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POLITICAL RISKS FACED BY INVESTORS OF DIRECT INVESTMENT

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ABSTRACT

Investment always includes risk factors to affect investment development and it can change the Indonesian economy. Foreign investors also strive to avoid losses due to political risk. Governments of the countries should guarantee the protection of foreign investment from possibility of political risk. Therefore, this study examines what are the political risks faced by direct investment investors. Researchers use certain legal theories as the analysis basis to find answers of study problem. The theories used are Legal Protection Theory, Certainty Law Theory, Investment Theory, and Insurance Theory. The approach method used is normative juridical. This study uses 4 approaches, namely the statutory approach, conceptual approach, case approach, and comparative approach. This study is descriptive analysis to express the overall symptoms of investigated aspects to explain the conditions. Political risk is the change in political environment that can have a detrimental effect on the value of company's business activities (Griffin, Ricky: 212). Assessment of Political Risk Map is done by the RGE method (Roubini Global Economics) (Roubini, 2014: 14). Roubini Global Economics (RGE) is an independent research company, the maker of global macroeconomic strategies developed by Roubini, a well known economist. RGE method has six risk measures, namely: Exchange Transfer, Non-Sovereign Payment, Political Interference, Supply Chain Disruption, Legal and Regulatory Risk and Political Violence.

Key words: Political Risk, Direct Investment

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1. INTRODUCTION

Investment has an important role to shape economic growth. It also relates to increase community income. Investment will encourage higher production. Basically the community has two alternatives below to make investments:

- Direct Investment, by establishing a business he chooses among various fields. Direct investment is regulated in Law No. 25 year 2007 on Investment;
- Portfolio Investment, by investing through the purchase of securities. Sporadic regulation of portfolio investment depends on investment form (related to capital market regulated in Law No. 8 year 1995 on the Capital Market) (Jened, Rahmi, 2016: 29).

Investing in Indonesia can be very profitable but also implies more risk than the developed countries because Indonesia has certain dynamics and characteristics that (can) derail investment and disrupt the investment climate. At least there are three most important elements in process of reciprocal relations, namely the way political factors influence economic outcomes (Ikbar, 2007: 10).

- Political systems shape the economic system, because the structure and work of international economic system (in a broad sense) is also determined by structure and work of international political system
- Political views often shape the economic policy, because economic policies are generally dictated by political interests.
- International economic relations itself is a political relationship, because international economic interactions, such as international political interaction, is a process where state and non-state actors overcome the conflicts or failing to resolve conflicts and the cooperation fail to achieve common goals.

The political risk described above has great effects on the investment development and it can change the Indonesian economy. Establishment of Law No. 25 year 2007 on Investment is a juridical consequence of WTO agreement ratification, including TRIMs (vide General Explanation of Law No. 25 year 2007 on Capital Investment), it is a normative form of globalization (Albrow, 1990), and legal globalization especially shows the threat side than opportunity.

Indonesia has enormous potential to develop investment activities. However, there are obstacles to attract investment (especially direct investment), as confirmed by Djisman Simanjuntak (as the designer of academic text of Law No. 25 year 2007 on Investment), among others: "lack of legal certainty and legal protection mechanisms for investors who are less credible, so the investors are less profitable (Simanjuntak, 2006). According to Kusumaatmadja (1996), main problem in Indonesia and complained by investors is legal certainty, both regarding the provisions of legislation where many things still unclear and contradictory, and the implementation of court decisions.

The capital investment in Indonesia shows ups and downs every year. This allows the government to continue to make efforts to attract more investment desire in according to economic growth in Indonesia. Encouragement from regulatory sector is urgently needed to create business certainty for investment (Ilmar, Aminuddin, 2004, 125.).

Robock et. al. (1983: 342) explained political risk by following formulation: "...is the likelihood that political forces will cause drastic changes in a country's business environment that affect the profit and other goals of a particular business enterprise." Therefore, political risk has four main elements below (Robock et al., 1983: 342):

- Discontinuities, these are drastic changes in business environment.
- Uncertainly, these are the changes that are very difficult to estimate and / or anticipated before.
- Political forces, these are the drivers and / or the causes of changes are state power holders and / or other political forces.
- Business impact, these are the changes to create loss and / or reduction in profit or other companies goal.

