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INDONESIA

SELECTED ISSUES OF INDUSTRIAL DEVELOPMENT  
AND TRADE STRATEGY

THE MAIN REPORT

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East Asia and Pacific Regional Office

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CURRENCY EQUIVALENTS

Currency:   Rupiah (Rp)

US\$1	=	Rp 625 (November 1978)
Rp 1	=	US cents 1.6
Rp 1,000,000	=	US\$1,600

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

BAPPENAS	Government Planning Agency
BAPINDO	State-Owned Development Bank
BKPM	Badan Koordinasi Penanaman Modal (Investment Coordinating Board), also ICB
BPS	Biro Pusat Statistek (Central Bureau of Statistics), also CBS
CBS	Central Bureau of Statistics
GOI	Government of Indonesia
IDFC	Indonesian Development Finance Corporation
KIK	Kredit Investasi Kecil (Small-Scale Investment Credit Program)
KMKP	Kredit Modal Kerja Penanaman (Working Capital Credit Program)
NAFED	National Agency for Export Development
PDFCI	Private Development Finance Corporation of Indonesia
PLN	State Electricity Corporation
PMA	Penanaman Modal Asing (Foreign Investment Projects)
PMDN	Penanaman Modal Dalam Negeri (Domestic Investment Projects)

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SUMMARY AND CONCLUSIONSIntroduction

At the time of independence, Indonesia inherited a small and very underdeveloped industrial sector. After the economic disruption of the middle 1960s, the Government set out to develop the sector so as to provide increasing incomes and employment to the rapidly growing population, and to exploit and process the country's natural resources. Other elements which were included in the country's industrial development objectives were, inter alia, regional dispersion, the prevention of the creation of excess capacity, the utilization of domestic raw materials, "orderly" industrialization, and the stimulation of indigenous entrepreneurship. Apart from involving itself directly in a number of large projects, the Government attempted to realize its various objectives through the creation of incentives to the private sector, and through direct regulation of private industrial activity. As a guiding principle for its development strategy, the Government's Third Five-Year Plan adopted the Development Trilogy of equity, growth and stability.

As in many other developing countries, it has proven to be difficult to realize a complex set of social and economic objectives without the introduction of an equally complex set of public measures and regulations. Also, specific short-term policy problems have a tendency to be addressed in an ad hoc fashion and, as has happened in other developing countries, this tends, over time, to make the whole system unwieldy. Eventually, a situation may result in which the whole complex of Government interventions, through all kinds of unintended or side effects, obstructs rather than facilitates the attainment of the stated objectives. Evidence has been mounting that this has been happening in Indonesia.

This report attempts to assist the Government in addressing these issues. It analyses the policy environment within which investment decisions are made by firms in the private sector and suggests short- and long-run policies that will stimulate industrial growth. It does not deal with public sector investment decisions and planning. The specific areas covered include the incentive structure and the trade regime, the impact of the 1978 devaluation on the manufacturing sector, the regulatory climate and the system of administrative controls, the financial policy environment and policies towards private foreign investment. In all these areas, policy reforms are required to enhance the international competitiveness of the Indonesian industrial sector because the industrial incentives conflict with many of the Government's priorities and stated objectives. The policy recommendations made in this report are not commodity-specific; they are, instead, specific recommendations designed to improve the general investment climate for firms in the industrial sector. These recommendations are supported, in most cases, by empirical evidence and reflect our current knowledge and understanding of economic processes. In this summary, we review the main characteristics of the industrial sector, discuss our findings and present our main policy recommendations. The main report covers these topics more extensively and the five Annexes provide supporting detail.

### The Structure of the Manufacturing Sector

The manufacturing sector in Indonesia has, over the period 1970-78, experienced a high average annual growth rate of value-added of 12.4%. But the base is very small; the share of manufacturing in GDP at 9% is below that of the mean value of all low-income countries (13%) and considerably less than that of middle-income countries (25%). A comparison between Indonesia and other Asian nations such as Malaysia (17%), Thailand (18%), Pakistan (16%) and Sri Lanka (23%) provides further evidence of the small size of the industrial sector.

Within the industrial sector, the small and cottage firms are dominant in terms of numbers and employment; there are over one million such firms compared to 7,000 medium- and large-scale firms, and over 85% of manufacturing employment originates in these small firms. It is, however, the large and medium firms that contribute the most to manufacturing value-added - 80% of the total - and their productivity, defined as value-added per employee, is over twenty-five times that of the small and cottage firms. Employment in the large- and medium-scale firms has grown at a high average annual rate of 11.8% over the period 1970-73 and 8.6% from 1974-77, but the employment base is low; 916,000 workers were employed by these firms in 1977.

