



## **Foreign Direct Investment in Indonesia: An Analysis from Investors Perspective**

**Manuel Fernandez\*, Mariam Mohamed Almaazmi, Robinson Joseph**

School of Business, Skyline University College, Sharjah, UAE. \*Email: [qln\\_manuel@yahoo.com](mailto:qln_manuel@yahoo.com)

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### **ABSTRACT**

Globalization has made worldwide mobility of money extremely easy. The investors prefer to invest in places that offer attractive returns and are relatively less risky. The inflow of foreign direct investment (FDI) gives developing countries access to capital that would otherwise be not available. FDI also provides much needed foreign exchange and therefore helps to adjust some of the macroeconomic imbalances in developing countries. Every country is trying to attract investors by providing business friendly environment, which are quite attractive and easy to start and generate profits. The main objectives of this study are to find out the status of Indonesia as a destination for FDI; the factors that attract FDI into Indonesia and how these can be enhanced, and the factors that hinder the flow of FDI into Indonesia and how these can be reduced. The study covers a period of 5 years from 2014-2015 to 2018-2019. The study analysis various determinants of FDI like market size, economic growth, infrastructure, political risk, corruption, labor market, raw materials, technological readiness, innovation, financial system, taxation, cost of capital, ease of doing business and government policies. The study shows that Indonesian environment is investor-friendly and has the potential to grow.

**Keywords:** Foreign Direct Investment, Transnational Corporations, Indonesia, Investor-friendly

**JEL Classifications:** F21, G11

### **1. INTRODUCTION**

The high degree of globalization and modern technologies have made the movement of money across continents quite fast and cheap. Investors are in search of investment friendly destinations to invest quite heavily and collect handsome returns on investments. Asian countries have become very prominent in this regard because of the vast investment opportunities, cheap labor, geographical facilities; and are less risky but offers higher returns. Each country has its own characteristics and investors, both individuals and corporates invest in different countries that matches their requirements and ability. The reason for choosing a particular country for investment and trade is always backed by several factors and these factors determine the attractiveness of the destination.

Foreign Direct Investment (FDI) is the type of investment where the host country provides the opportunities of investment to the

investor country to invest. The nature and the type of investment could be acquisition or joint venturing or establishment of a new company in the host country. Globally the competition to attract FDI is increasing because of the potential benefits for the economy of the host countries and of course the better returns for the investors.

World Economy has seen a rapid rise in foreign direct investment for more than three and half decades. World Investment Report (2018) stated that there has been a decline in global FDI by 23%, i.e. \$1.43 trillion. Even with this decline the FDI to developing economies remained stable at \$671 billion in 2017. Asia was the largest recipient of FDI in the World with a total of \$476 billion inflows in 2017 (Singh, 2019). The inflow of FDI gives developing countries access to capital that would otherwise be not available, as Transnational Corporations (TNCs) often have privileged access to capital from the international banking sector. Similarly, FDI

provides needed foreign exchange and therefore helps to adjust some of the macroeconomic imbalances in developing countries. Many countries in Asia, Africa and in the Middle East are in the growth mode but the resources available for development with them are limited and insufficient, hence all these nations are competing against each other to make the investment climate better and project itself as the best FDI friendly destination. At the same time FDI is extremely important for corporate profitability and competitiveness, the contributions of FDI to the corporate profitability and competitiveness has been significant and has grown steadily over the past several years, from just 26% in 2016 to 32% in 2019. (FDI Confidence Index Report, 2019).

Asia is considered as the largest continental economy in the world which is growing at a fast pace. Asia has sited many modern economic booms from Japan to China and India at present. The Asian economy is seeing variations inside region and between the states due to the factors like environment, cultural differences and the political structure perused by the countries. In Asia the climate and geographical location is very much attractive for the investors. Asian countries have the ability to provide gateway for the trade of many countries, but the scarcity of the resource is one of the major hurdles in the fuller development of some of these countries. Indonesia is a Southeast Asian country. Indonesia is the world's largest island in the world as it has 17,508 island. As per the recent consensus the total population of the country comprises of 270 million people and is ranked as 4<sup>th</sup> populous Muslim majority country in the world. In Southeast Asia, Indonesian economy is considered as the largest economy and the fastest emerging market economies globally. Indonesia is also the G20 member and also rose up as modern industrialized country. In terms of economic growth Indonesia is ranked as 16<sup>th</sup> in terms of normal GDP (Gross Domestic Product) and 7<sup>th</sup> in GDP (PPP). Table 1 gives the data on the inflow of FDI into Indonesia during the period 2013 to 2018.

The inflow of FDI has decreased form US\$ 23,282 million in 2013 to a very low level of US\$ 4,542 million in 2016. However, in 2017 there was a spectacular recovery with an inflow of US\$ 20,510 million, but in 2018 it declined to US\$ 20,008 million. These fluctuations in the inflow of the FDI into Indonesia calls for a proper probe, to identify the causes and take remedial actions.

The main objectives of this study are to find out the status of Indonesia as a destination for FDI; the factors that attract FDI into Indonesia and how these can be enhanced; and the factors that hinder the flow of FDI into Indonesia and how these can be reduced. The findings of the study would help the investors to arrive at a better decision regarding FDI into Indonesia, and similarly help the regulators and other stakeholders to formulate appropriate policies and take necessary steps to enhance the FDI attractiveness of Indonesia. The remaining part of this paper is

organized as follows: Section 2 presents a literature review on FDI. Section 3 states the methodology. Section 4 focusses on analysis and discussions, and Section 5 concludes the paper.