Risks based on the objects can be divided into 3 parts (Robock et al., 1983: 342): personal risk, property risk and liability risk. Personal risk relates to someone's death or disability. The die is something that is certain to happen, but when someone dies cannot be ascertained. Therefore, this study examines what are the political risks faced by direct investment investors.

2. THEORY

Theory can be defined as a relationship between two or more facts or arrangement of facts in according to certain ways (Marwan and Jimmy, 2009). Theory has important role in knowledge because theory is a tool to better understand and solving problems. Theory is a set of concepts, boundaries, and propositions to present a systematic view of phenomena by examining relationships between variables to explain and predicting the symptoms (Kerlinger in Khudzaifah Dimyati, 2004: 37).

To find answers of this study problems, researcher will use certain legal theories as an analysis basis. The theory includes; Legal Protection Theory, Certainty Law Theory, Investment Theory, and Insurance Theory.

3. METHODOLOGY

This study uses normative juridical approach method. Normative legal study prioritizes the library materials or normative data by researching the library materials or secondary data which includes primary and secondary legal material. This normative legal research is done by reviewing a legal inventory, finding legal principles, finding legal history, and approaching legislation, especially statutory provisions in relation to direct investment. The normative juridical approach examines, tests and applies legal principles and general principles of investment law. This study uses 4 approaches, namely the statute approach, conceptual approach, case approach, and comparative approach.

Normative legal research does not use field data to solve legal issues while providing an explanation of what research resources should be needed. Sources of legal material in this study use primary and secondary legal materials.

This is a library research. Legal materials compilation was produced from library studies. Therefore the legal material collection techniques used in this study are literature and documentary studies. Collection of legal materials is done by (1) tracing the norms to manage insurance, and (2) analyzing deeply to answer the problem statement.

This research is descriptive analysis. The descriptive means the effort to express the symptoms fully for the investigated aspects to describe the conditions. The analysis is an effort to solve problems with similarities and differences in symptoms found, measure the dimensions of a symptom, set standards, and determine the relationship between the symptoms and so on.

4. RESEARCH RESULTS AND DISCUSSION

Investment can be defined as investing money today to get benefits (remuneration or profit) in future (Noor, 2014). Foreign investment is divided into two types, namely Foreign Direct Investment (FDI) and Foreign Portfolio Investment. Foreign portfolio investments are the purchase of foreign financial assets (stocks, bonds, and certificates of deposit) with other purpose than for control (Griffin, 2015: 2). Keown et al (1999: 17) said that direct investment occurs when Multi National Corporate (MNC) holding and / or operations in more than one country control the investment and building manufacture facilities abroad ".

The Foreign Direct Investment (FDI) that can be done through cooperation with foreign companies, buying foreign companies, establishing subsidiaries in foreign countries and buying company shares to control the company (Madura, 2011: 101). FDI requires a substantial investment and risk is also high. Investors must analyze carefully before investing and understand the potential and risks that can occur, especially political risk.

Risk is uncertainty about something, an unwanted event, something that happened outside the original purpose, and possibility of something harmful (Noor, 2014: 22). Risk arises because of uncertainty about the outcome later. Something is considered a risk if it happens outside the initial goal set, it is a consequence that must be borne due to uncertainty.

The world economic forum has detailed the risk factors for investment in table 1 (World Economic Forum, 2017):

Table 1 Risk Factor in Investment

Risk	(%)
Corruption	13.8
Inefficient government bureaucracy	11.1
Access to financing	9.2
Inadequate supply of infrastructure	8.8
Political risk	8.6
Government instability/coups	6.5
Tax rates	6.4
Poor work ethic in national labour force	5.8
Tax regulations	5.2
Inflation	4.7
Inadequately educated workforce	4.3
Crime	4.0
Restrictive labour regulations	4.0
Foreign currency regulations	3.3
Insufficient capacity to innovate	2.5
Poor public health	1.8

Investors will pay attention to risks in a country when they want to make foreign investments. This risk is called country risk. The level is different in each country due to different political and economic factors. The country risk is differentiated into political risk and macro-economic risk as one considerations of risk assessment, each has its own assessment for FDI.

The Indonesian government has taken steps to improve the financial performance sector in recent years. The large restructuring of banking sector was triggered by 1997-1998 crises. Banks have become stronger against shocks but slow to lend for investment. The Indonesian financial sector has an open system for foreign investors for more than 20 years. Investment insurance has not been created to protect investors from political risks. Indonesia also does not have a registration system for collateral, but the Credit Bureau has been established to facilitate the flow of information between financial institutions.

