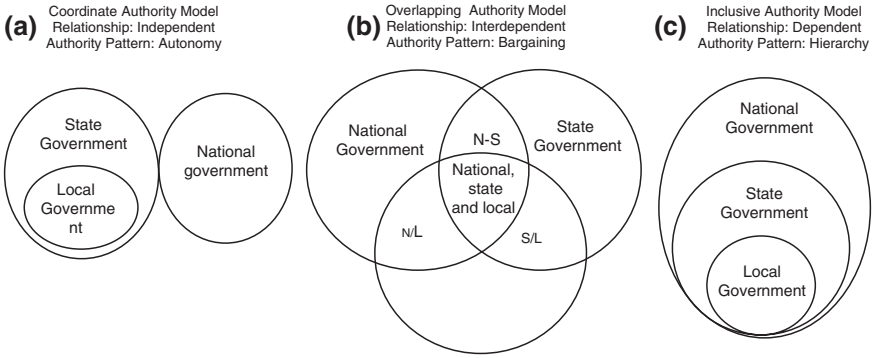

Fig. 2 Model of intergovernmental relations. *Source* Wright (1988). Understanding intergovernmental relations, Third Edition, California

local levels that enable those institutions to cooperate within a single institutional arrangement. From those perspectives, we define the intergovernmental relations as a process or institution of which all levels of government can cooperate to achieve common goals. Hence, the intergovernmental relation is more than the distribution of authorities but also the mechanism of cooperation among level of governments.

There are two mechanisms of interaction between level of government: formal and informal (Phillimore 2013). Formal mechanism is a mechanism that is stated in the formal regulations such as the constitution, statutes, agreements, and other formal mechanisms. Informal mechanisms are those mechanisms that are not stated in the formal regulation such unspoken rules, conventions, or principles accepted among all levels of governments. This article scrutinizes the formal mechanism of intergovernmental relations in Indonesia in relation with the implementation of investment policies to achieve more sustainable development.

Furthermore, looking from the formal mechanism of intergovernmental relations, there are three models of intergovernmental relations (Wright 1988) as shown in Fig. 2.

5.3.1 Coordinate Authority Model

The coordinate authority model is characterized by a distinct boundary separating the national and state government, with the local government included within state governments (Wright 1988). The power relations between national and state government can be described as independent and autonomous; thus national and state government are equally powerful. When there are conflicts between national and state/local government, there is a third party who acts as arbiter and usually a Supreme Court to take the final decision.

5.3.2 Overlapping Authority Model

The middle model presented in Fig. 2, the overlapping authority model, is different from previous model, because it does not emphasize the formal hierarchy, but rather the function. The characteristics of this model are as follows: (1) that some functions and authorities involve national, state, and local government; (2) that there is no area of autonomy that is fully independent and having full discretion without considering other jurisdictions; and (3) that the power relation is based on the bargaining.

5.3.3 Inclusive Authority Model

The inclusive authority model is characterized by abolishing state/local/national boundaries, where state/local governments are inside the national jurisdiction. If a national government wants to expand its power, it just reduces the authority of local/state government or enlarges the power of national government with or without reducing local/state power. In this model, the national government is more powerful than the state/local government, so when conflicts occur, the national government will win.

Based on the previous literature review, we develop a conceptual framework that will be used as a basis for the analysis (see Fig. 3). In fact, FDI brings both positive and negative impacts to development. Using IPFSD, there are several strategies to achieve a more sustainable development. However, under the decentralization system when the authorities are dispersed to local levels, the policies themselves are not sufficient. The effectiveness of the policies is dependent on the cooperation among all levels of government officials, so that intergovernmental relations are an important factor to achieve a more sustainable development.

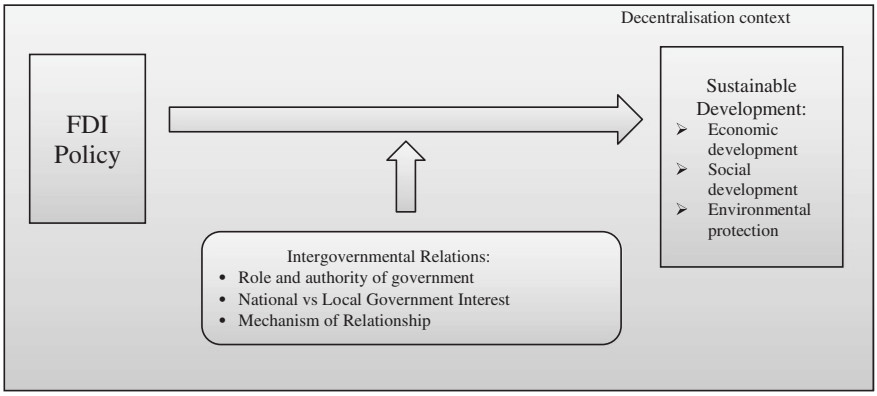

Fig. 3 Conceptual framework

6 Discussion and Analysis

This paper examines the investment and related investment policies in Indonesia over time using the IPFSD approach. The examination aims to understand how the Indonesian government achieves sustainable development from FDI. This paper also discusses the intergovernmental relations especially in the implementation of the policies. The discussion describes how the intergovernmental relations play an important role in the effectiveness of the policy. We divided the periods into three time periods: the Centralized Era (1967–1998), the First Wave of Decentralization (1999–2003), and the Second Wave of Decentralization (2004–present).

6.1 The Investment Policies in Indonesia

6.1.1 The Centralized Era (1967–1998)

During this period, all the FDI processes were managed by the central government and the local governments were seen only as beneficiaries. The regulations on the procedure of foreign investment were changed four times during this period. The latest version for this period was the Presidential Decree No. 97 Year 1993. According to the decree, the foreign investment application was granted by the President (Presidential Decree 97/1993).[5] In order to manage FDI, the body BKPM[6] was created, which functioned to provide advice, to guide and administer the FDI, and to monitor the implementation of the investment project. The body was also responsible for granting the domestic investment applications. The local governments provided some non-investment permits such as building permits and nuisance permits.[7] Hence, the President's office played a substantial role in the FDI management process.

In 1998, the President had decentralized the authorities to grant FDI to the BKPM (Presidential Decree 115 Year 1998).[8] The authority was decentralized to the BKPM to increase the effectiveness and reduce the time of the application procedure, in order to attract more small and medium foreign enterprises to invest in Indonesia. In addition, according to the decree, the BKPM was authorized to grant FDI projects with values of $100 million or less. Therefore, the BKPM had a

[5]Presidential Decree No. 97 Year 1993 on Procedure of Investment is a regulation which regulates the procedure and mechanism of domestic and foreign investment in Indonesia.

[6]BKPM is the National Investment Coordinating Board of the Republic of Indonesia which is responsible to coordinate domestic and foreign direct investment in Indonesia. Information can be seen in http://www4.bkpm.go.id/contents/general/2/about-us#.VFdiQ6NgW70.

[7]Nuisance permit is a permit given by local government to ensure that the business operation does not disturb the surrounding neighbourhood.

[8]Presidential Decree No. 115 Year 1998 on Procedure of Investment.

stronger role at this time. Local governments in this period, on the contrary, remained powerless with little authority to guide FDI projects.