Most of the observed growth in the manufacturing sector, over the 1970-78 period, can be attributed to the Government's investments in the large-scale, capital-intensive sectors such as cement, fertilizers, steel and pulp and paper. However, the observed decline in the overall growth rate in the manufacturing sector since 1975 may indicate that the stage of early import-substitution industrialization may be over in Indonesia; this is evidenced by a decline in the growth of "early" industries such as textiles and food processing. Preliminary estimates indicate a further decline in the growth rate of real value-added in 1979 to about 9% p.a., as compared to 11.6% p.a. over the period 1976 to 1978.

Recent policy pronouncements and the stated objectives of the Third Five-Year Plan, Repelita III, are, in part, designed to reverse this trend. In particular, considerable emphasis is now being placed on the promotion of labor-intensive industries, on the expansion of manufactured exports and employment growth and on the stimulation of the private sector. However, at the same time, Repelita III also lays the basis of an ambitious program to develop a heavy industry base which will lay a large claim on public resources; one estimate indicates the total cost to be around \$20 billion over the next five years. A large allocation to capital-intensive, public sector projects, as in the past, may restrict the availability of investment funds to and thus the development of the private sector which is already constrained by the policy environment. To exploit Indonesia's comparative advantage, and especially its large supplies of cheap labor, specific policies need to be designed to develop an efficient industrial base which would include an appropriate mix of labor-intensive and capital-intensive (natural resource-based) sectors.

## The Incentive Structure and the Trade Regime

For historical reasons discussed in more detail in the main report, the incentive structure governing the behavior of private entrepreneurs in Indonesia is now very complex and uneven. The system consists of numerous price and non-price interventions that greatly influence the incentives for production and exports. While the average level of protection for all tradeable goods is relatively moderate (about 30% in 1975), there is considerable variation of protection between various industries, ranging (in 1975) from +4315% for the tire and tube industry to -35% for the batic industry. There is, however, some evidence that this large variation in protection was reduced in (pre-devaluation) 1978. The adoption of policy instruments that have resulted in these substantial differentials appears to be largely in response to ad hoc requests from private firms and manufacturers' associations. The resulting biases in the incentive structure have encouraged the development of several industries that do not have a comparative advantage. As in many other developing countries, the instruments have also resulted in an overall trade policy which is biased towards production for the domestic market and against exports; the weighted average effective protection for the import-competing sectors was 61% in 1975, while that for the exportable sectors was -6.4%.

The types of policies that have been instituted have also resulted in resources being allocated to the capital-intensive sectors and not, as intended by the Government, to the labor-intensive sectors. Thus, the highly protected, import-competing sectors such as motor vehicles use significantly more capital and skills than the least protected ones such as kretek cigarettes and sawmilling; the latter group, which are the exportable sectors, use more than double the amount of labor per unit of value-added than the former group. This bias against exports, therefore, slows their growth and that of productive employment.

The misallocation of resources resulting from the uneven nature of the incentive structure is also indicated by the dispersion across sectors of the domestic resource costs required to earn or save a unit of foreign exchange. The most highly protected sectors, as one might expect, have higher domestic resource costs and are relatively more inefficient than those with lower protection. The latter, which are essentially labor-intensive, include sectors such as wood products, sawmilling, tanneries and leather finishing, and certain classes of textiles. Because of her natural resource endowments, Indonesia also appears to have a comparative advantage in certain capital-intensive sectors such as fertilizers, petroleum products and the LPG industries. Therefore, appropriate policies for resource allocation and reduction in the import-substitution bias will channel investment resources into those sectors that will most contribute to direct and indirect employment creation and export expansion.

Apart from the incentive structure, there are many other obstacles to expanding exports. Some are related to the loading procedures at ports, and others are associated with the Government's transportation policies

that are designed to protect the ailing domestic shipping industry. These factors increase the cost of Indonesian exports and contribute further to making them internationally noncompetitive. The newly instituted export certificate scheme is one of the most innovative programs introduced by the Government to expand exports, but further improvements in its administration are possible and needed to facilitate the exports of manufactured goods.

In November 1978, the Government undertook a major policy step designed to boost exports and the production of labor-intensive industries. This was the devaluation of the rupiah by 33-1/3% and a simultaneous introduction of an export rebate scheme combined with reductions in import tariffs and sales taxes for intermediate goods. Consequently, the import-substitution bias appears to have been partially mitigated; but this may only be a short-run phenomenon as, in the post-devaluation period, effective protection appears to be increasing on an *ad hoc* basis for individual firms requesting and obtaining "temporary relief" from import competition.