## 2. LITERATURE REVIEW

History is full of examples where countries have made foreign direct investments in other regions. Foreign direct investment is widely perceived as a powerful development engine for many receiving (host) countries. FDI can play a key role in improving the capacity of the host country to respond to the opportunities offered by global economic integration. Virtually all countries are actively seeking to attract FDI, because of its expected favorable effect on income generation from capital inflows, advanced technology, management skills and market know-how (Cho, 2003).

Numerous studies have been conducted in different parts of the world and majority of the studies have inspected the effects of determinants of FDI inflow and found that relevant determinants include the size and growth potential of the host market, economic stability, economic growth, political stability, infrastructure, human capital, interest rate, per capita income, tax rates, wage rates, quality of institutions, etc. The presentation of the literature review is sequenced in such a manner that the literature relating to market size is presented first, followed by political stability and then all literature relating to all other factors.

Market size is expected to have a positive relationship with FDI. Market-oriented FDI aims to set up enterprises to supply goods and services to the local market. The general implication is that host countries with larger market size, faster economic growth and a higher degree of economic development will provide more and better opportunities for these industries to exploit their ownership advantages and therefore, will attract more market-oriented FDI (OECD, 2000). The study by Resmini (2000), looking into manufacturing FDI, finds that countries in Central and Eastern Europe with larger populations tend to attract more FDI. The studies by Na and Lightfoot (2006) revealed that FDI inflow has been largely attracted by the market size and market potential. Xaypanya et al. (2015) investigated the significant factors determining foreign direct in Cambodia, Laos, and Vietnam (ASEAN3) and Indonesia, Malaysia, the Philippines, Thailand, and Singapore (ASEAN5), and found that market size and infrastructure facility are significant factors to attract FDI. Dunning (1973) studied econometric models using a statistical analysis of surveys on the determinants of FDI and found that market force such as market size, growth and per capital income in the host country, and cost factors like labor cost and inflation as factors attracting FDI. Casi and Resmini (2010) inspected the determinants of FDI in the EU region and found that the main determinants are GDP growth rate, labor costs, and market potential. The study by

**Table 1: Foreign direct investment in Indonesia: Net inflows (US\$ in Million)**

FDI	2013	2014	2015	2016	2017	2018
Net inflows	23,282	25,121	19,779	4,542	20,510	20,008
Increase		1,839	-5,342	-15,237	15,968	-502
Y-O-Y growth		7.90%	-21.27%	-77.04%	351.56%	-2.45%

Source: Compiled from World Bank data base

Makki et al. (2004) on US food processing industry found that market size, per-capita income, and openness significantly affected US food processing firms' decisions to invest abroad. Khachoo and Khan (2012) conducted a study to examine the determinants of FDI in 32 developing countries from 1982 to 2008 using an econometric model. Their empirical results showed that market size, total reserve, and infrastructure were positively related to FDI inflows. Thus one may presume that large host countries with high growth rate and higher per capita income attract higher foreign direct investment due to larger potential demand.

Political stability and reliability determine the FDI inflows. TNCs prefer stable government so that their investment is protected. Political instability may be in the form of the negative attitude of the government towards TNCs, non-allowance of fund transfer, currency convertibility, war, bureaucracy and corruption. Political stability can also be measured by the number of changes of democratically elected governments (Gedam, 1996). The study by Root and Ahmed (1979), and Schneider and Frey (1985), looking at aggregate investment flows into developing economies found that political instability significantly affects FDI inflows.

The study by Haddad (2018) on the impact the inflow and outflow of FDI on the economic growth measured by health, income and education in the United Arab Emirates shows that the impact is clear and big, but the influences of inflow is more insignificant. The study by Cakerri et al. (2020) on the empirical relationship between FDI and economic growth in Albania using time series data found that inflow of FDI is attracted by political and macroeconomic stability, improved business climate and legislation.

Tax policies including corporate and personal tax rates influence inward FDI. Other things being equal a country with lower tax rates should stand a greater chance of attracting FDI projects than a country with higher rates (Chopra, 2003). According to Neumayer and De Soysa (2005), availability of raw materials provides investors with an added advantage with regards to producing efficiently.

The study of Uwubanmwun and Ajao (2012) shows that trade openness, interest rate, government size, and GDP exerted a positive control on cross-border investments in Nigeria and a negative relationship was found between FDI and exchange rates. According to Milner (2014), the presence of a productive labor force is one of the determinants that influence the scope of FDI in a country.

A glance at the literature on advantages of inflow of FDI shows that the foremost advantage of FDI is increased revenues that can be used for expanding growth opportunities in the investment destination. According to Almutawa et al. (2014), investments by foreigners refers to additional revenue that supports various economic projects of a country. According to Muysken and Samia (2006), unemployment rates are reduced as a result of capital injections and job opportunities from foreign-based companies. FDI also increases the competitive advantage of a country by developing financial and business hubs that boost economic growth. Mina (2007) points out that FDI promotes the economic

growth of a nation by stimulating various sectors of the economy such as manufacturing and tourism.