We argue that during this period, the concept of sustainable development had not yet become a serious concern of many policy makers. The concern of policy makers was more on the efforts to attract as much FDI as possible. The introduction of the Foreign Investment Law in 1967 started the market liberalization process (OECD 2010). The law did not explicitly mention the sustainable development as the main objective of FDI. The law paid more attention to the efforts to attract foreign capital. Hill (1988) argued that, historically, the FIL 1967 was introduced to improve the country's credibility to international business and to attract foreign capital by providing many incentives. The law also focused on the guarantee from the government to protect foreign companies from nationalization; to treat domestic and foreign companies equally; and to provide financial incentives to foreign companies. The law opened many sectors for foreign companies, except ten strategic sectors: ports development, electricity production, transition and distribution, aviation, education, drinking water and irrigation, railway system, nuclear technology, press media, and arsenal industry. In this time period, the obligations of foreign companies for knowledge transfer to local companies and corporate social responsibilities were not explicitly mentioned in the law.

In terms of economic development, the policies to promote linkage from the FDI as guided by UNCTAD remained limited. According to the IPFSD, the investment regulations shall generate FDI to promote linkage between foreign companies and domestic enterprises, and the good public governance shall exist in order to ensure that FDI can generate economic wealth (UNTAD 2012). In 1980s, in order to promote linkage, the government limited FDI to several strategic sectors, required foreign investors to divest some of their money in local companies, and restricted the number of foreign workers to support the transfer of technology (Hill 1988). However, in 1994, those limitations were eliminated by Government Regulation No. 20 Year 1994. Hence, specific intervention policy to ensure domestic enterprises taking advantages from the FDI was absent when the divestment requirement is eliminated and foreign ownership in the nine strategic sectors that were previously closed for FDI is allowed.

In terms of social development, according to the IPFSD, the foreign companies shall be mandated with the social obligation and the labour regulations should support job creations and protect the workers (UNCTAD, 2012). Nevertheless, a policy that mandated social responsibilities for companies did not exist at that time. In fact, there were no policies that mandated the social corporate responsibilities and the transfer of skill and technologies as part of the MNCs obligation. The FIL 1967 was not explicitly mentioned the obligations, and the Manpower Law 1969 did not mandate the transfer of skilled requirement and the increase of labour skilled attached as the foreign companies obligations. Furthermore, while the system was centralized, there was no legal mechanism for local people to participate in the development process; hence, local voices were less accommodated.

In terms of environmental protection, the environmental impact assessment shall be part of the investment procedure and the environmental standard shall adhere to international standards of environmental protections (UNCTAD 2012).

However, during this period, the environmental impact assessment was yet not part of the investment procedure process. The Environmental Law 1982 did not mandate the environmental impacts assessment as part of the investment procedure. Furthermore, according to the Government Regulations on the procedure of foreign investments, the environmental impact assessment was not part of the requirements for the investment. Therefore, the environmental issue was not yet a serious concern of many policy makers.

Since the focus of the policies was to attract FDI, Indonesia received a large amount of inward FDI but failed to gain sustained positive impacts from the development. In 1996, the net inflow FDI was $5.59 billion, which was double from what it was in the 1970s, at $2.7 billion. Indonesia ranked 17th in the world and 3rd in the Southeast Asia for the largest recipient of FDI (ADB 2013). FDI had positive impacts on the economic growth at that time, where the economic growth was 7 % annually (Tambunan 2013). However, despite the national economic growth, a study found that local firms were not able to take full advantage, especially in upgrading the technology capacities from the existence of FDI, due to the unclear investment policy (Thee 2006). Furthermore, Takii (2005) found that in the manufacturing sectors from 1990 to 1995, the technological level of local firms was not adequate to facilitate large spill-over technology from foreign companies to domestic ones; hence, the productivity spill-over was small.

6.1.2 First Wave of Decentralization (1999–2003)

After the economic crisis in 1997, Indonesia began to embark on several major reforms to its intergovernmental system. One of the reforms was decentralization, the transfer of authority, and responsibility from the central to the local government, to manage regional economic development. The changed governance system was followed by several investment policies modifications. When previously the central government took all responsibility and authority to manage FDI, in 1999, the FDI management was decentralized to the provincial government. According to the Government Regulation No. 117 Year 1999, the Ministry of Investment/Head of National Investment Board decentralized the authorities to grant FDI to the Governor. In fact, the Regional Autonomy Law 1999 also mandated all duties and authorities retained by central government were transferred to regencies or municipalities excluding these six affairs: monetary, judicial system, national security, national defence, foreign, and religious affairs (Law No. 22 Year 1999).

During this period, the government tried to balance between bringing back investment to Indonesia and achieving more sustainable development. Simultaneously, the liberalization policies were continued, but several investment policies became stricter. In economic development, there were some efforts to protect the domestic enterprises by limiting the foreign investment in some sectors through Presidential Decree No. 96 Year 2000 on the Negative List of Investment. The Decree prohibited foreign investment in the following sectors: the forestry and plantation sectors (germ-plasma seeding, natural forest right to conserve, forest logging contractor), the public transportation sectors (bus/taxi and public

transportation), the trade sectors (all trade sectors except big scale trade sectors such as mall, supermarket, department store, wholesaler, etc.), and the communication sectors (radio, television, multimedia, and printing media, film/movie). In addition, there were 33 sectors reserved only for domestic small and medium enterprises. These policies were taken in order to promote linkage between foreign and domestic enterprises.

On the other hand, in order to increase the national competitiveness and to attract FDI to Indonesia, some public governance reforms were taken. Rajenthran (2002) argues that the focus of the new government was to bring investors back to Indonesia by streamlining procedures, revising the negative list of investments, providing more incentives, and privatizing some states enterprises. Furthermore, the government also enacted the Competition Law of 1999 in order to eradicate previous monopoly created by state enterprises, and introduced the Property Right Laws such as the patent law, the brand law, the copy-right law, and the industrial design law to eradicate piracy. It also established the Corruption Eradication Commission to combat massive corruption practices in many sectors. These policies were directed to improve the public governance of Indonesia.

In terms of social development, one indication that the sustainable development became a concern of policy makers is the enactment of Law 21 Year 2000. This law allowed for the creation of labour unions. The significant impacts of the law can be seen in the provision of wage determination. Under the new law, in order to determine the minimum wage standard, the government shall facilitate the companies' representatives and the labour union representatives, so that the voice of workers was heard. However, the obligation for companies especially foreign companies to help the people nearby their project area through Corporate Social Responsibilities had not yet been embedded in the investment policies.

In terms of environmental policy, the environmental impact assessment shall be part of the investment procedure (UNCTAD 2012). The government has embedded the environmental impact assessment in the investment procedure. The government issued Government Regulation No. 27 Year 1999 on Environmental Impact Analysis. The regulation mandated all companies shall conduct an environmental impact analysis assessment as part of the investment procedure. Furthermore, the government also enacted Law 41 Year 1999 on the forestry which limited the economic activities in protected areas. To summarize, we found that a series of policies were taken to achieve more sustainable developments from FDI.