Regulatory reforms have been limited the scope. The comprehensive regulatory reviews are planned and several independent regulatory agencies have a mandate to review government regulations. Decentralization initially was complicated because of low capacity and awareness at local level and coordination between the centre and local government, but these constraints have been gradually overcome by central government, further clarifying local government authority and providing more guidance. The business sector and civil society groups have actively participated in this reform effort. Combating corruption has become the government's top priority, and Corruption Eradication Commission (CEC) formed in 2003 has actively investigated and prosecuted corrupt public officials at all levels of government. Indonesian legislation is aligned with United Nations Convention to assist in this process and cooperation with Organization for Economic Cooperation and Development (OECD) to fight against bribery. Trade policies have been liberalized unilaterally and through international agreements. The problem of corporate governance was a major contributor to Indonesia in economic collapse of 1997-1998. Indonesia has made progress by establishing a corporate governance framework, especially in 2007. The Asian economic crisis year 1997-1998 damaged the country's economic and political stability, causing many foreign investors withdraw their capital, and foreign investment was slow to return to Indonesia. Government policies to improve the investment climate, including the enactment of new Investment Law (Law No. 25 year 2007), transforms the state into a democratic and decentralized country with a more transparent government structure. This also shows how the flow of Foreign Direct Investment (FDI) has responded to policy changes over time and highlights the contribution of foreign investment to Indonesian economy.

Indonesia's economic recovery since 2000 has been relatively slow compared to other Asian countries hit by the crisis, especially in terms of FDI inflows and exports. Better macroeconomic and political stability improve the investor confidence. Annual inflows for past five years averaged USD 7 billion. During the current global financial crisis, inflows fell in each quarter year 2009 but recovered sharply in first quarter year 2010. Investors generally remained strong with historical standards for Indonesia compared to FDI in Organization for Economic countries Co-operation and Development (OECD). However, many important countries' sources of investment in Indonesia are severely affected by crisis and it needs investment promotion efforts and central deregulation to maintain inflows in near future. Quarterly figures are volatile and subject to revision, making difficult predictions, but there is no indication that current crisis has changed the perception of investment in Indonesia. Southeast Asia offers a large and dynamic market, and many producers in OECD and elsewhere have long-term interest to maintain market presence.

Political risk is the change in political environment that can have a detrimental effect on value of companies business activities (Griffin, 2015: 212). The assessment of Political Risk Map was done using the Roubini Global Economics (RGE) method (Roubini, 2014: 14). Roubini Global Economics (RGE) is an independent research company, the maker of global macroeconomic strategies developed by renowned economist Roubini. There are six measures of risk below used in RGE method.

Exchange Transfer

Risk of inability to pay hard currency as a result of applying local currency controls. The measurement factors are government exchange rate, size of capital account openness, scope of foreign exchange reserves, and various other macroeconomic measures against the vulnerability of capital outflows.

Non-Sovereign Payment

Risk of government failure or foreign entity government to pay obligations in relation with loans or other financial commitments. The measurement factors are government's ability to pay are the level of government debt and trajectory, and fiscal deficit measures, while a measure of government's willingness to pay can be seen from political risk, rule of law, and exchange rate regime.

Political Interference

The risk of host government intervention in economic or other policy that negatively affects the foreign business interests. The examples are nationalization and expropriation. The measurement factors are action with political risk, quality of government actions, business environment and regulation quality measures, and protection of property rights and corporate governance.

Supply Chain Disruption

The risk of flow disruption of goods and / or services in or out of a country as a result of political, social, economic and environmental instabilities. The measurement factors are various quality of transportation infrastructure, a combined measure of climate risk to supply chains, various measures of government's ability to respond to existing disruptions, historical upheavals that have affected supply chains, state trade as part of its Gross Domestic Product (GDP) and total world trades.

Legal and Regulatory Risk

Risk of financial or reputation loss as a result of difficulties to comply the laws and regulations of host country. The measurement factors are government effectiveness, vote size and accountability, legal rules &corruption control, quality of regulations, and various measures to protect property rights.

Political Violence

The risk of strikes, riots, civil unrest, sabotage, terrorism, crime acts, war, civil war, rebellion, revolution, hostile actions to authority, rebellion or coup. The measurement factors are political instability and violence, peace, specific violence and state actions failures.

