

Indonesia – Aceh/Nias

Mini-Diagnostic Analysis of the Investment Climate

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Foreword

This report was prepared by FIAS in response to a request from IFC/PENSA to undertake a rapid response, mini-diagnostic analysis of the investment climate in Aceh/Nias. The work is considered to be the first step toward the development of an investment climate and investment promotion strategy for the region.

FIAS conducted the mini-diagnostic over the period September 19-30, 2005 in close cooperation with IFC/PENSA and the World Bank in Jakarta. The work was underpinned by a 3-day field visit to Banda Aceh to consult with the Aceh Reconstruction and Rehabilitation Agency (BRR), other government agencies, private sector participants, and NGOs.

Executive Summary

Nine months after a devastating earthquake and tsunami, the economy of Aceh/Nias is still reeling from the human and physical losses inflicted by this natural disaster. Yet, even before the disaster, the investment climate of Aceh/Nias had suffered from three decades of political instability. The cumulative effects of natural disaster and political upheaval have created an investment climate characterised as follows:

- coastal infrastructure (ports, harbour buildings, surrounding businesses, customs facilities) has been destroyed;
- local government capacity is at its weakest point with many staff lost to the catastrophe, and public records and systems either absent or inoperable;
- uncertainty prevails about the application of provincial and local government laws and regulations;
- business entry procedures are unclear and inefficiently administered;
- the property titling system is decimated;
- provincial investment laws and regulations are only now in the process of being formed in light of Aceh's special autonomy status; and
- investment promotion is at a virtual standstill.

In addressing the shortcomings of the current investment environment, attention will need to be given simultaneously to developing a long-term strategy for bolstering investor confidence and interest in the region, as well as short-term priorities. This mini-diagnostic recommends a number of potential priorities for investment climate reform, as follows:

- accelerate drafting of provisions to relating investment policy in the new law on the governing of Aceh/Nias;
- promulgate an investment policy statement for Aceh/Nias leveraging off its special status as an autonomous region;
- conduct a baseline study of the extent, sectoral breakdown, size, and characteristics of firms in the informal sector;
- develop provincial-level policy to help guide the development of streamlined and standardized registration procedures, and registration centres in affected municipalities to promote business registration;

- quickly mobilize an Investor Service Centre to assist potential investors;
- conduct a training needs assessment for the key agencies interacting with the investor community such as BKPMD and other relevant branches of local government;
- conduct training workshops on investment promotion strategies and techniques, simplification of investment processes, and investment facilitation services; and
- undertake a cost-benefit assessment of the proposal to reactivate the special economic zone status of Sabang Island.

1 Investment climate assessment

Introduction

Nine months after a devastating earthquake and tsunami, the economy of Aceh/Nias is still reeling from the human and physical losses inflicted by this natural disaster. Total damages and losses have been estimated at about 97 percent of Aceh's GDP, and more than three quarters of total losses were suffered by the private sector. Current economic conditions remain depressed although the retail economy in Banda Aceh appears to have recovered quickly. The overall investment climate picture is one of weakened government capacity, poor infrastructure, a highly fractured productive base (outside of the oil and gas sector), scarce employment opportunities, rising inflation, and a financial system only slowly re-emerging to begin lending activities to the business community.

In response to this situation, FIAS agreed to participate in a cooperative venture with the nascent IFC-sponsored Private Enterprise Partnership (PEP) for Aceh/Nias and the Indonesian Aceh Reconstruction and Rehabilitation Agency (BRR) to develop an investment climate and promotion strategy for the region.

Under its business climate development component, the PEP Aceh/Nias implementation plan envisages a range of initiatives for which the need for FIAS expertise could be anticipated during the reconstruction and rehabilitation period. These include:

- *The Business Climate Mapping Initiative*, to compile a comprehensive map of the environment for business start up and operation in Aceh/Nias;
- *The Business Climate Recommendations Report Initiative*, to make recommendations to BRR on opportunities for improvement including with respect to business registration and licensing;
- *The Business Climate Support Initiative*, to work with BRR on selected opportunities for business climate reform;
- *The Priority Investor Identification Initiative*, to identify areas of longer-term comparative advantage for Aceh/Nias; and
- *The Support for New Investors Initiative*, to help identify and promote new investment and support the entry of priority investors to Aceh/Nias.

The first step in developing an investment climate improvement strategy is to conduct the present mini-diagnostic with a view to highlighting areas where immediate support, consistent with longer-term objectives, would be warranted.

The mini-diagnostic is based on interviews with public officials, private sector representatives, and selected representatives of the donor community (see Appendix A). Given the rapid response nature of the diagnostic, the assessment also necessarily draws heavily on other studies; in particular those conducted by the National Planning Agency (BAPPENAS) in conjunction with the World Bank (see Appendix B).