In brief, the trend in FDI flows differs by region and country. Although FDI has innumerable effects on the economy of host countries and most countries are trying hard to attract FDI, the inflow of FDI continues to be uneven, with some countries getting the lion's share and others barely getting any.

### 3. METHODOLOGY

The main objectives of this study are to find out the status of Indonesia as a destination for FDI; the factors that attract FDI into Indonesia and how these can be enhanced, and the factors that hinder the flow of FDI into Indonesia and how these can be reduced. The study is solely based on secondary data collected from local, regional and international agencies like Government of Indonesia, Central Bank of Indonesia, Indonesian Economic Forums, World Economic Forum, International Monetary Fund, Transparency International, World Bank group, United Nations and various publications of the statistical departments, governments, and the press. The study covers a period of 5 years from 2014-2015 to 2018-2019. The collected data are tabulated and analyzed using appropriate analytical tools.

### 4. ANALYSIS AND DISCUSSIONS

The Global Competitiveness Report 2019 published by the World Economic Forum assesses the competitiveness landscape of 141 economies, providing insight into the drivers of their productivity and prosperity. These 141 economies account for 99% of the world's GDP. The competitiveness ranking is based on indicators organized into 12 'pillars': Institutions; Infrastructure; ICT adoption; Macroeconomic stability; Health; Skills; Product market; Labor market; Financial system; Market size; Business dynamism; and Innovation capability. Each indicator, or 'pillar' uses a scale from 0 to 100, to show how close an economy is to the ideal state or 'frontier' of competitiveness in that area (Global Competitiveness Report, 2019). The Report series remains the most comprehensive assessment of national competitiveness worldwide. Table 2 presents the year-wise ranking, of Indonesia by global competitiveness index for the year 2014 to 2019.

The data in Table 2 show the relative ranking of Indonesia has declined from rank 34 in the year 2014 to rank 50 in the year 2019, which could be either Indonesia is going back in competitiveness or other countries are boosting their competitiveness and leaping forward which is pushing Indonesia back in the relative ranking. The analysis of various determinants of FDI begins here, starting with market size.

**Table 2: Global competitiveness index: Ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	34	37	41	36	45	50

Source: World Economic Forum, Global Competitiveness Report 2014-2019

### 4.1. Market Size

Market size, growth in market size and market efficiency are important determinants of FDI. The market size and the growth prospects of the market of the host country are important pull factors and are positively related to the level of FDI flows (Dunning, 1993 and Chandalert, 2000). A huge market size allows the attainment of economies of scale, and transaction costs are lower in countries with higher levels of economic development (Caves, 1971; Zhao and Zhu, 2000).

Indonesia is a huge market with total population of approximately 270 million. The GDP of Indonesia reached all-time high of 1,042.17 billion USD in 2018, this is an indication of the ability of Indonesia to grow quite steadily, and currently the economy is in a growth mode. The market size can be measured by the population and the population growth of the country. Table 3 gives the population, the growth of population, the population density and land area of the top 10 countries with the highest population.

The size of the Indonesian market (based on population) has increased by almost 26% during the 10-year period 2000 to 2019; and it is projected that the expected population will be 300 million by the year 2050. A larger population means a better domestic market that can consume goods and services provided by investors.

Expanding the domestic market is a priority in relation to improving the investment climate in any country and moreover in Indonesia the density of population is appreciably high with 149 per sq. km. The growing population, brings plenty of opportunities for the investors both domestic and international. This attracts more FDI. Table 4 gives the global ranking for Indonesia on market size for the period 2014 to 2019.

Indonesia's main strengths seems to be its market size, which had been gradually and steadily improving from rank 15 in 2014 and is currently at rank 7. Moreover, Indonesia has one of the fastest-growing middle class in the world: more than 50 million people have disposable incomes and growing demands for expensive goods and services.

### 4.2. Economic Growth

Indonesia's economy has grown at annual average rates of over 5% for the last two decades, almost twice as fast as the world economy (World bank national accounts data, 2019). Growth

averaged 5.24% in the 2000s and 5.36% in the 2011–2018 period (World Development Indicators, 2019). But, over the past decade, growth in advanced economies has been very weak. Many emerging economies - including Argentina, Brazil, Russia, India and China - are experiencing some slowdown or stagnation. In least-developed economies, growth remains well below potential and highly volatile. Productivity growth started slowing down well before the financial crisis of 2008. Between 2000 and 2007, total factor productivity (TFP) annual growth averaged just 1% in advanced economies and 2.8% in emerging and developing economies. TFP then plummeted during the crisis. Between 2011 and 2016, TFP grew by 0.3% in advanced economies and 1.3% in emerging and developing economies (Obstfeld and Duval, 2018). Corporates do not operate in vacuum, they are highly influenced and attracted by the environmental factors and economic growth of the economy in which they do business. Corporates in high growth economies can envisage to growth at a higher rate than those in the low growth countries as the environment highly influences the entity. For emerging economies like Indonesia FDI is often referred to as the most effective way to transfer capital and technology from other economies especially the developed ones. Developed economies look at emerging economies like Indonesia as an economy with immense growth potential. Table 5 shows the GDP, the annual percentage growth rate of GDP at market prices based on constant local currency, for Indonesia during the period 2014 to 2018.