The basic problems of international investment and political risk have different interpretations. Eaton and Gersovitz (1983: 75) considered the agreement's impropriety (explicit or implicit) as the main reason why international investors are exposed to risk of default and takeover. The new political economy approach shows the absence of a supranational enforcement mechanism that distinguishes domestic from international investment. Traditional political risk studies model show the behavior of host countries as a result of a comparison of representative agents for costs and benefits of policies. This implication clearly contradicts with the historical evidence and showing negative correlation between per capita income and measure of political risk. Therefore, it is necessary to establish a positive relationship between a country's income and cost of retaliation, both as an aggregate reduction in productivity, possibility of being limited to trading, or the assets seizure of host country.

Evidence of capital outflow from developing countries shows that political risk does not only occur from government's temptation to impose discriminatory actions to foreign investors. Conversely, actual conclusions for foreign investors can arise from possibility of being involved in national distribution conflicts to affect both the owners of domestic and foreign capital. On other hand, possibility abroad investment can disrupt political stability if the agents are pessimistic about the future tax rates and react with capital flight. The measure shows the political risk has a strong correlation with per capita income of a country. The explanation is foreign investors are disappointed, policies are considered very high in poorest countries in world, and this can explain caution of international investment towards low-income countries.

The evidence of political risk as a business contributor or investment risk is found in practice of investment insurance coverage which is extended to foreign operations by international private banks and investment insurance companies. The coverage required can be calculated by quantitative political risk analysis during the capital budgeting process. Investment insurance is used as a political risk management strategy where an unknown environment requires attention and judgment before an investment is made.

Political risk broadly presupposes the probability that a business will make smaller money, or smaller profits as a result of investors action (or) reaction of political system to events, decisions, and policies. In relation with freezing profitability by other actors than investors, private insurance companies agree on political risks insured against host government actions to include nationalization or expropriation, restrictions on remittances, denial of contracts, forced divestments or even forced neglect. Although International Law recognizes the sovereign rights of any country to take over foreign investment or private property, it can only be enforced if the action is legally compensated, non-discriminatory, taken for public purposes, taken in according to legal process, and does not violate certain contractual agreements with licensing and concession contractors (De la Torreand Neckar 1988: 221-241). Foreign investment in host country simultaneously brings the need to transfer currency in form of dividends or profits. During the economic slowdown, political risk can increase due to a need to maintain a hard currency in the country. This is the reason why political risk insurance clause needs to be included to ensure that actions of host government do not negatively affect the company's profitability.

Instability and political uncertainty are properties of political risk, where the first refers to biased uncertainties about the possibility of political events. Basically, political uncertainty is created by inadequate information, whereas political risk is rather more objective to measure the number of doubts, in contrast to traits that are more subjective to instability and uncertainty (Howell, 1985). Political instability refers to unexpected changes in leadership succession, government policy, or the exercise of government power (Kennedy, 1991).

Political instability is used as a criterion to leads to probability of political risks occurrence. Foreign investors must be advised to be vigilant when managing or avoiding operations in context of physical conflict that develops from political instability. The risk underlying political instability is political imbalance in government's limitations to generate profits. Political instability is a political risk factor that can contribute to losses incurred by foreign investment. The loss can also be caused by host government nationalization and acts of confiscation, denial of contracts in extraction industry of host country. Other political risk factors are political violence / war, and terrorism. To measure the possible threat of nationalization and seizure not only requires knowledge on host country's political structure, but the philosophy and personality of political and elite management must also be considered (Kennedy, 1991). Different cultural and political influence the ideology, even theocracy in some parts of country where foreign investment is planned to take place. As explained earlier, political risk is not only present in macro environment, but also in specific (micro) industries.

This can vary between different industries in one country, depending on nature of foreign investment and type of market entered.