Nevertheless, as a result of this change in policy, exports in 1979 increased significantly over the 1978 level for several industries such as woven cotton fabrics (684%); clothing (341%); furniture (104%) and wood products (82%). The increase in incentives to export is indicated by the substantial increases in the actual exchange rates for individual export commodities; they range from a low of Rp 633 per dollar for monosodium glutamate to a high of Rp 900 per dollar for men's jeans. However, due to continued differences between Indonesian and foreign rates of inflation and the appreciation of the dollar since November 1978, the real exchange rate and, thus, the incentives to export have not been maintained.

Most of the export growth, in the short period from 1978-79, has taken place in the labor-intensive industries; it has grown from a small base in 1978 and has been brought about, in many cases, by the presence of excess capacity and earlier decisions made to build capacity ahead of demand. Furthermore, the Government's incentive program, biased in favor of domestic sales rather than exports, is not conducive to long-run export growth. Therefore, despite the large magnitude of the devaluation, the emergence of the desired structural transformation awaits confirmation.

#### The Regulatory Environment and Administrative Controls

In addition to the system of incentives discussed above, the private sector is controlled through an extensive system of regulations which, as a whole, has a substantial disincentive effect and which restricts the expansion of industrial output. The main objectives of the regulatory system appear to include: employment creation and income distribution; the development of the indigenous entrepreneurs and the control of the non-indigenous business class; "orderly" industrialization; development of a strong industrial base; and regional dispersion.

To achieve these objectives, a wide range of licenses and permits of various kinds is used. In principle, almost all forms of manufacturing economic activity require several licenses to operate; in addition to investment licenses, firms usually also require other licenses such as trading licenses, and labor safety licenses. If firms engage in more substantial activities, then the number of additional licenses required increases significantly. Thus, the number of approvals required is substantial, and at times, difficult to arrange. Despite attempts at simplification in certain areas, the system remains unwieldy. Moreover, compliance with all requirements is generally difficult for industrial enterprises, and many firms appear to operate in breach of many requirements for much of the time. In addition, enforcement of all of the requirements, for a range of reasons, appears to be difficult.

The Investment Coordinating Board (BKPM) issues some of these licenses to certain investors and is assigned the dual responsibility of both controlling and promoting investment. Its procedures involve a detailed evaluation of investment proposals. With the exception of very large projects (natural resource-based activities) undertaken by foreign investors, the costs of such a role played by the BKPM appear to exceed the benefits. The Industrial Priority List (DSP) system of controlling capacity, and the associated complex master list system on which import tariff rebates for capital equipment and raw materials are based, are the major instruments used by the BKPM to control investments. The Priority List for 1980 has been published with proposed changes which are intended to be less restrictive. Nevertheless, this list specifies a large number of subsectors which are subject to numerous licenses and differentiated tax and investment allowances and which, in turn, are dependent on several conditions specified for each subsector. Because of the procedures and time delays involved, the need to provide detailed reports and to obtain re-approval for project modifications from the BKPM after initial licenses have been issued, many domestic investors prefer to forego the tax incentives offered by the BKPM and to establish their firms under the Company Regulations Ordinance of 1934, the BRO regulations.<sup>/1</sup> Consequently, the proposed plans of the Government to include the BRO sector under the DSP system would, therefore, not only increase the administrative burden of the Government, but would also impede the growth of the industrial sector, and result in the closing of a useful safety valve.

In general, the large number of licenses and controls required and regulations promulgated every year by various Government bodies appear to have led to confusion on part of domestic and foreign firms and to their evasion, often because of the ignorance of their existence. Part of the confusion arises from the fact that many laws and rules date from the Dutch period and

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<sup>/1</sup> Firms in the BRO sector are registered under the BRO regulations (Dutch Company Regulations Ordinance of 1934); these regulations are simpler than those which are applied to firms registered with the BKPM.

have only been partially amended and are unsuited for the present industrial structure. Furthermore, the precise legal basis of many regulations affecting industrial development is not very clear. Laws and regulations are often couched in broad terms and, frequently, in ways that are ambiguous. Consequently, the system generates considerable uncertainty and adds to the scope for personnel discretion available to officials.

In such situations, illegal payments become features of the regulatory system and such payments are often made either for the proper execution or for the adjustment of the rules. This situation is exacerbated by the relatively weak administrative infrastructure. Areas most susceptible to this form of payment are the taxation processes, when negotiations with tax assessors take place, and the customs clearance necessary for the imports of various goods; despite attempts at reform, import procedures at ports still cause considerable difficulties. Thus, the system tends to reward those who are capable of making such payments by erecting barriers for potential entrants who are not familiar with the various detailed procedures that must be followed to conduct business in Indonesia. Consequently, skills, such as dealing efficiently with the bureaucracy carry a premium, and the relatively smaller, inexperienced economically weak firms with fewer resources are, in practice, discriminated against.