The global average growth rate for 2018 was 3.31%. In 2018 Indonesia had the 40<sup>th</sup> highest growth rate of 5.17%. During the last 5 years Indonesia was growing at an annual average rate of 5.03%, which is far ahead of the global average growth rate. The Gross Domestic Product (GDP) in Indonesia was worth 1,126 billion US dollars in 2019, according to official data from the World Bank and projections from Trading Economics. The GDP value of Indonesia represents 0.93 percent of the world economy. The GDP is growing steadily during recent past. The ever expanding market size and increasing purchasing power of the consumers in the country is an attraction for the FDI.

### 4.3. Infrastructure

Infrastructure is a major determinant of FDI. Excellent infrastructure plays a major role in the productivity and profitability of Multinational Corporations (MNCs), and thus, their decision about FDI location. Table 6 gives the global ranking of Indonesia for the

**Table 3: Top ten countries with the highest population**

#	Country	2000	2019	2050	Growth pop % 2000-2019	Density (P/Km <sup>2</sup> )	Land area (Km <sup>2</sup> )
		Population	Population	Expected population			
1	China	1,268,301,605	1,420,062,022	1,301,627,048	11.90	153	9,388,211
2	India	1,006,300,297	1,368,737,513	1,656,553,632	36.00	460	2,973,190
3	United States	282,162,411	329,093,110	398,328,349	16.60	36	9,147,420
4	Indonesia	214,090,575	269,536,482	300,183,166	25.90	149	1,811,570
5	Brazil	174,315,386	212,392,717	232,304,177	21.80	25	8,358,140
6	Pakistan	152,429,036	204,596,442	290,847,790	34.20	281	770,880
7	Nigeria	123,945,463	200,962,417	391,296,754	62.10	221	910,770
8	Bangladesh	128,734,672	168,065,920	193,092,763	30.50	1,253	130,170
9	Russia	147,053,966	143,895,551	129,908,086	-2.20	9	16,376,870
10	Mexico	99,775,434	132,328,035	150,567,503	32.60	66	1,943,950

Source: compiled from <https://www.internetworldstats.com/stats8.htm> & density & land area from: <https://www.worldometers.info>

period 2014 to 2019 based on road connectivity, quality of road infrastructure, railroad density, efficiency of train services, airport connectivity, efficiency of air transport services, liner shipping connectivity, efficiency of seaport services, utility infrastructure, electricity access, electricity supply quality, exposure to unsafe drinking water and reliability of water supply.

Infrastructure is vital for the long-term growth and competitiveness of emerging economies. It helps create jobs and improves standards of living, and the Government is continuously investing in infrastructure projects and is keen on initiating policies encouraging the private sector players to heavily invest in the infrastructure projects, that would ensure time-bound creation of world class infrastructure in the country. However, many Asian countries such as Indonesia are still facing constraints in developing and funding infrastructure projects. In 2019 Indonesia is ranked 72 in the Global competitiveness report, whereas in 2017 the rank was higher at 52, which shows that even though Indonesia's infrastructure is developing at a high rate, but other nations have grown at a higher rate and thus Indonesia got pushed to a lower rank. For getting a clearer picture let us browse into the Logistics Performance Index.

#### 4.3.1. Logistics performance index

Logistics is the backbone of trade, and good logistics can reduce trade cost and make countries compete globally. Getting logistics

right, means improving infrastructure, skills, customs and regulations, policies and governance at the right proportion. The Logistics Performance Index (LPI) is reported by the World Bank once in every 2 years, based on qualitative and quantitative data on six core performance components: (1) The efficiency of customs and border clearance, (2) The quality of trade and transport infrastructure, (3) The ease of arranging competitively priced shipments, (4) The competence and quality of logistics services, (5) The ability to track and trace consignments, (6) The frequency with which shipments reach consignees within scheduled or expected delivery times. Table 7 gives the ranking of Indonesia from 2014 to 2018.

Indonesia's ranking in the World Bank's Logistics Performance Index (LPI) improved from 53 in 2014 to 46 in 2018 globally among 160 countries based on six different parameters. The position of Indonesia among the emerging markets is quite appreciable as it is ranked fourth in the 2020 Agility Emerging Markets Logistics Index. To stay competitive, the policies makers, have to take steps to strengthen the logistic sector, and investments in this sector is highly recommended and will be beneficial not only for the investor and the country, but also for the international trade. The current initiatives are quite promising, as Indonesia is ratcheting up infrastructure spending to upgrade roads, ports, water facilities, and power plants. Indonesia has recently made a proposal to invest US\$412 billion from 2020 to 2024, in building projects, from constructing 25 airports to new power plants, as the government seeks to stoke up growth in Southeast Asia's largest economy. About 60% of the spending will go toward transportation-related infrastructure (Harry and Karlis, 2019). Instead of leaning heavily on public funds to get them done, the government is inviting the private sector to foot a good chunk of the bill and take advantage of investment opportunities.

#### 4.4. Productive Labor Market

The vibrant diversified labor force attracts foreign direct investments. When international investors look for an investment destination, considerations about the skilled nature of the labor force are a matter of priority that determines their scope of success in a country (Brakman and Harry, 2008). Table 8 gives the data for the labor force which comprises people with ages 15 and older who supply labor for the production of goods and services during the period of study. It includes people who are currently employed and people who are unemployed but seeking work as well as 1<sup>st</sup>-time job-seekers.