Overview

Even before the 2004 earthquake and tsunami, the investment climate of Aceh/Nias suffered as a result of escalating political instability. As a consequence, investment dwindled to minimal levels, the economy shifted from an urban and service-based to an agrarian one. Rapid out-migration was accompanied by falling employment levels. The conflict's negative impact on the investment climate has been severe, characterised by poor security, degraded infrastructure, lack of access to bank credit, and weakened provincial government. Between 1997 and 2001, the province accounted for only 2 percent of Indonesia's approved non-oil and gas investment and only 1.8 percent of approved oil and gas investment. Provincial economic output declined by 20 percent over the same period. Aceh's investment to regional GDP ratio has remained low, at around 12 percent.

The earthquake and tsunami further damaged what was already a depressed investment climate. Much of the existing coastal infrastructure (ports, harbour buildings, surrounding businesses, customs facilities) has been destroyed, and local government capacity to administer public sector programs is now at its weakest point with many staff lost to the catastrophe, and records and systems simply absent or inoperable. This has led to uncertainty about the application of provincial and local government laws and regulations, with business entry procedures becoming unclear and inefficiently administered.

The property titling system is decimated, meaning that access to land and the enforcement of property rights have suddenly become a severe constraint to increasing investment levels. New provincial investment laws and regulations are only now in the process of being formed in light of Aceh's special autonomy status. Investment promotion is at a standstill.

In addressing this bleak investment environment, attention will need to be given simultaneously to short-term priorities—which this diagnostic identifies—as well as longer term issues in order to develop a responsive and credible strategy for bolstering investor confidence and interest in the region. A coordinated effort by government to address key business development issues such as permits, licenses, business registration, inspections, property rights, zoning, access to credit, imports, and exports should be planned and initial implementation with local civil authorities begun. Particular efforts will be needed to ensure freedom of internal trade within Aceh/Nias, and between Aceh/Nias and North Sumatra and other parts of Indonesia.

In short, while Aceh's growth prospects will depend on a range of interrelated factors, rejuvenation of the investment climate will need to take primacy and will in large measure involve revitalizing small and medium scale enterprises. Since the vast majority of businesses affected by the disaster were micro and small-scale businesses—mostly household-based and informal—a local investment climate revival strategy should focus on local entrepreneurship and the promotion of micro/small enterprises, enhancing their capacity to identify and respond to emerging market opportunities.

Assessment of selected features of the investment climate

Regional autonomy and the legal framework

Decentralization and special autonomy have endowed Aceh/Nias with relatively abundant budgetary resources compared to other regions of the country. In addition to the financial transfers stipulated in Law 33/2004 on fiscal transfers under decentralization, Law 18/2001 on special autonomy allocates 55 percent of oil revenues and 40 percent of the natural gas to the region for the eight years following the implementation of the law. Furthermore, under the Memorandum of Understanding between the central government and the Free Aceh Movement (the so-called peace accord), Aceh/Nias will have the additional authority to “set and raise taxes to fund official internal activities”.

While these aspects of Aceh's special status have been laid down in very general terms, much needs to be done on the legislative and regulatory front to build a strong legal foundation upon which the local economy could be expected to flourish. Following the signing of the peace accord, a new law on the governing of Aceh/Nias is to be promulgated and entered into force no later than 31 March 2006. Drafting teams are preparing the various components of the new law which will cover, *inter alia*, recommendations on local tax policy and administration, revenue sharing arrangements, and regional investment policy. Implementation guidelines will also be prepared, and “socialization” of the draft law is expected to commence before the end of the year.

Administrative procedures

A World Bank investment climate assessment (ICA) conducted in 2003 found that administrative procedures at the sub-national level across Indonesia imposed an undue burden on investors both in terms of cost and time spent on complying with the procedures. Many of the procedures adopted at the local level were either unclear or redundant, and often associated with illegitimate payments. Moreover, the decentralization initiative underway since 2001 appears to have worsened rather than improved the situation. The most recent ICA undertaken by the World Bank in 2005 highlighted that new regulations imposed by local governments (at the *kabupaten* and *kota* levels) have further impinged on investors particularly with respect to labour regulations, tax nuisances, access to land (see also below), and business licensing.

Business start-up procedures

In the time available, and given the constrained capacity of government departments to service an onslaught of donors, business start up procedures could not be assessed in detail. However, the mini-diagnostic team was able to ascertain that the Asia Foundation, in partnership with Syiah Kuala University, Banda Aceh, plan to implement a technical assistance program to establish a one-stop-shop for obtaining local (*kabupaten/kota*) licenses and permits for Kota Banda Aceh. Others interviewed considered that access to finance was a more significant short-term constraint to business start-up than compliance with official paperwork and procedures at this immediately-post-crisis stage.