This clouded legal situation combined with the existence of irregular payments seems to contribute, in great measure, to a general atmosphere of uncertainty within both the foreign and the domestic business community. This, in turn, shortens the time horizons of investors, discourages risk-taking and long-term investments and encourages the search for quick-yielding high profit activities. Additional costs which are imposed on the Indonesian economy through these regulations, include biases in favor of capital-intensive technologies, the large size of the bureaucracy required to administer the system, the resulting diversion of skilled manpower into nonproductive activities and foregone employment and output. None of these are conducive to the long-term growth of the industrial sector. In the final analysis, the regulatory environment imposes a high social cost that Indonesia can ill-afford to carry.

The difficulties associated with the regulatory system have been recognized by the Government and attempts have been made to improve the situation. In March 1979, a series of reforms were introduced to improve the administration of tax laws, and in August 1979, a special team was appointed by the Minister of Industry to investigate the problems of the licensing system. The BKPM has been turned into a "one-stop" agency and foreign advisors have been hired to improve its operations. The Government has also made several attempts to improve the customs procedures, but with limited success as this is dependent upon numerous factors. These are all steps in the right direction, but clearly much remains to be done.

### Financial Policies Affecting the Industrial Sector

The Indonesian financial sector is still in the early stages of development. It consists of a commercial banking system dominated by five state-owned banks, which are regulated by the central bank, Bank Indonesia, several private domestic and foreign banks and three development finance companies. However, the state banks account for almost 80% of the assets of all deposit money banks. They are also the major suppliers of credit to the industrial sector; their share in total outstanding credit is about 85%.

Currently the asset structure is characterized by a dearth of long-term credits; short-term credits, of maturity less than one year, account for approximately 77% of all credits to the manufacturing sector. This lack of long-term instruments has led to the roll-over of short-term credits; between 70% and 90% of all short-term credits are rolled over. Furthermore, almost 60% of all long-term manufacturing credit is allocated to large government-sponsored projects. Consequently, short-term credits have become an important source of financing investments in the private sector.

Financial policies in Indonesia have attempted to play a strong promotional role in the development of the industrial sector. The four major objectives of these policies are the use of increased resources for overall development while maintaining price stability; the allocation of credit to priority sectors including industry; the promotion of economically weak entrepreneurs; and the creation of an institutional environment to increase the range of financial services. The major instruments used by the Government to achieve these objectives have been the budget, overall credit ceilings, a mandated interest rate structure, the rediscount rate and the proportion of loans rediscounted and various regulations. The differential nature of the rediscount rate and loan proportions rediscounted demarcate special credit schemes such as the KIB, and the KIK/KMKP programs, export credits and credit Kelayakan.

The instruments used indicate that current monetary policies are characterized by a more administratively determined system than were the policies which were in effect before 1974. The post-1974 recourse to more direct controls was motivated, in part, by the price stabilization objective and partly by social and equity considerations. However, the pursuit of price stability has prompted the Government to emphasize the use of administrative policies that have ultimately resulted in a larger allocation of credit to large, state-owned, capital- and energy-intensive projects implies the neglect of the more labor-intensive, energy-conserving industries in the private sector.

The current interest rate structure also hampers efforts at resource mobilization. Over the period 1975 to 1979, the regulation of interest rates led to negative or low positive real deposit rates which has

diverted investment funds away from the formal banking sector. Furthermore, since on-lending rates for financial institutions are fixed, this mandated interest rate structure also precludes the issuance of bonds by institutions, such as BAPINDO, unless substantial subsidies are involved. This, in turn, further interferes with efforts to mobilize resources for industry and with the development of efficient financial intermediation. The subsidization of lending rates and the selective access to funds has also led to credit arbitrage and to the distortion of choices of technology against labor-intensive ones; this has a detrimental effect on employment creation and income distribution. The use of the interest rate as a viable policy instrument for resource allocation and economic efficiency has effectively been abandoned.

As a result, the financial system is heavily dependent on overall credit ceilings to control the total money supply. Although the dependence on overall credit ceilings to contain liquidity can be justified as a short-term instrument, it has deleterious effects in the long run. The combination of ceilings and mandated interest rates leads to an allocation of credit based on the preferences of the banks for primary customers; this is, in all likelihood, a suboptimal allocation of capital. Furthermore, the preferences of the Government authorities for financing state enterprises and for ear-making lines of credit to "prime" customers further distorts the credit market and prevents credit allocation according to the opportunity cost of capital.

The credit mechanism is also used as an instrument of social policy. While the support of the weaker economic group is an important objective, the choice of instruments results in high economic costs and to conflicts between economic and social policy. There is evidence indicating that credit rationing policies designed to enhance entrepreneurship among the weaker economic groups may not be completely successful in achieving their goals; the availability of cheap credit may not necessarily be the primary solution. Nevertheless, the political benefits to the Government from adopting these policies may exceed the economic costs; this is a determination that only the Government can make.