**Table 4: Market size: Global competitiveness index ranking of Indonesia – 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	15	10	10	9	8	7

Source: Compiled from Global Competitiveness Reports 2014-2019

**Table 5: Economic growth of Indonesia - 2014-2018**

Year	2014	2015	2016	2017	2018	Average
Growth rate	5.01%	4.88%	5.03%	5.07%	5.17%	5.03%
Global rank	49	45	37	38	40	

Source: Compiled from GlobalEconomy.com, reports 2014-2018

**Table 6: Infrastructure: global competitiveness index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	56	62	60	52	71	72

Source: Compiled from Global Competitiveness Reports 2014-2019

**Table 7: Logistics performance index: Ranking of Indonesia - 2014-2018**

Year	LPI Global rank	Parameter-wise Global ranks					
		Customs	Infrastructure	International shipments	Logistics competence	Tracking and tracing	Timeliness
2014	53	55	56	74	41	58	50
2016	63	69	73	71	55	51	62
2018	46	62	54	42	44	39	41

Source: Compiled from Logistics Performance Index, 2014 - 2018

**Table 8: Labor force in Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Labor Force (million)	123.30	124.90	126.26	129.91	131.96	133.95
Global Rank	4	4	4	4	4	4

Source: Compiled from The Global Economy.com reports 2014 to 2019

In 2019 the labor force in Indonesia was 133.95 million just behind China, India and the USA which has higher number of labor force of 783.19, 519.47 and 165.74 million people respectively. Throughout the period of study Indonesia had been retaining the fourth position globally. Moreover, Indonesia's total median age is 31.1 years (2020 estimate, CIA World Fact book), which indicates that 50% of the population is younger than 31.1 years. Such numbers indicate that, from a demographic perspective, there is great potential for both productivity and creativity in Indonesia. Now let us look at the labor market efficiency, Table 9 gives the ranking for Indonesia on labor market efficiency during 2014 to 2019 based on cooperation in labor-employer relations, flexibility of wage determination, hiring and firing practices, redundancy costs, active labor market policies, workers' rights, ease of hiring foreign labor, internal labor mobility, effect of taxation on incentives to work, pay and productivity, reliance on professional management, and the ratio of women in labor force.

An efficient labor market, easy availability of skilled labor, the ready availability of training facility and capacity to attract and retain right talent from within the country and other parts of the globe are the most important factors that attract international investors. But Indonesia is ranked 85 out of 141 nations ranked which calls for immediate and drastic improvement in this sector if Indonesia has to improve the FDI attractiveness. To improve this Indonesia may have to look into its education and training system and ensure that the students graduating out of their higher education institutions have the knowledge and skills matching their peers graduating out of globally high ranked universities, and that the training institutions in Indonesia are providing trainings that are globally the best. As far the investors are concerned they can be assured of the ready supply of skilled manpower, only thing they have to do is select the most suitable candidate and give them the right orientation then the employers will prefer them to anyone else.

#### 4.5. Political Risk

TNCs usually assess political risk before investing in any country. There are many forms of political risks, but the extreme form is the possibility that the host country will take over a subsidiary. However, this form of political risk is an extreme case and not very common in today's global world. The more common forms of political risk include the negative attitude of the host government to TNCs, blockage of fund transfer, currency inconvertibility, war, bureaucracy, and corruption. Credendo Group provides Business and economic data for 200 countries and have classified country risk under different indicators like political risk short term, political risk medium/long term, special transactions risk, transfer risk, expropriation risk and political violence risk; under each of these indicators countries are classified into seven categories: from 1 (low risk) to 7 (high risk); among them the last three are related to Direct Investments, and let us probe into that a little bite.

**Table 9: Labor market efficiency: global competitiveness index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	110	115	108	96	82	85

Source: Compiled from Global Competitiveness Reports 2014 to 2019

##### 4.5.1. Transfer risk

The currency inconvertibility and transfer restriction risk refers to the inability to convert and transfer out of the host country any funds related to the investment. The average value for Indonesia during the period of study is 3 for each year from 2014 to 2019. Which indicates that currency inconvertibility and transfer restriction risk is low for Indonesia.

##### 4.5.2. Expropriation risk

The risk of expropriation encompasses all discriminatory measures taken by a host government which deprive the investor of its investment without any adequate compensation; and also includes events of embargo, change of (legal) regime and denial of justice, and the probability of a negative change in attitude towards foreign investments. The average value for Indonesia during the period of study is 3 for each year from 2014 to 2019. Which indicates that expropriation risk is low in Indonesia.

##### 4.5.3. Political violence risk

Political violence includes all violent act(s) undertaken with a political objective; and includes: terrorism (political, religious and ideological objectives) and political violence damage (damage to material assets as a result of political violence); business interruption as a result of political violence damage. In order to assess the political violence risk, the index looks at the actual levels of internal violence in and external conflict with a country, but also at the conflict potential that arises from (lingering) internal and external tensions, frustration and dissatisfaction. The average value for Indonesia during the period of study is 4, with a minimum of 3 index points in 2014 and a maximum of 4 index points in 2017. Which indicates that the political violence risk is low for Indonesia. Table 10 gives the consolidated ranking for the period 2014 to 2019.