Although many policy makers have already been aware of the sustainable development, the impact of the policies was not sufficiently well perceived since Indonesia was still struggling with economic crisis. In fact, due to uncertain economic situation, the FDI performance also was not positive. From 1998 to 2003, Indonesia experienced negative inflow of FDI. In 2000, the net inflow of FDI reached $ 4.5 billion (ADB 2013). This means that Indonesia was not attractive for investors, so that many foreign investors moved their investments to other countries. In terms of the contribution of FDI on the economic growth, the data shows that the inward FDI stock as percentage of GDP declined from 2.2 % in 1995 to 0.3 % in 2003 (ADB 2013).

6.1.3 Second Wave of Decentralization (2004–Present)

After a series of evaluations, the regional autonomy law was changed into Law No. 32 Year 2004. According to this law, excluding six absolute affairs retained by the central government (i.e. monetary, judicial system, national security, national defence, foreign affairs, and religious affairs), the remaining areas of government policy are distributed to all levels of governments based on three criteria: externalities, accountabilities, and efficiencies. The criteria of externalities mean that the authority is shared among levels of governments by considering the scale impacts. The criteria of accountability mean that the authorities are shared based on their closeness to the citizens, and the criteria of efficiency mean that the authorities are shared based on the cost and time effectiveness (Regional Autonomy Law 2004).

In terms of FDI management processes, the authority to approve FDI projects was taken back to the central government (Head of BKPM Decree No. 58/SK/2004). Furthermore, all the foreign investment application must first go through the National Investment Board (BKPM). The central government grants both the principal investment permits[9] and operational investment permits[10] for FDI through the one-stop services office. In this office, all ministries delegate their authority to grant investment permits in their sector so that the investors only need to meet in one office to apply for their investment permits.

In this period, sustainable development has become a serious concern of many policy makers in Indonesia. Sustainable development became one of the objectives in the investment policy, and it is mentioned explicitly in the Investment Law 2007. More specifically, the law mentions that the objectives of investment are to increase national economic growth, to create jobs, to enhance sustainable development, to increase national competitiveness and technology capacity, to support local enterprises, and to improve people welfare (Article 1, verse 2 Investment Law 2007). Furthermore, the IPFSD mentions that investment policies should be geared toward the realization of national sustainable development goals and the government shall create a strategic investment plan to achieve sustainable development (UNCTAD 2012). In fact, Indonesia has developed a national strategic investment plan. The plan determines seven grounded policy of Investment: (1) improvement in the investment climate; (2) wider distribution of investment projects across the country; (3) prioritization of investment in food, infrastructure and energy sectors; (4) promotion of green investment; (5) empowerment of small and medium enterprises; (6) facilitating and providing incentives for FDI; and (7) increased investment promotion.

Although the sustainable development has been considered as an important aspect in the investment policy, there is no specific intervention policy to promote linkage between foreign and domestic enterprises. Furthermore, the government has focused on the improvement of the quality of the institutional framework and continued market

[9]A principal permit is a permit given by national/provincial/district governments that should be held by the company wishing to establish a business in Indonesia.

[10]Operational investment permit is a permit given by the national/provincial/district governments that should be held by company to operate their business in Indonesia.

liberalization to increase FDI. The government issued regulation on the Negative List of Investment which now has opened all sectors except the arsenal industry for foreign investment, and increases the maximum equity up to 95 % foreign ownership in several sectors. In order to improve the quality of institution, the government launched the One Stop Services integrated with electronic system for investment licenses and non-licenses services by issuing Presidential Decree No. 27 Year 2009 on one-stop service (Tambunan 2013). Furthermore, some regulations were also introduced to attract FDI such as freedom of public information law[11] and public services law.[12]

In terms of social development, there are significant efforts that have been undertaken by the government. The government revised labour law[13] that increased the role of local governments to determine the wage standard in the regions. Furthermore, the role of labour union has become stronger under the new law and also the role of chamber of commerce has been strengthened. Furthermore, the Corporate Social Responsibility is embedded into a company's obligation and the obligation is mentioned in the Company Law.[14] Therefore, through these laws, the FDI is expected to beneficial for not only the economic development but also the local citizens.

In terms of environment protection, the government has revised the environment law.[15] In the new law, all companies, both domestic and foreign companies, must obtain environmental permits as part of the investment procedure. In order to obtain the investment permit, the foreign companies shall conduct an environmental impact analysis which is assessed by the environmental agency at the local level. Furthermore, all regions shall conduct an environmental strategic plan as part of the Regional Land Use Plan in order to limit the investments which destroy the quality of the environment.

During this period, FDI performance improved significantly. It reached $924.7 billion USD in 2012 (ADB 2013). As a result, Indonesia became once again one of the most attractive countries for foreign investment, ranked 79 in the world, higher than its regional middle-income peers, Malaysia, Thailand, and the Philippines. UNCTAD (2013) put Indonesia as the fourth of the top five countries to receive the most FDI in East and Southeast Asian regions in 2012.

6.2 *Implementation Policies and Intergovernmental Relations*

Investment policies in Indonesia have changed during these three periods of time as discussed in the previous section. In this section, we discuss the change in the

[11]Law No. 14 Year 2008 on the Open Information for Public.

[12]Law No. 25 Year 2009 on the Public Services.

[13]Law No. 13 Year 2003 on Manpower.

[14]Law No. 40 Year 2007 on Company Law that mentions the obligation of companies to do CSR.

[15]Law No. 32 Year 2009 on Environmental Management.

relationship between national and local government before and after decentralization. We explain intergovernmental relations by examining the roles of each level of government, mechanisms of interaction, and the intergovernmental relations model.

6.2.1 Centralized Periods (1967–1998)

As mentioned in the previous section, during the centralized period, the FDI was fully managed by the central government. Therefore, we argue that intergovernmental relationships can be categorized as "**the inclusive authority model**" as seen previously in Fig. 2. The model is characterized by abolishing of state/local/national boundary, placing state/local governments inside the national jurisdiction (Wright 1988). In this period, the central government played a central role in managing FDI, and the Provincial and municipal/district governments were subjected to decisions made by central government. In term of procedures for FDI, the investment permit was granted by the President, and the application was screened and verified by the BKPM as the central government body. According to the procedure of investment regulations, the roles of local governments were limited to provide only the nuisance permit[16] and building permit. The central government is only body which determined the location of investment project.

The government structure also showed us that the central government played a dominant role in managing FDI. According to the Presidential Decree No. 26 Year 1980, the Regional Investment Coordinating Agency (BKPMD) was created to administer domestic but not foreign investment at the regional level. The Head of BKPMD was appointed by Governor with approval of the Minister of Home Affairs and the Head of BKPM. The Head of BKPMD was subordinate to the Governor, but the Governor could not freely control the activities because all activities and regional investment policies shall be consulted and coordinated to central government through the BKPM.[17] Hence, the BKPMD was actually the only branch of central government at regional level. Morfit (1986) in Hidayat (2008) found that the roles of central government agency in the regions or regional branches were more dominant than the regional government's body. Therefore, the mechanism of intergovernmental relations was hierarchical, in which the central government was more dominant than provincial and district governments.