Credit policies instituted in Indonesia have, directly or indirectly, also had a detrimental effect on financial intermediation for industry and on the banking sector. The ceilings on credit and the various regulations determining the allocation of this credit have led to the current excess liquidity position of the state banks. The same regulations prevent these banks from allocating credit based on the economic viability of the project if it does not meet particular sector or economic group requirements; at the same time, financially viable projects from the economically disadvantaged entrepreneurs are scarce. As a result, the state banks often deposit their excess funds in off-shore markets such as Singapore, and some of these funds are subsequently recycled into the country through these off-shore capital markets with a higher cost and a

foreign exchange risk by non-indigenous Indonesians and joint venture firms. Consequently, the process of domestic financial intermediation is restricted and the development of the banking sector is hindered.

Effective financial intermediation for industry is further inhibited by the dominance of the state banks in the financial system and by the absence of competition faced by these banks for deposit mobilization and loans. The state banks are heavily protected through subsidies from Bank Indonesia's rediscount facilities available to them for certain types of loans, additional subsidies on their deposit rates, regulations mandating insurance companies to invest part of their funds in time-deposits with state banks, tax incentives of various sorts, and the restrictions on entry of new foreign and domestic private banks into Indonesia. As a result, these state banks tend to be relatively inefficient in their lending and resource mobilization operations. This manifests itself in poor appraisals, lengthy loan processing time caused by extensive cross-checking, and high arrears. This is compounded by the multiple objectives imposed on state banks by the Government. Since these banks are, in effect, the largest source of long-term funds in the country, their protection from competition and the resulting inefficiencies continue to retard the development of an efficient financial system in which, at the early stages, banks have a rather important role to play. Furthermore, such policies not only retard the growth of the industrial sector, but also have a detrimental effect on the development of the economically disadvantaged entrepreneurs that particularly need financial and technical support.

#### Foreign Investment in the Manufacturing Sector

Foreign investment in the manufacturing sector accounts for almost 65% of total foreign investment in Indonesia excluding investments in the petroleum, banking and insurance sectors. Japan is by far the most important source country, accounting for 35% of all approvals (1967-78), followed by the US (11%) and Hong Kong (10%). Within the manufacturing sector, textiles account for the largest share (36%), followed by metal products (18%) and chemical and rubber products (15%). But, over the period 1967-79, actual investments amounted to only 44% of approved investments. This low rate reflects, in part, the delays associated with the implementation of projects and the difficulties associated with monitoring investment flows.

Prior to 1974, the Government had adopted essentially "open-door" policies, but in the post-1974 period, these policies became increasingly restrictionist. The most important changes included increased control on foreign investment by sector and location, increased local ownership of foreign firms, requirements regarding more rapid promotion of Indonesians to managerial positions, restrictions on foreign firms engaging in distribution and marketing activities, and restrictions on the operations of foreign firms and joint ventures in the domestic market for investment credit. As

a result, realized foreign investment peaked in 1974 at a level of \$1.4 billion, and, compared to the 1970-74 period, it declined by 26% in real terms in the period 1975-79. Moreover, the size of one single project, the Asahan hydroelectric aluminum smelter, distorts the investment data significantly. The exclusion of this project shows that total approved investments dropped from about \$4 billion in the five years, 1970-74, to less than \$0.9 billion in the subsequent five years, 1975-79.

Furthermore, many Government policies that are not designed with private foreign investment and joint ventures in mind, nevertheless, have an impact on such investments. Foreign exchange policies (especially the 1978 devaluation), subsidy policies for wage goods and oil products, trade policies, and the regulatory system are examples of this. As mentioned earlier, extensive controls have tied up considerable quantities of Indonesia's most scarce resources. In fact, although it is clear that the system contains many informal safety valves whereby control and interferences can be evaded, the costs of having such a system are high in the area of foreign investment. Established foreign and joint venture firms have learned to operate very profitably within the system. Nevertheless, the disincentives associated with such a system have acted as a very serious impediment to the inflow of new private foreign investment. Many potential new entrants, encouraged by the Government's public relations abroad, are taken aback and disillusioned by the amorphous barriers erected in their paths by these regulations. It is not surprising, therefore, that most of the recorded private foreign investment since 1974 has been due to the expansion of existing firms rather than to the entry of new enterprises.

Government policies specifically designed to encourage foreign investment and joint ventures into Indonesia also appear to cause some confusion in the foreign business community. Several managers have not succeeded in their attempt to understand the Government's objectives and intentions with respect to foreign investment. Furthermore, the disincentives, in terms of the legal framework, vague tax laws, the financial and physical infrastructure, and the regulatory environment, outweigh the tax incentives afforded to these investors by the BKPM. The Government has made significant efforts to alleviate many of the problems faced by these investors. But it appears that greater emphasis on the removal of disincentives, such as those mentioned above, and less on tax incentives, combined with a clear and unambiguous articulation of Government policies would go a long way to attract foreign investment into Indonesia.