Hence the international investors can be sure that they will get a warm welcome in Indonesia, their funds will not be blocked, enjoy easy convertibility, and less bureaucracy bottlenecks. Now let us go deeper into the level of corruption in Indonesia.

##### 4.5.4. Corruption

Corruption distorts competition and investment and hinders free and fair trade. The study by Mauro (1995) found that corruption lowers investment and thereby economic growth. In regard to foreign direct investment, studies have shown that there exist economic consequences of corruption, the study by Smarzynska and Wei (2001) revealed that foreign investor's choice of entry mode may be affected by the extent of corruption in a host country. Corruption makes dealing with government officials, for example, to obtain local licenses and permits, less transparent and costlier, particularly for foreign investors. In this case, having a local

**Table 10: Country risk: Credendo group index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Transfer risk	3	3	3	3	3	3
Expropriation risk	3	3	3	3	3	3
Political violence risk	3	3	3	4	4	4

Source: Compiled from Credendo group index reports 2014 to 2019

partner lowers the transaction cost, such as the cost of securing local permits. At the same time sharing ownership may lead to technology leakage. Both costs of local permits and losses from technology leakage are positively related to the extent of corruption in a host country.

When corruption level is sufficiently high no investment will take place. Indonesia is the least corrupt country in South Asian and offers a business-friendly environment, with an effective and efficient public administration. Transparency International (TI) has published the Corruption Perceptions Index (CPI) since 1995, annually ranking countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys. The CPI generally defines corruption as “the misuse of public power for private benefit.” Table 11 displays the ranks assigned to Indonesia during the last 6 years.

The ranking by the Corruption Perceptions Index shows that the nation has to improve a lot in containing and controlling corruption, the data in the table do not confirm much improvement year by year in reducing corruption. Hope the steps taken by the current government sees positive results in the near future.

#### 4.6. Interest Rates

High interest rates tend to slow the growth of an economy and reduce the demand for the TNC’s products and thus can negatively impact the flow of FDI. High loan interests translate into cost burden of a company and have been evidenced by the companies that decide to halt operations and move to other regions with low interest rates. From the perspective of an investor, low interest rates are better as compared to high rates because returns are high when the interest charges are low. Reduction of interest on loans is being introduced by the government of Indonesia for the purpose of creating an ideal environment for both domestic and international investments. Destinations with such incentives are bound to attract more investors than destinations with high interest rates.

Lending rate is the bank rate that usually meets the short- and medium-term financing needs of the private sector. This rate is normally differentiated according to creditworthiness of borrowers and objectives of financing. Table 12 gives the lending interest rates in Indonesia during the period 2014 to 2018

The global average lending interest rates for 2018 was 11.41%. The lending rate in Indonesia is lower than the global average and is decreasing year after year, which is a good sign as the lenders

**Table 11: Corruption: global ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	107	88	90	96	89	85

Source: Compiled from the corruption perceptions index 2014 to 2019

**Table 12: Lending interest rates in Indonesia - 2014-2018**

Year	2014	2015	2016	2017	2018
Interest rate	12.60%	12.66%	11.89%	11.07%	10.54%
Global rank	43	44	49	47	42

Source: Compiled from The Global Economy.com reports 2014 to 2018

can avail loans at a lower cost, as the cost of capital impacts the corporate decisions and return on investment measuring parameters.

#### 4.6.1. Developed financial system

The presence of financial institutions with sufficient liquidity and transparency to grant quick loans at competitive rates is an important determinant. Licensees under Bank Indonesia (BI) and the Financial Services Authority (OJK) are a large and diverse group, totaling almost 2000 financial services providers (Oxford Business Group, 2020). Of that, 110 are commercial banks and 1,578 are rural banks (as of September 2019). Commercial banks comprise 96 conventional commercial banks and 14 sharia banks. The banking system is dominated by state-owned banks and government-owned regional development banks (Bank for International Settlements, 2020). The investors, market participants, and analysts have been comfortable with Indonesian banking system.

Table 13 gives the ranking for Financial System of Indonesia 2014 to 2019 based on the availability of domestic credit to private sector, financing of SMEs, venture capital availability, market capitalization, insurance premium, soundness of banks, non-performing loans as percentage of loan portfolio value, credit gap and banks’ regulatory capital ratio

Indonesia was ranked at 37 in 2017 and it dropped to 58 in 2019, which call the attention of policy makers and regulators to do more to strengthen the financial system. A modernized technology driven financial system is the need of the hour. In recent decades, Indonesia has made impressive progress in building a financial sector that fits its unique development needs. Yet in a world where payments can be sent with a click of a button from the most basic cell phone, it is crucial that countries have financial sectors that ensure stability while offering deep, well-regulated markets and being agile enough to respond to rapid innovation in the industry. Thus the Indonesian financial sector offers plenty of investment opportunities that can be availed by both domestic and international investors, who can make the Indonesian financial sector stronger and investor friendly.

#### 4.7. Tax Rates and Clarity of Taxation Policies

Lower tax will give corporates and individuals more after-tax income that could enhance the wealth of the corporates and individuals could use for buying more goods and services, or for saving. Investors prefer lower-tax locations to locate or relocate their businesses.

#### 4.7.1. Corporate tax

Table 14 gives the corporate tax rates for few selected Southeast Asian Countries, and the averages.