6.2.2 The First Wave of Decentralization (1999–2003)

In 1999, the central government decentralized the authorities to grant FDI permits to Head of provincial government, the Governor. Looking at these mechanisms,

[16]Nuisance permit is a permit given by local government to ensure that the business operation does not disturb the surrounding neighbourhood.

[17]Presidential Decree No. 26 Year 1980 article 8.

we argue that the intergovernmental relation model follows "**the coordinate authority model**". The coordinate authority model is characterized by distinct boundaries between the national governments and the local/state government, in which local government are included within state governments (Wright 1988). During this period, the Governor possessed the power to grant foreign investment permits. According to the Presidential Decree No. 117 Year 1999, the provincial government was also able to determine the regional investment policy and develop regional investment procedures.

The governance structure was also significantly changed, especially relating to the role of local governments in managing FDI. According to the Presidential Decree on the procedure of investment, the BKPMD, a regional investment body, was not only able to grant the domestic investment permits but was also able to grant FDI permits. At the same time, the BKPMD was able to issue some financial facilitation for FDI, such as issuing the Import Identification Number, foreign employees' permit which previously was the authority of the BKPM. The Head of BKPMD was responsible to the Governor of the province and was not the subordinate of the BKPM, central body which managed the FDI. In short, the provincial government became an independent body which was able to determine the regional investment policy with little intervention from the central government.

However, the change of governance structure was not followed by a clear mechanism of intergovernmental relationships. Two regulations that defined each level of the government's functions in managing FDI were in conflict with each other. The Government Regulation No. 25 Year 2000 on division of power between levels of governments and Foreign Investment Law 1967 showed that the central government through BKPM was the only body which was authorized to grant FDI and not the provincial governments. On the other hand, in accordance with the Presidential Decree No. 117 Year 1999, FDI management was decentralized to the provincial government. This situation led to the confusion among stakeholders.

The unclear intergovernmental relationship mechanism made the cooperation among government levels less feasible. For example, the local and central government acted differently to the foreign investors. On the one hand, as the focus of the new government's economic development was to improve the economic conditions after hit by crisis, the central government tried to enhance the current existing FDI projects and to attract as much FDI as possible by offering some incentives and reducing the business cost (Rajenthran 2002). On the other hand, in contrast to the central government, local governments attempted to maximize the existing FDI projects by increasing the taxes, which means increased the business cost and made foreign companies moved from Indonesia to other countries. In fact, under the decentralized system, the local government was able to impose taxes for any investment projects in the regions by enacting local regulations. In 2000 for instance, PT Newmont Minahasa Raya, an American company, was shut down by the local government because it refused to pay local taxes. On the other hand, due to the economic condition, the central government wanted to keep the company in Indonesia. In fact, 13 other foreign companies in the oil sector had to stop their operations due to similar actions by other local governments. (*Jakarta Post*

20/June/00). Due to the local governments' action to impose taxes on the investment projects, KADIN requested the central government to abolish 1,006 local regulations related to local taxes for investors (Patunru and Wardhani 2008).

The situation mentioned above resulted in a deterioration of the investment climate. A study conducted by Asian Development Bank and World Bank (2005) found that decentralization deteriorated the investment climate in Indonesia. Another study conducted by LPEM UI[18] (2002a) also confirmed that decentralization worsened the investment climate and increased the cost of doing business in Indonesia. From this study, local political instability, labour problems, local taxes, and corruption increased the cost of doing business in Indonesia. Furthermore, Kuncoro (2006) found that the massive decentralization had also increased the number of corruption and bribery. Asian Development Bank and World Bank survey (2005) obtained the fact that the large foreign firms must pay an irregular payment up to 15.8 % of total investment to receive the contract. Furthermore, the illegal payments by companies reached up to 4.6 % of total sales. Therefore, due to the conflict, all the policies were not implemented properly.

6.2.3 The Second Wave of Decentralization (2004–Present)

In 2004, due to uncertain condition caused by conflicts between levels of government, the regional autonomy law was changed. According to the new regional autonomy law and the Head of BKPM decree, the authority to approve the FDI projects, which had been given to local governments, was retaken back to the central government. We argue that the intergovernmental relations after the second wave of decentralization follows "**the inclusive authority model**". The provincial and district governments are part of central government and must follow national policy. The central government now plays a dominant role in managing FDI. However, different from the situation during the centralized era, the provincial and district/local governments are given larger discretion in terms of determining regional investment policy under BKPM supervision and coordination. The cooperation among districts or among provincial governments is encouraged and the functions are distributed among various levels of government. The distribution becomes more complex as explained in Table 1.

As the distribution of function is based on three criteria (externalities, efficiencies, and accountability), the coordination mechanism becomes more complex. Although the FDI is managed centrally, according to the regulation on Procedure of Investment,[19] the local government retains authority for granting the nuisance

[18]LPEM UI is a Research Center of Economic Development in University of Indonesia.

[19]Head of BKPM regulation No. 5 Year 2013 on Procedure of Investment that substitute Head of BKPM regulation No. 12 Year 2009 that substitute Head of BKPM regulation No. 1/P/2008 and substitute Head of BKPM regulation No. 57/SK/2004.

Table 1 Distribution of the government's function in investment sectors

No	Functions or authorities	National government	Provincial government	District/local governments
1	Stipulating investment policy	• Develop and stipulate the national investment policy (foreign and domestic investment)	• Develop and stipulate the regional investment policy (domestic investment)	• Develop and stipulate the investment policy at district level (domestic investment)
2	Investment promotion	• Develop and stipulate the national investment promotion plan • Coordinate the investment promotion activities in foreign countries	• Investment promotion of local potential asset at regional level	• Investment promotion of local potential asset at district level
3	Investment license services	• Implement the national one-stop services for investment and provide guidance for regional/local one-stop services for investment • Provide investment permits for foreign investment include FDI • Provide investment permits for domestic investment (high technology investment, high risk and strategic investment, investment that across provincial boundary, investment that related to the national security) • Provide non-investment licenses such as incentives for foreign investment and domestic investment	• Implement the one-stop services for investment at the provincial level • Provide investment permits for domestic investment (the investment involve two or more districts; the investment that is decentralized by BKPM to governor • Provide non-investment licenses such as incentives for domestic investment	• Implement the one-stop services for investment at district/municipality level • Provide investment permits for domestic investment at district area • Provide non-investment licenses such as incentives domestic Investment
4	Monitoring the implementation of FDI	• Monitoring implementation of FDI project at national level	• Monitoring implementation of FDI project at the provincial level	• Monitoring implementation of FDI project at the district level
5	Information system	• Develop an national information system for investment	• Develop an provincial information system for investment	• Develop an provincial information system for investment

Source Government Regulation No. 38 Year 2007 on Distribution of function and authorities between national–local governments

permits,[20] building permits, and environmental permits.[21] After received the approval from the BKPM, all foreign investors shall obtain operational permits, and in order to obtain the operational permits, the foreign investors must show the locational permits. The local government of where the investment project located is able to approve or reject the project by issuing the locational permits based on the environment assessment and the social impacts of the FDI.