#### Policy and Recommendations and Conclusions

Clearly, the Government sees the industrial sector as an important element in the overall socio-economic development of the country; it is, therefore, attempting to encourage industrialization while at the same time influencing its pattern so as to further a complex set of development objectives. The instruments used to attain these objectives have, in general,

emphasized state intervention in the production process and have often been ad hoc and occasionally uncoordinated. This had led to a highly biased structure of industrial incentives which, however unintentional, has become inimical to the realization of some of the very objectives that the Government is attempting to realize. The same elements are also present in the regulatory environment and in the financial policy framework. What is now required is a careful review of the objectives of industrial policy and the extent to which they can be realized in practice through a policy framework that does not become so complex as to be counterproductive. This review can then lead to an articulation and implementation of a coherent policy program that safeguards the Government's main objectives of growth and equity while at the same time creating an investment climate in which Indonesian entrepreneurs are able to exploit the economic opportunities that arise.

Consequently, the Government needs to consider reshaping the regulatory environment to one that permeates certainty and inspires confidence in foreign and domestic investors. This involves a major simplification, rather than only a streamlining, of the complex licensing system and of the customs procedures at ports; this implies that "fewer" controls rather than "better" controls should be the long-run goal. Given the magnitude and the complexity of the task at hand, it is suggested that a Deregulation Commission be established to disentangle the existing procedures for issuing licenses and to undertake a long-range reform of the Investment Priority List system for allocating licenses. Other major long-run tasks that need to be addressed by the Government relate to the tax regulations and the legal infrastructure.

The positive impact of these changes is not likely to be great without simultaneous policy changes in the foreign trade sector. A major focus of the Government should, therefore, be on the long-run goal of creating a more open international trading environment. This implies a transition from the current import-substitution strategy towards eventually a neutral trade policy that gives approximately equal incentives to Indonesian manufacturers to produce for the domestic and foreign markets, and one that is based on the principle of comparative advantage as a criterion of efficient industrialization. This involves setting clearly specified time targets for replacing the existing import quotas by tariffs, reducing the variance in effective protection rates and eventually reducing the home market bias by lowering and equalizing tariffs on import substitutes with export incentives. Optimal export taxes, however, will be necessary for products, such as timber, in which Indonesia has a monopoly or quasi-monopoly power.

As in many developing countries, the provision of credit in Indonesia constrains industrial development. The financial policy framework, therefore, also needs to evolve, in a phased manner, to ensure a smooth transition from an allocation system which is administratively determined to a price determined one. This implies that inflation control should not be undertaken through exclusive reliance on credit ceilings, but rather through the budget, the reserve ratio requirement, and rediscount

rates. This will permit a more effective use of interest rates in allocating financial resources. Institutional reforms are also essential to expedite the process of financial intermediation; but administrative reforms alone, without a change in the financial policy environment will have only limited, short-run benefits.

The above reforms should aid in eliminating many of the distortions in the manufacturing sector and, thus, stimulate domestic as well as foreign investment. But specific actions regarding foreign investment also need to be considered. They include, over the long run, obtaining an agreement within the ASEAN region to moderate and create more uniformity in incentives for foreign investment, relaxation on the restrictions on new investments and on the use of foreign workers, and a reconsideration, by the Government, of current ownership regulations that appear to be ineffective in permitting Indonesians to exercise control or in developing local entrepreneurship, but, instead, deter new foreign investments away from Indonesia. The Government can also undertake joint efforts with foreign firms to develop educational and training programs to enhance the quality of labor and to facilitate the transfer of technology.

To support the weaker economic groups, the Government can provide cheap credit financed through direct subsidies to all banks rather than through the rediscount mechanism. This will require an annual allocation of a fixed quantum amount in the budget for the weaker economic group. Moreover, the KIK/KMKP credits targetted to the small entrepreneurs should also be continued. But all banks, state and private, should be encouraged to provide these credits by assuring them adequate margins through the budget subsidy. More effective support for economically disadvantaged firms may be provided by coordinating credit schemes with other programs such as the development of mini-industrial estates and industrial extension services that provide technical nonfinancial support. The Government may also consider a tax incentive scheme designed to encourage private firms to employ and provide training to the weaker economic group. A graduated tax incentive system could also be devised to encourage private firms to increase their share of indigenous management and ownership. In addition, the state banks, in concert with Regional Development Banks, should be strengthened and encouraged to provide institutional equity funds to be treated as surrogate indigenous capital with the intention that these shares could be later sold to individual indigenous Indonesian investors. Additional policies that the Government may also undertake to promote economically weak firms include the establishment of special training facilities and business schools throughout Indonesia.