Taxes, customs, and investment incentives

Throughout the conflict years, voluntary compliance with national tax and customs laws waned, and, in the aftermath of the decentralization initiative, local governments have added to the complexity of doing business by imposing their own taxes and fees. Even more prominently after the tsunami, compliance with national and local taxes alike fell sharply. For example, one local business representative considered that very little value added tax (PPN) was being collected even though retail trade was evident in the city centre. Income taxes receipts will also have fallen following the destruction of many businesses and individual livelihoods in the disaster.

All these factors threaten the medium-term financial viability of the region, and thus the attractiveness of the region to investors. Unless local and national taxes can be properly coordinated, and simple and transparent collection and enforcement procedures can be quickly developed to ease the compliance burden on the re-emerging taxpaying community, scarce investor resources are likely to go elsewhere. In short, the current level of uncertainty faced by potential investors with respect to their tax and procedural obligations is impacting negatively on the overall investment climate.

Access to land¹

The earthquake and tsunami caused extreme damage not only to physical property but also to any evidence of property rights (fencing, building structures, ownership documentation), and to the land administration system. Across the region (especially the affected coastal areas) the destruction has obliterated land boundary markers, and the death toll has taken with it the human archive on which memory of the location of these boundaries is based. The destruction of many government land books and cadastral (land) maps held in the provincial and district land offices of the National Land Agency (BPN) has made the reconstruction of property rights even more difficult. More complicated still, the majority of landowners in Indonesia do not hold registered title to their property. For these people, possessory rights are only secured through long and established occupation. It is estimated that there may be 3-5 times as many land holders with unregistered rights compared to those whose holding registered title.

Land rights recovery and protection clearly should be a priority task, and will have two integral parts. First, protection should be provided to those whose rights were registered before the tsunami. Property rights should be revalidated and confirmed, and new title certificates issued to those landowners. Second, but more difficult issue concerns occupiers of land without registered title. Although their possessory rights were not registered with the government, they have actually held possessory (or occupancy) rights to land, which has been widely accepted and mutually recognized by the community.

The donor community has given strong focus to land rights issues. An implementation framework for the reconstruction of property rights has already been adopted by the government under the Reconstruction of Aceh Land Administration (RALAS) Project. This project, implemented under the direction of BPN, and funded by a \$28.5 million Multi-Donor Trust Fund Grant, became effective on August 22, 2005. The objectives of the project include: (i) to recover and protect ownership land rights of the people in the affected and surrounding areas; and (ii) to rebuild the land administration system.

¹ This assessment has been sourced from the forthcoming 9-month progress report on economic and social developments in Aceh/Nias by the World Bank.

Investment promotion and investor servicing

The regional level Investment Coordinating Board (BKPM) is once again functioning even though it suffered massive water damage and severe loss of life. Seven staff members (from a total of 50) were killed in the tsunami. The new chairman of the agency was able to quickly reinstate investment approval procedures, and produce information material on investment priorities and opportunities for the reconstruction period. Proposals were also put forward to BKPM headquarters for the creation of an investor assistance centre to provide information to potential post-crisis investors, but the proposal was reportedly turned down by the National Planning and Development Agency (BAPPENAS) as a low priority.

Although the agency is functioning, it is operating at minimal capacity. There exists significant longer-term potential for improving investment regulations, procedures, and promotion. Of particular note, Aceh/Nias possesses a unique opportunity for reform in this important area because its special autonomous status endows it with the right to deal directly with the external investor community. In other words, Aceh/Nias will have the legal authority to operate outside the national policy and administrative framework which to date has governed investment issues in all other provinces.

In the short-term, priority needs to be given to augmenting provincial-level investment promotion capacity through the provision of investor facilitation services so that potential investors can be better informed of conditions, options, and opportunities.

2 Potential reform priorities

Laws and regulations arising from Aceh's special autonomous status

Issue

The period leading up to March 2006 presents a window of opportunity to ensure consistency between the national level investment law and local investment policy and regulations. Ultimately, Aceh/Nias should aim to streamline registration/approval processes, seek to consistently apply any investment-related policies such as restricted lists, and advocate for uniform application of investment incentives. Improvements made now will be critical in securing sustained enhancements in investment activity in the region over the coming years.

Objective

To improve the quality, consistency, and timeliness of local investment laws and regulations.