**Table 13: Financial system: Global competitiveness index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	42	49	42	37	52	58

Source: Compiled from Global Competitiveness Reports 2014-2019

The corporate tax rates are quite high in Indonesia. During the period of study, the corporate tax rates in Indonesia is higher than most of the other Southeast Asian countries, it is also higher than the Asian and the global average. The policy makers will have to reduce the tax rates drastically to make Indonesia friendlier to the corporates operating in Indonesia and to attract MNCs from around the globe to invest in Indonesia.

#### 4.7.2. Income tax

Table 15 gives the individual income tax rates for few selected Southeast Asian Countries, and the averages.

The individual income tax rates are quite high in Indonesia. During the period of study, the individual income tax rates in Indonesia is higher than Singapore and Malaysia and of course lower than all other Southeast Asian countries, it is also higher than the Asian average. The policy makers will have to give a proper thought as have to reduce it without heavily impacting the revenue of the nation. Lower income tax reduces the cost of running a business, because at the time of salary negotiations the prospective employee looks at the after-tax annual pay package offered. The country will have to carry out reforms in the taxation policy to attract highly talented and skilled workforce needed for the domestic and MNCs operating in the country.

#### 4.8. Geographical Location/Global Connectivity

Indonesia is the Southeast Asia country and lies between Pacific and Indian ocean. It is also connected with South Malaysia and northwest of Australia. Thus, Indonesia is strategically situated between two oceans (the Pacific and Indian Oceans) and two continents (Asia and Australia). So it is connecting with the major countries of the world for trading. A large percentage of world trade transits the strategically important Straits of Malacca that link the Indonesian ocean littoral to the South China Sea and the larger

**Table 14: Corporate tax rates (in %) for select Southeast Asian Countries - 2014 to 2019**

Location	2014	2015	2016	2017	2018	2019
Indonesia	25	25	25	25	25	25
Malaysia	25	24	24	24	24	24
Philippines	30	30	30	30	30	30
Singapore	17	17	17	17	17	17
Thailand	20	20	20	20	20	20
Vietnam	22	22	22	20	20	20
Asia average	22	21.98	21.41	21.08	21.21	21.09
Global average	23.88	23.77	23.62	24.06	24.02	23.79

Source: Compiled from KPMG data

**Table 15: Income tax rates (in %) for select Southeast Asian Countries - 2014-2019**

Location	2014	2015	2016	2017	2018	2019
Indonesia	30	30	30	30	30	30
Malaysia	26	25	28	28	28	28
Philippines	32	32	32	32	35	35
Singapore	20	20	22	22	22	22
Thailand	35	35	35	35	35	35
Vietnam	35	35	35	35	35	35
Asia average	27.2	27.09	27.35	27.65	27.67	27.99
Global average	31.08	30.8	30.97	31.41	31.39	31.23

Source: Compiled from KPMG data

Pacific Ocean basin. The dominating trading members of Indonesia are South Korea, United States, Thailand, European Union and Japan. The number of trade partners are also increasing due to the improved global competitiveness and ease of doing business.

#### 4.9. Availability/Easiness to Import of Raw Materials

Availability of raw materials means that international investors can do business in the country without having concerns for the supply of production materials. Indonesia is rich in natural resources, coal, minerals like tin, gold, copper, nickel and bauxite, oil and gas and fertile land to support agricultural products. These wide range of raw materials that can be used for manufacturing processes and has motivated many investors abroad to invest in the country. The import export policy is quite friendly and liberal, which permits manufacturers to import those raw materials that are not readily available in the country. But, the government will have to still improve the policies to attract more FDI into the country

#### 4.10. Technology Adoption and Innovation

Technology is an important consideration made by foreign investors because it determines the scope of operational efficiency. From an investment perspective, the lack of efficient technology systems implies that operations would be slow and costly, and, thus, there will be a need for choosing destinations with a higher level of technology. Table 16 gives the ranking for Indonesia on ICT adoption during 2014 to 2019 based on mobile-cellular telephone subscriptions, mobile-broadband subscriptions, fixed broadband internet subscriptions, fiber internet subscriptions and internet users.

In ICT adoption Indonesia is ranked relatively low, but the policy makers have come out with large ICT infrastructure spending that is expected to accelerate from \$15 billion to \$26 billion by 2024, with projects promising to expand digital access across the islands, facilitating easy access to e-commerce and internet access for schools across a country. Table 17 gives the ranking for Indonesia on innovation friendliness during 2014 to 2019 based on diversity of workforce, state of cluster development, international co-inventions, multi-stakeholder collaboration, scientific publications, patent applications, R&D expenditures, prominence of research institutions, buyer sophistication and applications made for trademark.

In innovation friendliness Indonesia was having a relatively better rank of 31 in 2014, but since 2016 it is observed to be decreasing and is ranked as low as 74 in the year 2019, which calls for

**Table 16: ICT adoption: Global competitiveness index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	77	85	91	80	50	72

Source: Compiled from Global Competitiveness Reports 2014 to 2019

**Table 17: Innovation capacity: Global competitiveness index ranking of Indonesia - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
Global rank	31	30	31	31	68	74

Source: Compiled from Global Competitiveness Reports 2014 to 2019

immediate intervention from the part of the policy makers. Now let us look at the ranking of by Global Innovation Index (GII) co-published by Cornell University, INSEAD, and the World Intellectual Property Organization (WIPO, an agency of the United Nations). The Index is a ranking of the innovation capabilities and results of world economies. It measures innovation based on criteria that includes institutions, human capital and research, infrastructure, credit, investment, linkages; the creation, absorption and diffusion of knowledge; and creative outputs. Table 18 gives the ranking of Indonesia in the Global Innovation Index during 2014 to 2019.