The local governments also retain authority to issue regulations related to labour wages, environmental and land use development plans, and corporate social responsibility for any investment projects in their region. In relation to the labour policy, the central government has determined the procedure of determining minimum wage standards in the regions. In accordance with the labour law,[22] the provincial/district government is responsible to determine minimum wage standards in their region and to increase productivity of local workforce by providing training. Each local government must create a Local Wage Council which consists of representative of the business community, labour unions, and the local government. The creation of the body aims to increase the welfare of employees at the same time increasing the capacity of the workforce. Furthermore, the investment law[23] and the company law[24] allows provincial/district government to enforce the company's obligation to take corporate social responsibility in their regions, including all foreign corporations.

In order to protect the environment, the company shall apply for the environmental permit as part of the operational permit (Environment Law 2009). The provincial/district government issues the environmental permit when the investment meets the environmental standard developed by both central and local governments. Furthermore, according to environmental law,[25] the provincial/district government also has the authority to determine the land use planning and to issue environmental permits. Therefore, trough the land use planning, the local government can control the investment projects in their region.

Currently, the central government has fully decentralized the authority to manage foreign investment to several regions which are categorized as Special Economic Regions (SER) or Free Trade Zones (FTZ) and which have an outstanding one-stop service office. Recently, there were six regions that were categorized as SER and FTZ and received full authority to manage the FDI in their regions: FTZ Batam, FTZ Bintan, FTZ Karimun, SER Tanjung Lesung, and SER Sei Mangkei.

---

[20]Nuisance permit is a permit given by local government to ensure that the business operation does not disturb the surrounding neighbourhood.

[21]Environmental permit is a permit given by local government to ensure that the business operation does not disturb the environmental quality.

[22]Law No. 13 year 2003 on Manpower.

[23]Law No. 25 Year 2007 on Investment.

[24]Law No. 40 Year 2007 on Limited Corporation.

[25]Law No. 32 Year 2009 on Environment.

With the central government playing a dominant role in the FDI management process and the regional governments retaining important authority, the coordination mechanism becomes more complex. Below is an example of the coordination mechanism in the implementation of the one-stop service office project.

Mechanism of Intergovernmental Relations through the One-Stop Services Office

The investment climate in Indonesia remains an important issue for economic development. One of the significant policies to reduce business costs is the implementation of the one-stop service office in every region, namely PTSP.[26] There are three main objectives of this policy: (1) establishment of the one-stop service office for investment in every region; (2) the PTSP office is equipped with electronic system for investment information and licensing service (SPIPISE); and (3) the approval authority for business application that is owned by Head of Regencies must be decentralized to the Head of PTSP.

In order to achieve these goals, cooperation between the national government and local government must be enhanced. The national government provides guidance, develops a standard, and monitors the performance of regional PTSP. Three national agencies, the BKPM, the Ministry of Home Affairs (MoHA), and the Ministry of Apparatus and Bureaucratic Reform (MENPAN), are all working together. The BKPM functions to develop national standards and procedures of investment and provides both technical and managerial assistance to local PTSP offices. The MoHA functions to monitor the achievements of local governments in implementing PTSP, and finally the MENPAN functions to provide assistance in terms of organizational and human resources management PTSP offices. The local governments play the role of the implementing agency of PTSP at the regional level and must follow the standard that has been developed by the national government.

There are two mechanisms of cooperation in the intergovernmental relations. First, the central government provides grants for provincial government to monitor and assist the implementation of PTSP at the district level, namely "De-concentration Fund". The purpose of the grants is (1) to increase the role of provincial governments to monitor and evaluate PTSP at the district level; (2) to facilitate the establishment of PTSP at the district level; (3) to assist the organizational and human resources development of PTSP at the district level; (4) to monitor and evaluate the PTSP at the district level; and (5) to coordinate of the implementation of PTSP. On average, each province receives 500 million IDR per year of that grant (MoHA 2013). The mechanism effectively encourages local governments to establish a one-stop service office in their region.

[26]PTSP acronym for Pelayanan Terpadu Satu Pintu is the One Stop Service.

Table 2 Regional investment award winner

Year	Best district	Best municipalities	Best provinces
2009	1. Purwakarta 2. Sidoarjo 3. Sragen	1. Yogyakarta 2. Cimahi 3. Bandung	–
2010	1. Sragen 2. Sidoarjo 3. Purwakarta	1. Cimahi 2. Pekalongan 3. Bitung	1. East Java 2. South Sumatera 3. West Java
2011	1. Rokan Hulu 2. Indragiri Hulu 3. Ogan Komering Ilir	1. Pare-Pare 2. Dumai 3. Surakarta	1. Aceh 2. Central Java 3. West Kalimantan 4. South Sulawesi 5. Central Sulawesi 6. North Sulawesi 7. West Sulawesi
2012	1. Sragen 2. Purwakarta 3. Trenggalek	1. Palembang 2. Semarang 3. Salatiga	1. East Java 2. West Sumatera 3. West Java
2013	1. Ogan Komering Ilir 2. Lamongan 3. Rokan Hulu	1. Payakumbuh 2. Tarakan 3. Pare-Pare	1. East Java 2. West Java 3. East Kalimantan

Source BKPM 2014

Second, the BKPM provides the Investment Award to regions which perform well in PTSP. The award is given as an appreciation to the local governments' commitment to improve the investment climate. Table 2 shows the data about the districts which receive the regional investment award.

These mechanisms are successfully encouraging local governments to use the best regions as a benchmark for improving their own PTSP. Currently, most of the objectives of PTSP are successfully achieved. In fact, 31 out 33 provinces have established the one-stop services office and have implemented SPIPISE. In addition, 90 % of regencies/municipalities (460 regencies) have established PTSP Office. However, only 32 % (116 regions) of them have implemented SPIPISE (MoHA 2013) and only a few head of local governments have decentralized this approval authority to the head of the PTSP office. The PTSP programme results in an improvement of the Ease of Doing Business index in Indonesia. Data World Bank on the Ease of Doing Business (2014) shows that the average time of starting business reduced significantly from 168 days in 2004 to only 48 days in 2014. The cost of doing business in Indonesia also significantly reduced from 136 % of total income per-capita in 2004 to only 20.5 % of total income per-capita in 2014. Furthermore, investors obtain the construction permit 10 days earlier and these are 181 % cheaper than in 2004 (World Bank 2014).

7 Conclusion

In conclusion, the investment policies in Indonesia have been directed to achieve more sustainable development, albeit gradually. Furthermore, the change of the governance system from centralized to the more decentralized system has also changed the intergovernmental relationship in the way of FDI was managed in Indonesia. During centralized era, the sustainable development was not the main objective of the investment policies. As a result, although FDI had a positive impact on the economic growth, local citizens and domestic firms did not take full advantage of its existence. After FDI was decentralized to the local governments in the first wave of decentralization, the sustainable development in developing the investment policies increasingly became a serious concern of many policy makers. Several policy changes have been made in order to achieve sustainable development from FDI. Furthermore, during the second wave of decentralization, sustainable development became an ultimate goal of the investment policies in Indonesia.