All these reforms are discussed in much greater detail in Chapters 7 and 8 of the main report; Chapter 7 discusses the general framework and directions for a long-term industrial strategy in Indonesia, while Chapter 8 presents an agenda for specific and detailed policy adjustments and sequencing covering a ten-year period. These proposal for reform are made in the spirit that they present an alternative approach to attain the objectives of the Government of increasing growth and improving equity at a lower social cost than those incurred by current policies.

## 1. INTRODUCTION

1.01 Indonesia has recently entered the period of its Third Five-Year Plan, Repelita III (1979/80-1983/84). A key question currently facing Indonesian policy makers relates to the type of industrialization strategy that should be formulated in the medium and the long term./1 This is an important issue since industrialization has barely begun in Indonesia, particularly when compared to the other countries in the region and in South Asia.

1.02 Since 1970, Indonesia has experienced a relatively high growth of the manufacturing sector of 12.4% p.a. (1970-78); this is higher than that of the rest of the economy which grew at 7.8% p.a. over the same period./2 Nevertheless, the underlying base of the manufacturing sector is still very small. Currently, this sector is characterized by a trade policy biased towards the domestic market, a substantial involvement of the Government in large capital-intensive projects, relatively low efficiency and productivity of state enterprises, a private sector that is regulated and controlled and, thus, constrained from rapid expansion, excess production capacity in many sectors, and a geographical concentration of firms (and manufacturing employment) in Java, particularly in Jakarta. Furthermore, since 1974, there has been increasing concern on part of the Government to involve the weaker economic group in the development of this sector. Consequently, state intervention in the production process, in the credit market and in the direction of private domestic and foreign capital have been the major instruments used to foster both the growth of the industrial sector and of the indigenous Indonesian entrepreneurial class. These issues, therefore, suggest the need to search for an industrialization strategy designed to enlarge the existing manufacturing base by laying the foundation for efficient industrial growth and to further the objectives of the Government to promote growth with improved equity (para. 2.26)./3

1.03 The importance of developing an industrial base in Indonesia cannot be based on arguments of static efficiency; the oil sector, which is clearly dominant is, in the short-run, the most profitable. However, Indonesia cannot depend on oil forever, and the expansion of an efficient industrial sector, based on the principle of comparative advantage, can lead to

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/1 In this report, unless where explicitly noted, "industry" will refer to the manufacturing sector and will exclude oil and other extractive sectors

/2 See The World Development Report, 1980, the World Bank, August 1980.

/3 These issues were identified in Indonesia: Growth Patterns, Social Progress and Development Prospects. The World Bank, Report No. 2083-IND, February 20, 1978.

long-run benefits, and provide productive employment and increased income-earning opportunities. This structural transformation of the economy needs to be achieved as it is essential to the process of industrialization. The central feature of industrialization in most economies, is a decline in the share of value-added in primary production (agriculture and mining) and an increase in the share of industry (defined as manufacturing and construction); research in this field has shown that, in most countries, as incomes rise, the industry share tapers off at about 35% of GDP and then declines; subsequently services become more important. This process is simultaneously accompanied by a shift of labor out of primary production into industry and services./1 The beginnings of such a structural transformation are already evident in Indonesia.

1.04 Indonesia is also one of the few countries that is relatively well-endowed with both natural resources and cheap labor. This implies that Indonesia should not focus exclusively on a labor-intensive industrialization strategy. Efficient industrialization requires a judicious mix of both capital- and labor-intensive industries. The need for accelerated industrialization, therefore, suggests a careful selection, on the part of the Government, of the instruments of economic policy to formulate an appropriate trade strategy and to encourage industrial development.

1.05 In this report, it has not been possible to cover every issue because the problems of industrial development are far too complex to permit a careful analysis and treatment in one single attempt. However, those problems not discussed here will be addressed and analyzed in forthcoming special studies and reports. The focus of this report will be specifically on policies designed to foster industrial growth in the private sector; the issue dealing with public sector investment planning and decision-making is not addressed. Where appropriate, however, the report will discuss issues relating to the Government's investments in the large-scale, capital-intensive sectors. Issues specific to the small-scale industries have already been dealt with in a previous report;/2 this sector will only be discussed insofar as it is affected by the general industrial policy climate. Environmental issues are addressed only in the context of the regulatory and control system. Clearly, such issues are important, but their in-depth treatment has not been possible partly due to the mission's lack of expertise in this area.

1.06 While this report briefly reviews the performance of the industrial sector over the last 15 years and notes that impressive progress has been made, its basic focus remains on developing a forward-looking strategy for long-term industrial growth. Such an approach necessarily centers on a discussion of policy problems and constraints facing the sector today.