Recommendations

- In a cooperative effort between, BRR, BKPM, BAPPEDA, and the Aceh Governance and Development Program, prepare drafts of relevant provisions relating investment policy for the new law on the governing of Aceh/Nias. FIAS could contribute its international expertise with the drafting of investment laws and implementing decrees, and first hand knowledge of the draft national investment law.
- Prepare an investment policy statement for Aceh/Nias leveraging off the special status of Aceh/Nias as an autonomous region. FIAS has relevant experience in this area, and has assisted several Asian countries draft and disseminate their investment policies.

Business re-registration

Issue

Many business records and government facilities that process these records have been destroyed. Affected businesses and new investors alike will need to be registered to ensure that a minimal number remain in the informal sector. This will require that a well-organized and business-friendly registration system program be initiated as a priority.

Objective

To help re-register businesses and promote participation in the formal sector.

Recommendations

- Conduct a baseline study of the extent, sectoral breakdown, size, and characteristics of firms in the informal sector. FIAS could provide assistance to carry out such a study/survey based on similar work it has conducted, or plans to conduct, in a number of other countries.
- Develop provincial-level policy to help guide the development of streamlined and standardized registration procedures and registration centres in affected municipalities and promote business registration. The Asia Foundation will soon commence a project to implement a registration and licensing ‘one-stop-shop’ for *Kota Banda Aceh*. FIAS could provide its broader, international expertise to help establish and promulgate *provincial-level* policy guidelines.

Investor servicing

Issue

While BKPMD has made good progress in recovering from the tsunami disaster, it is struggling to provide adequate services to potential investors interested in developing business opportunities during reconstruction and rehabilitation.

Objective

To facilitate the matching of potential investors with investment opportunities in the small and medium scale industries.

Recommendations

- Based on its worldwide experience in designing investment promotion strategies and supporting institutional frameworks, FIAS could assist in quickly mobilizing an Investor Service Centre to provide services to potential investors, including:
 - Information on general business and operating conditions;
 - Information on entry requirements and procedures;
 - Referrals to sources within individual *kabupaten*;
 - Aftercare services to investment projects.

Systems design and capacity development

Issue

The weakened state of capacity across all levels of regional government threatens the ability of the authorities to implement and activate required policy and administrative reforms. The policy framework needed to strengthen the investment climate, such as the legal system, the tax and customs codes, the investment law, and the land code will shortly be in place. Yet if these framework improvements are not activated and implemented quickly their impact will be minimal in stimulating new investment and growth in the economy. A wide range of training programs and capacity development initiatives will be needed.

Objective

To support capacity development within the various arms of local government interacting with the investor community.

Recommendations

- Conduct a training needs analysis for key agencies interacting with the investor community such as BKPM and other relevant branches of local government. FIAS could provide subject matter expertise on the key skills required for successful foreign investor registration, investment promotion, and other relevant programs.
- On a rapid response basis, FIAS could conduct workshops for key government officials and the private sector on, for example:
 - Investment promotion strategies and techniques;
 - Simplification of investment processes; and
 - Investment facilitation services.

The role of special economic zones

Issue

Interest has emerged among some local decision makers in the potential of the Sabang free port becoming an engine for growth of the regional economy, and in particular, as a means of attracting foreign investors to the region. These proposals would benefit from closer examination as there has been no formal analysis of whether a free trade zone on Sabang Island would deliver the intended benefits and at what cost.

Objective

To inform the emerging debate on this issue, and help shape policy on the basis of sound economic principles.

Recommendations

- Undertake a cost-benefit assessment of the proposal to reactivate the special economic zone status of Sabang Island. FIAS possesses the expertise to conduct this analysis, probably with the support of local consultants.

A List of officials and private sector representatives met

- Anna Juliastuti, Senior Program Officer, The Asia Foundation
- T. Sachrul Ismail, Coordinator, Aceh Governance and Development Program
- Abdul Rahman Lubis, Chairman, Regional Planning and Development Board, Aceh Province
- H. Musfiari Haridhi, Director, PT Sarana Aceh Ventura
- J. Victor Bottini, Resident Representative, World Bank Office, Banda Aceh
- Ir. H. Hanifah Affan, Head, Aceh Regional Investment Coordinating Board
- Peter Stevenson, Director of Programs, MercyCorps, Banda Aceh
- Sasha Muench, Financial Access Program Manager, MercyCorps, Banda Aceh
- Oleksiy Ivaschenko, Economist, Poverty Reduction and Economic Management Unit, East Asia and Pacific Region, Jakarta

B List of sources and existing diagnostics

- Indonesia: Preliminary Damage and Loss Assessment, the December 26, 2004 Natural Disaster, a Technical Report Prepared by BAPPENAS and the International Donor Community, January 2005.
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