Although the policies have been directed to achieve sustainable development, the implementation of these policies is highly affected by the intergovernmental relations. In fact, the intergovernmental relationships changed due to decentralization process. In the centralized era, the intergovernmental relations followed the inclusive authority model, in which the national government played a dominant role in managing the FDI. Although the coordination between the levels of government was good, the citizen participation was less accommodated. In the first wave of decentralization, the intergovernmental relations followed "the coordinate authority model", in which the provincial and local governments were more powerful than before. However, great devolution power to the local governments in managing FDI without clear mechanism of intergovernmental relations led to a deterioration of the investment climate. In the second wave of decentralization, the intergovernmental relations followed "the inclusive authority model", in which the central government was more dominant than province and local governments. In contrast to the centralized era, the central government provided more room for local governments to participate in the development process. Hence, cooperation between the national and local governments was more enhanced during this period.

Appendix 1

Table of FDI policy for sustainable development in Indonesia

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
1.	*Policy to attract FDI*				
	(a) Investment regulation and promotion	1. Openness and avoiding investment protectionism 2. Ownership restriction should be justified by legitimate national policy and should be clearly specified, and the registration of ownership should be secure and effective 3. Screening procedure of investment entry and establishment should be conducted following pre-established objective criteria 4. Government should avoid direct or indirect intrusion in business management and respect the freedom of operations of private companies	Indonesia embarked upon a new liberalism of investment policy in accordance with Law No. 1 Year 1967 on Foreign Investment Law. It followed the guideline which can be described below • It opened many fields for investment, only ten strategic sectors were closed to FDI i.e., ports development; electricity production, transition and distribution; telecommunication; education; aviation; water drinking; railway; nuclear technology; press; and arsenal industry • It provided similar treatment between domestic and foreign enterprises	After the economic crisis in 1997, and several negative sentiments toward foreign investment, Indonesia revisited the investment law. However, the priority of government was to bring the investors back to Indonesia to drive its economy. Law No. 1 Year 1967 remained the basis of Investment Policy so that openness, ownership restriction, similar treatment between national and foreign enterprises and protection from expropriation remained a concern of the government The government issued Presidential Decree No. 96 Year 2000 on Negative List of Investment which mentioned that the business fields closed to FDI were	During the second wave of decentralization, liberalization policy is continued. The parliament enacted Law No. 25 Year 2007 on Investment as basis of Investment Law • The only business field closed for FDI is arsenal industry and others industries mentioned by laws • No difference between domestic and foreign investment • Guarantee for FDI from expropriation and nationalization

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		5. Similar treatment between foreign and domestic enterprises 6. Protection from expropriation and nationalization	• It explicitly stated that the government was prohibited from nationalizing and expropriation action In order to attract more FDI, the government enacted Government Regulation No. 20. Year 1994 on share-holding ownership on FDI which widened its openness regulation • It allowed full foreign ownership • From ten "strategic sectors" closed to FDI under previous law, only arsenal industry was kept close for FDI. The other nine strategic sectors were opened for FDI (ports, energy sector, telecommunication, shipping, civil aviation, water supply, railways, nuclear power and media)	• Forestry and plantation sectors: germ-plasm seeding, natural forest right to conserve; forest logging contractor • Transportation sectors: bus/taxi and public transportation; • Trade sectors: all trade sectors except big scale trade sectors such as mall, supermarket, department store, wholesaler, etc. • Communication sectors: radio, television, multimedia, and printing media, film/movie	Furthermore, the government enacted Presidential Regulation No. 76 Year 2007 on criteria and requirements for the determination of business field closed and open with conditions to investment • Criteria for industry closed for FI are health, safety, national security, environmental protection, culture and moral protection and national interest • Criteria to determine industry which open with some restriction: natural resources protection, small and medium domestic enterprises, production and distribution control; technology capacities; domestic shareholding participation; cooperation between government and enterprises

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
			• The divestment requirement was eliminated At that time the focus of government was to attract FDI and to maintain its economic conditions by emphasizing industrialization projects		Several regulations on the negative list of investment are enacted such as Presidential Regulation No. 77 Year 2007 that amended by Presidential Regulation No. 111 Year 2007 and amended by Presidential Regulation No. 36/2010 and lastly amended by Presidential Regulation No. 39 year 2014 on Negative List of Investment • All sectors are open for FDI • The maximum equity of 95 % foreign ownership in energy sectors (previously only 49 %) • Maximum 49 % foreign ownership for ports development and • 95 % foreign ownership for Public Private Partnership • Minimum investment only $250,000 (previously $1,000,000)

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
	(b) Investment related policies	1. Trade and financial incentives	1. Indonesia provided many financial incentives to attract FDI	1. Indonesia provided financial incentives for FDI	1. Indonesia provides financial incentives for FDI through Government Regulation No. 62/2008 on tax facilities for investment: Tax allowance for 23 sub-sectors in 77 business fields; and Government Regulation 94/2010 Tax holiday is entitled for pioneering industries Tax deduction of 30 % total investment values
		2. Intellectual property rights laws and regulations	2. Law to protect intellectual property rights were exist such as Law No. 12 Year 1997 juncto Law No. 6 Year 1982 on Copy rights; Law No. 6 Year 1989 on Patent and Law No. 19 Year 1992 on Brand	2. Some regulations related to intellectual property rights are enacted: Law No. 41 Year 2001 on Patent; Law No. 15 Year 2001 on Brand; Law No. 19 Year 2002 on Copy Rights; Law No. 31 Year 2000 on Industrial Design	2. Focusing on the implementation of the regulation on intellectual property rights

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		3. Competition laws and regulations	3. The competition law were not exist	3. Enactment of competition Law No. 5 Year 1999 and establishment of the commission for the supervision of business competition (KPPU). The law contains prohibition on oligopolistic practice, price fixing and discrimination; prohibited activities such as monopoly, market controlling, tender collusion; and prohibition of dominant position	3. After enactment of competition policy, enforcement of law becomes serious concern of KPPU
		4. Reducing the business cost and eliminate barrier	–	Presidential Decree No. 29 Year 2004 on Investment Procedure through One Stop Service	President regulation No. 10 Year 2008 on electronic system usage in national single windows. implementation In order to reduce the business cost and Presidential Decree No. 27/2009 on one stop services

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		5. Predictable and secure access to land	• The basis of law is Law No. 5 Year 1960 on Agrarian • In order to make predictable, the government enacted Presidential Decree No. 97 Year 1993 which mentioned that locational permits includes right to land, the process takes only 12 days, and investors can be granted right to use land for 35 years, Right to Use Building for 30 years	• In 1999, the government issued Head of National Land Agency Decree No. 2 Year 1999 mentioned: (1) locational permits is also right to use land; (2) locational permits were not necessary for business expansion; (3) the locational permits were granted by regent/mayor	• Law No. 25 Year 2007 expanded the right to use land from 35 to 95 years, right to use building from 30 to 80 years