Over the last 6 years, Indonesia has improved its ranking in innovation inputs, reaching the position 87 this year, up from 117 in 2014. Whereas, innovation outputs have decreased from 60 in the year 2014 to 78 in the year 2019. The above data shows that Indonesia requires more investments and more friendly policies to enhance technology adoption and innovations. This is a huge opportunity for both domestic and international investors to invest and reap high returns and at the same time make Indonesia a better place to live and do business.

#### 4.11. Ease of Doing Business

The World Bank Group's Doing Business Report ranks economies based on their ease of doing business. These reports provide quantitative indicators on regulation for starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. A high ease of doing business ranking means the regulatory environment is more conducive to the starting and operation of a local firm. Table 19 gives the ranking for Indonesia from 2015 to 2020.

Doing Business data for the past 6 years show that the position of Indonesia has improved a lot from 114<sup>th</sup> position in 2015 to 73<sup>rd</sup> position in 2020, it is easier to file for a new business, get a construction permit and trade goods across the border. Still more has to be done to make Indonesia more investment-friendly and attractive to FDI's.

#### 4.12. Government Initiatives in Making Indonesia Investment Friendly

FDI is a critical driver of economic growth, and is a major source of non-debt financial resource for the economic development of

Indonesia. Foreign companies invest in Indonesia to take advantage of relatively lower wages, special investment privileges such as tax exemptions, etc. For Indonesia it is also a means of achieving technical know-how and generating employment. Indonesian government's favorable policy regime and robust business environment have ensured that foreign capital keeps flowing into the country. The government has taken many initiatives in recent years, and few of them are listed here:

In January 2015 Indonesia Investment Coordinating Board (BKPM) launched a one-stop shop for investment in the country, assuming licensure responsibilities for 22 different ministries and government agencies, in order to make the investment process easy and faster. Moreover, the business licensing applications between ministries are being expedited, synchronized, and integrated into an Electronic Single Submission System (OSS). The latest instalment of OSS 1.1 came online on November 4, 2019.

Recently the government amended the law on public-private partnerships to improve transparency and clarity in the tender process of infrastructure projects. It also established the Indonesia Infrastructure Guarantee Fund to arrange government guarantees for public-private partnership projects.

During the last 4 years the Indonesian government has released sixteen Economic Reform Packages (referred to locally as Paket Kebijakan Ekonomi), which are intended to stimulate investment, including foreign investment. The government has also prioritized the accelerated development of infrastructure.

In 2018, in order to attract more investment to support the country's economic growth, Indonesia issued a regulation granting a 100% Corporate Income Tax (CIT) cut to new FDI-backed businesses. Under the regulation, the newly established companies with a minimum investment of Rp500 billion (US\$36.4 million) up to under Rp1 trillion (US\$72.5 million) can enjoy exemption from CIT for the first 5 years, while those investing more than Rp30 trillion (US\$2.2 billion) can enjoy a maximum CIT exemption for 20 years.

Moreover, the current global economic outlook is precarious due to the U.S.-China trade war and the Novel Coronavirus COVID-19. Indonesia is an attractive option for manufacturers fleeing China.

## 5. CONCLUSION

Over the years, Indonesia is emerging as an attractive hub for businessmen from all corners of the world and a magnet for foreign direct investment. With its quality investment climate and diverse and enormous investment opportunities, Indonesia continues to attract FDI. A number of global business indexes and global ranking agencies have recognized the advantages offered by Indonesia and has duly ranked Indonesia as an attractive FDI destination. The parameters making Indonesia an attractive destination is the enormous market, expanding infrastructure, low political risk, decreasing level of corruption, young growing labor force with diversified skills, competitive labor cost, well-organized financial system, technological readiness

**Table 18: Global Innovation Index: Indonesia's Ranking - 2014-2019**

Year	2014	2015	2016	2017	2018	2019
GII	87	97	88	87	85	85
Innovation inputs	117	114	99	99	90	87
Innovation outputs	60	85	76	73	73	78

Source: Compiled from the Global Innovation Index 2014 to 2019

**Table 19: Ease of doing business: Indonesia's ranking - 2015-2020**

Year	2015	2016	2017	2018	2019	2020
Global rank	114	109	91	72	73	73

Source: Compiled from the Doing Business Report 2015 to 2020

and innovation, friendly import-export policies, relatively lower corporate taxes, and reform-friendly government. These factors, combined with the current ambitious leadership that leads the country with proper vision and long terms strategic plans, make Indonesia an attractive destination for Foreign Direct Investments.

Limitations of this study is that the impact of current Novel Coronavirus COVID-19 is not factored into the study, as it is still an ongoing pandemic, hence the investors are requested to factor in that while making the investment decisions.

Exchange Rate: IDR 1 = US\$ 0.00007 as on July 20, 2020.

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