A country may not want to pay a loan despite being able to do so, it leads to a problem of political risk in sense that government does not want to repay the loan, whether for ideological reasons or other reasons. A country may be willing to pay a loan, but cannot do it (Calvo and Mendoza, 1996). However, cases of low transfer risk combined with high political risk need to be carefully examined in countries identified as destinations for foreign investment. It becomes clear that problem of country risk occurs when there is damage to a country's willingness or capacity to pay debt (Calverly, 1985). The difference between desires and ability to repay is important, although it is sometimes difficult to distinguish where political risks come into play. For example, a country that is able to meet its payment obligations does not want to do based on politics, then political risk due to hostile actions is an indication of politics where further government action has a negative impact on foreign business. But it seems that country's ability to repay loans is usually associated with political will to do so. Borrower countries do not want to see the process of structural adjustment through conditionality for an increase in balance of payments. The government anticipates that social spending reduction can create civil unrest, thereby increase the level of political risk in a country. Therefore, country's risk is depending on balance of payments component of a country. The fluctuations in these components are really symptoms of policy problems that are manifested and in depth can be identified by conducting a political risk analysis, for example presenting errors or fundamental problematic tendencies in relation of political risk and country risk. Export scarcity, for example, reflects the composition of exports or dependence on a narrow range of goods and services. Export performance in turn reflects the economic structure, or the effectiveness of economic management. Capital flight and divestment are the result of more fierce problems. The concerns about the economy or the political risks posed by political events can encourage needed capital flows (Mohr, and Fourie, 1995).

A slow or inadequate government response to a problematic economy is political risk factor. This is usually due to underlying political weaknesses that have been prevented and will prevent strong politics and subsequent economic leadership. Risk is still reflected in economic progress of a country. It will also occur in small part or too late to deal with the problems, thus creating a risk for foreign investors.

Political risk analysis not only helps to describe political phenomena in Indonesia, but also tries to explain or understand occurrence of political risk. The "analysis" term shows the history, current, and future of investment, and aims to interpret something based on its effects. Analysis of investment insurance companies is a process where investment potential is measured against the background of certain factors to contribute to level of political risk in a country. In a very basic sense, investors should take political risk factors and apply them to certain countries to draw conclusions whether a country really raises the possibility of political risk for foreign investment, measuring political risk factor indicators to explain political risk situation in a particular country and politics risk assessment from certain countries. At a high level of political risk in a particular country, state can stop investors from spending any investment capital. These factors and indicators must be discussed in detail, several factors including states failure, emergencies or rebellions, or countries in transition; quality and legal culture; political instability; internal or external border disputes; military rebellion, fiscal and monetary decisions were excessively influenced by ideology, foreign policy and international relations, and leadership with succession issue. Other factors to contribute to presence of political risk are politically uneducated or unemployed workers; and even the depletion of scarce resources as an indication of a country's economic prospects.

Calverly (1985) asserts that analysis of political risk must be based on fundamentals, because without the full appreciation of politics and economic system of a particular country, the results of political risk analysis often are seen as to represent the average results of indicators used.

5. CONCLUSION

This study is devoted to explore investment (direct investment), both domestic investment and Foreign Direct Investment (FDI). Investors must examine carefully before carrying out their investment projects and understand the potential and risks that might occur, such as political risk. Therefore, investors need to analyze in advance to minimize the existing risks. Risk is uncertainty regarding profit that arises from expectations that exist in investment decisions made. Investors generally always avoid risk. The important thing to consider is political risk, because political risk can also make investors get many losses. The world economic forum has noted that political risk factors are the fourth highest risk (reaching 8.6% of 16 risks). Political risk is part of country risk, where country risk consists of political and macro-economic risks. Country risk differs from political risk in sense that country risk can be explained as a potential financial loss due to problems arising from macro economic events in a country.

RGE (Roubini Global Economics) shows six method to measures risk, including; exchange transfer, non-sovereign payment, political interference, supply chain disruption, legal and regulatory risk. Political risk presupposes the probability that a business will make less money, or suffer losses as a result of investors action (or) reaction of political system to events, decisions, and policies.

6. SUGGESTION

It needs a strong theoretical foundation and a practical approach to measure and manage political risk manifested as a foreign investment risk. Political risk analysts at investment insurance companies must also consider social reactions to government behavior and rules and ability of political system to respond and overcome the tax demands, as well as events in their domestic and international environment. Tax demands and input in this political system should be dealt with in a highly consolidated system that has experienced the persistence and evolution in political development.

In investment agreement, investors must specifically mention the clauses. These specific clauses are intended to protect investors from political risks. The government should takes steps to ensure that laws and regulations on investment and investors, including small and medium-sized companies, are clear, transparent, easily implemented and enforced and do not impose unnecessary burdens.

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