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
2.	*Policy to generate economic wealth*				
	(a) Investment regulation to generate economic wealth by encouraging the promotion of linkage between foreign and domestic enterprises	1. Government should actively nurture and facilitate business linkage between national companies and foreign investors 2. Government should consider: (1) direct intermediation between national-foreign investors; (2) support national companies to upgrade the technology; (3) establishment of national norms and standards; (4) selective FDI targeting; (5) incentives for foreign investors to assist in upgrading SME	There is no specific intervention policy to ensure that domestic enterprises take benefit from the existence of FDI	In order to protect domestic enterprises and increase transfer of technology, knowledge and skill government enacted Presidential Decree No. 96 Year 2000 1. Prohibit foreign participation in sectors: radio, television broadcasting, printing, logging activities, public transportation, inter-island shipping services, trade and supporting services 2. Foreign entities may participate through joint venture (20 %) with domestic entities and only limited to 26 sectors 3. 33 sectors were reserved for only domestic enterprises 4. Joint venture is mandatory 5. Foreign participation in forest concession is not allowed However, special policies to nurture and facilitate business linkage did not exist	There is no specific intervention policy to ensure that domestic enterprises take benefit from the existence of FDI

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		3. Mandatory practice to promote linkage such as joint-venture requirement 4. Explicit responsibility and accountability should be assigned to IPA to nurture and promote business linkage 5. Specific policies should encourage business to offer training to employees			
	(b) Investment related policy to generate economic wealth				
	(1) Public Governance and Institutions	1. In implementation of investment policy, the government should have integrity, independent regulatory institutions, accountable, transparent and predictable, and service oriented bureaucracy	Indonesia has Anti Corruption law, which is Law No. 3 Year 1971 on Corruption, however, the law is not well implemented due to the patrimonial practices	Since economic crisis, the corruption became big concern so that the government enacted Law No. 20 Year 2001 on Corruption and established Commission for Eradication of Corruption through Law No. 30 Year 2002 on Commission for Eradication of Corruption	In order to reduce the business cost and Presidential Decree No. 27/2009 on One Stop Services Law No. 14/2008 on Freedom of public information to increase the social accountability of public governance and transparency of government activities

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		2. Close cooperation and good communication between agencies and investors 3. Government should adopt anti-corruption legislation and fight corruption		Beside that, improvement of investment climates was the top priority agenda for the government, but not significantly reduce the doing business cost	Law 37/2008 on Ombudsman and Law 25/2009 on Public Services to increase social accountability of public governance
3.	*Policy to support social development*				
	(a) Investment related Policy to support social development				
	(1) Labour Market Regulation	1. Labour market regulation should support job creation objectives in investment policy but the employees should be protected from abusive labour practices 2. Country need to guarantee internationally recognized labour standard i.e. child labour, right to collective representation	Law No. 14 Year 1969 on Manpower and Government Regulation No. 8 Year 1981 on Protection of Wage do not specify the protection of labour beside related to wage, do not mandate the training and transfer of skilled.	In order to protect the labour, law No 21 Year 2000 on Labour Union allow labour force to form labour union	Law No. 13 Year 2003 on Manpower regulated wage aspect, training aspect and synchronize with ILO standard 1. Wage policy is determined by considering Decent Living Index 2. Wage policy is determined by head of regions (Bupati/walikota/governor) 3. Every regions can conduct vocational training to increase labour productivity

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
		3. Adjustment costs or friction caused by shifting productive capacity and employment to priority investment area 4. Transfer of skill should be encouraged			
	(2) Corporate Social Responsibility	1. Government should encourage compliance with high standards of responsible investment and corporate behaviour	The mandatory obligation to do Corporate Social Responsibility was not mentioned in the law	The mandatory obligation to do Corporate Social Responsibility was not mentioned in the law	Law No. 40 Year 2007 on Limited Companies and Law No. 25 Year 2007 mandated all companies to compensate people surrounding manufacture through corporate social responsibility and all companies should follow good corporate governance practices Government regulation No. 47 Year 2012 on corporate social responsibility

(continued)

(continued)

No	Variables	Guidelines for investment policy framework for sustainable development (UNCTAD)	Centralized era (1967–1998)	First wave of decentralization (1999–2003)	Second wave of decentralization (2004–present)
4.	*Environmental protection*				
	(a) Investment related policy to protect environment	1. Environmental impact assessment (EIA) should be part of investment procedure 2. Foreign investors should adhere to international standards of environmental protection and committed not to engage in environmental dumping	Law No. 4 Year 1982 on Environment did not explicitly mandated environmental impact assessment as part of investment procedure.	Law No. 23 Year 1997 on environmental management has explicitly stated the principle of sustainable development. environmental impact assessment was part of the investment procedure The Law No. 41 Year 1999 on forestry is also able to protect the degradation of environment. However, the effectiveness of the law was questionable due to lack of law enforcement Government Regulation No. 27 Year 1999 on environmental impact analysis mandated all EIA shall be done by companies as part of investment procedure	Law No. 32 Year 2009 on Environment 1. Every companies shall conduct Environmental Analysis Impact and it is evaluated by local/national government 2. Every FDI shall receive environmental permits 3. Operational permits is given in accordance with land use planning which must consider environmental strategic study 4. Every business operation are subject to environmental audit 5. Ministry of environment has bigger authority to issue some licenses, to do audit and law enforcement

Source UNCTAD (2012) data created by Kuswanto

References

Asian Development Bank. (2013). *Key indicators for Asia and the Pacific 2013*. Retrieved at: http://www.adb.org/publications/key-indicators-asia-and-pacific-2013.

Asian Development Bank and World Bank. (2005). *Improving investment climate in Indonesia*, Asian Development Bank.

Baghirzade, N. (2012). *The impact of foreign direct investment on human development index in commonwealth of independent states*. Cyprus: Institute of Graduate Studies and Research, Eastern Mediterranean University.

Blomstrom, M., & Kokko, A. (1998). Multinational corporation and spillovers. *Journal of Economic Surveys, 12*, 247–277.

Caves, R. E. (1971). International corporations: The industrial economics of foreign investment. *Economica, 38*, 1–27.

Cheema, G. S., Rondinelli, A. D. (2007). *Decentralization and governance.* In Cheema, G. S., Rondinelli, A. D., (Eds.). Decentralizing governance: Emerging concepts and practices. Washington D.C.: Brooking Institution Press.

Cole, M., Elliot, R. J. R., & Frediksson, G. (2006). Endogenous pollution havens: Does FDI influence environmental regulation? *Scandinavian Journal of Economics, 108*(1), 157–158.

Colen, L., Maertens, M., & Swinnen, J. (2008). *Foreign direct investment as an engine for economic growth and human development: A review of the arguments and empirical evidence*. In Working paper IAP P6/06 projects, working package FDI-1 Licos. Leuven Centre for Global Governance Studies.

Effendi, N., & Soemantri, M. F. (2003). *Foreign direct investment and regional economic growth in Indonesia: A panel data study*. In Working paper in economics and development studies, No 200305, UNPAD.

Galagher, K., & Andres, L. (2008). *Foreign direct investment and sustainable development: Lesson from Americas*, Washington, D.C. In Working group on development and environment in the Americas.

Galagher, K. P., & Zarsky, L. (2007). *The enclave economy: Foreign investment and sustainable development in Mexico's silicon valley* (p. 2007). Cambridge, Massachusetts: The MIT Press.

Government Regulation No. 25 Year 2000 on Distribution of authorities between the National, Provincial and District Government.

Government Regulation No. 38 Year 2007 on Distribution of authorities between the National, Provincial and District Government.

Graham, E., & Krugman, P. (1991). *Foreign Direct Investment in the United States*, 3rd ed. Washington D.C: Institute for International Economics, 1995.

Hidayat, S. (2008). Desentralisasi dan Otonomi Daerah: Dalam perspective state-society relation. *Journal Poelitic*, *1*(1).

Hill, H. (1988). *Foreign investment and industrialization in Indonesia*. Oxford: Singapore.

Indonesian Law 22 Year 1999 on Local Governance.

Indonesian Law 32 Year 2004 on Local Governance.

Indonesian Law 25 Year 2007 on Investment.

Indonesian Law 32 Year 2009 on Environment Protection and Management.

Indonesian Law 3 Year 2013 on Manpower.

International Monetary Fund. (1997). Balance of payments manual. Retrieved from http://www.imf.org/external/pubs/ft/bopman/bopman.pdf.

KADIN. (2012). Decentralization, investment climates and business development in local area, policy paper No 9, August 2014. Retrieved from http://active.kadin-indonesia.or.id/front/policy_papers/IMG_20130501034353.pdf.

Kalamova, M. M. (2008). *Decentralization and foreign direct investment: Empirical evidence from the OECD countries*. Retrieved from https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=MWITFall2008&paper_id=74.

Kessing, G. S., Konrad, A. K., & Kotsogiannis, C. (2007). Foreign direct investment and the dark side of decentralization. *Economic Policy, 22*(49), 5–70.
Kuncoro, A. (2006). Corruption and business uncertainty in Indonesia. *ASEAN Economic Bulletin, 23*(1), Riding Along a Bumpy Road: Indonesian Economy in an Emerging Democratic Era. 11–30.
Letnes, B. (2002). *Foreign direct investment and human rights: An ambiguous relationship.* Forum for development studies, No 1.
Lipsey, E. R., & Sjolhom, F. (2002). *Foreign firms and Indonesian manufacturing wages: An analysis with panel data*. NBER Working Paper No. 9416, December 2002, Revised June 2006. Retrieved from http://www.nber.org/papers/w9417.pdf.
LPEM-FEUI. (2002). *Construction of regional index of doing business*. Jakarta: Universitas Indonesia.
Ministry of Home Affairs (2013). *The Yearly Ministry Report of 2012*, Ministry of Home Affairs.
Moran, T. H. (2011). *Enhancing the contribution of FDI to development: A new agenda for the corporate social responsibility community, international labor and civil society, aid donors and multilateral financial institution* Interactive Business Network Resources Library (http://findarticles.com).
Morfit, M. (1986). *Strengthening the Capacities of Local Government: Policies and Constraints*. In MacAndrew (ed) Central Government and Development in Indonesia, Singapore: Singapore University Press.
Mosley, L., & Uno, S. (2007). Racing to the bottom of climbing to the top? Economic liberalization and collective labour rights. *Comparative Political Studies, 40*, 923–942.
OECD. (1997). *Globalisation and environment: Preliminary perspective*. Paris: OECD.
OECD. (2001). *Foreign direct investment and sustainable development*. New Mexico City. Retrieved from http://www.oecd.org/daf/inv/investmentstatisticsandanalysis/2408079.pdf.
OECD. (2008). *OECD benchmark definition of foreign direct investment*. Paris: OCED.
OECD. (2010). *Indonesia—Investment policy review.* Paris, OECD. Retrieved from http://www.oecd.org/daf/inv/investmentfordevelopment/46314256.pdf.
Parjiono. (2003). *FDI and growth in Indonesia*. Retrieved from https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=ESAM07&paper_id=122.
Patunru, A. A., & Wardhani, B. S. (2008). *Political economy of local investment climates: A review of the Indonesian literature.* PAPI background paper political economy of the local investment climate in Indonesia' project.
Pavlinek, P. (2004). Regional development implication of foreign direct investment in central Europe. *European Urban and Regional Studies, 11*(1), 47–70.
Phillimore, J. (2013). Understanding intergovernmental relations: Key features and trends. *Australian Journal of Public Administration, 72*(3), 228–238.
Presidential Decree No. 26 Year 1980 on Creation of Regional Investment Coordinating Board.
Presidential Decree No. 97 Year 1993 on the Procedure of Investment.
Presidential Decree No. 117 Year 1999 on the second changed of Presidential Decree No. 97 Year 1993 on the Procedure of Investment.
Presidential Decree No. 96 Year 2000 on List of Business Field that are closed for investment.
Presidential Decree No. 27 Year 2009 on One Stop Services Office in Investment.
Rajenthran, A. (2002). *Indonesia: An overview of the legal framework for foreign direct investment*. Economic and finance No. 4, Singapore: Institute of South East Asian Studies.
Rodriguez-Clare, A. (1996). Multinationals, linkages, and economic development. *American Economic Review, 86*(4), 852–873.
Sodik, J., & Nuryadin, D. (2005). *Investment and economic growth: Case studies for 26 provinces in Indonesia before and after decentralization*. *Journal of Economic Development, 10*(2), 157–170 August 2005.
Takii, S. (2005). Productivity spillovers and characteristics of foreign multinational plants in Indonesian manufacturing 1990–1995. *Journal of Development Economic, 76*, 521–542.

Tambunan, T. (2013). Inward FDI in Indonesia and its policy context, Vale Columbia Center on Sustainable International Investment. Retrieved at http://ccsi.columbia.edu/files/2014/03/Indonesia-_IFDI_-_5_Nov_2013_-_FINAL_01.pdf.

Thee, K. W. (2001). The role of foreign direct investment in Indonesia's industrial technology development. *Internatinal Journal of Technology Management, 22*(5/6), 583–598.

Thee, K. W. (2006). *Technology and Indonesia's industrial competitiveness*. ADB Institute Discussion Paper No 43.

Tiebout, C. M. (1956). A pure theory of local expenditure. *Journal of Political Economy, 64*(5), 416–424.

UNCTAD. (2012). Investment policy framework for sustainable development. United Nation, New York and Geneva. Retrieved from http://unctad.org/en/PublicationsLibrary/diaepcb2012d5_en.pdf.

UNCTAD. (2013). *World investment report global value chains: Investment and trade for development*. United Nation Conference on Trade and Development, New York and Geneva, 2013, University Press Pte. Ltd.

Weingast, R. B. (1995). The economic role of political institutions: Market-preserving federalism and economic development. *Journal of Law, Economic & Organization, 11*(1), 1–31 (April 1995).

World Bank, (2014). *Doing Business Report 2014*, New York and Geneva 2014

World Commission on Environment and Development. (1987). *Our common future*. Oxford: Oxford University Press.

Wright, D. S. (1988). *Understanding intergovernmental relations*. California: Books/Cole Publishing Company.

Yong, W. (2008). *Fiscal decentralization, endogenous policies and technology adoption: Theory and evidence from China and India's FDI.* Retrieved from http://siteresources.worldbank.org/INTMACRO/Resources/YongWang.pdf.