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/1 See H.B. Chenery and M. Syrquin (1975). Patterns of Development, 1950-1970, Oxford University Press, New York.

/2 Indonesia: Cottage and Small Industry in the National Economy, Report No. 2490-IND, The World Bank, November 9, 1979.

Inevitably, this type of a discussion will be viewed by some readers as focusing too much on the difficulties facing the sector and not being fully appreciative of the complex choices confronting the policy-makers involved. Recognizing this, it is necessary to re-emphasize that major strides have indeed been made in the industrial sector. However, at the same time, it is important to note that the critical challenge now facing policy-makers is to develop an appropriate policy environment to deal with existing constraints and thereby provide the basis for a dramatic expansion in the role and size of the industrial sector. The analysis presented in this report is based on specific empirical findings; its focus is on the medium- and long-run policy goals. Concern with immediate problems and short-run solutions is necessary, but it is not sufficient. The policy prescriptions, however, will provide, where possible, the specific short-run steps that will facilitate the transition process to achieve the medium- and long-run objectives. The specific recommendations made are designed to improve the overall investment climate; they are, therefore, not commodity-specific. The analysis and the resulting recommendations reflect our current knowledge and understanding of economic processes. Consequently, the recommendations made include numerous practical suggestions for improvements within the existing policy framework.

1.07 This report is divided into eight chapters. Chapter 2 summarizes the pattern of recent industrial development. It provides basic information on the structure of the manufacturing sector, including employment, value added, geographical distribution and exports, and reviews the Government's plans and recent policies. This is followed, in Chapter 3, by an analysis of the existing incentive system and its implications for labor-intensive industries and manufactured exports. This chapter also discusses the impact on the manufacturing sector of the recent devaluation (November 15, 1978) and of the economic policies that were either instituted simultaneously or shortly thereafter. A discussion of the regulatory environment as it affects the investment decisions of the private sector is presented in Chapter 4. Chapter 5 analyses the Government's financial policies and their implication for industrial growth, while Chapter 6 highlights the role of foreign investment in the manufacturing sector. Chapters 3 to 6, therefore, provide an analysis of recent important Government actions that have influenced industrial growth in Indonesia. The relevant policy implications are discussed in the final two chapters. Chapter 7 presents a framework which forms the basis of and provides a general direction for a long-term industrial strategy in Indonesia, while Chapter 8 discusses an agenda for specific policy reforms, covering a ten-year period, designed to achieve the long-range goals. Moreover, most of the specific recommendations made in Chapter 8 can be accepted or rejected without requiring fundamental decisions on policy direction. The detailed, technical analyses are excluded from the main body of this report, but are presented in self-contained annexes for those wishing to delve deeper into the issues discussed in the main report.

## 2. THE PATTERN OF INDUSTRIAL DEVELOPMENT

### Introduction

2.01 The focus of this report is on economic policies designed to foster industrial growth and to transform the current structure of employment and production in the industrial sector. To place this analysis into proper perspective, this chapter provides an overview of the structural transformation, the current status and the characteristics of the Indonesian industrial sector. It also briefly reviews the evolution of industrial policy objectives and the plans of the Government.

### An Overview

2.02 Indonesia is currently in the early stages of a structural transformation as shown by the share of industrial production in the economy; this is an important indicator of the transformation process (Table 2.1). Despite the high growth rate of manufacturing of 12.4% p.a., over the period 1970-78, the share of manufacturing in GDP (in 1978) at 9%, in nominal terms, is below that of the mean value of all low-income countries (13%), and considerably less than that of the middle-income (25%) and industrialized countries (27%).<sup>/1</sup> This is indicative of the small base of the manufacturing sector in Indonesia.

2.03 Furthermore, compared to most other Asian nations, industry is considerably less important in Indonesia. For example, in 1978, the share of manufacturing in GDP in Malaysia was 17%; in Philippines 25%; in Thailand 18%; in India 17%; in Pakistan 16%; and in Sri Lanka it was 23%. An indicator of the absolute size of this sector is given by value-added in manufacturing. In Indonesia, this amounted to \$1.67 billion in 1978 compared to \$8.97 billion in India, \$3.93 billion in the Republic of Korea and \$2.33 billion in the Philippines. The population of a country such as India, however, may distort these figures. But adjustments for population show that in per capita terms, value-added in manufacturing in Indonesia is one of the lowest in Asia at \$12.4. Figures 2.1 and 2.2 present a graphical comparison of selected countries.<sup>/2</sup>

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<sup>/1</sup> In the World Development Report, 1980, Indonesia, with a per capital GNP of \$360, is classified as a low-income country; all countries with GNP per capita up to \$360 are classified as low-income; the next group up to \$4,120 are classified as middle-income and the remainder, up to \$12,100, are the industrialized countries. These classifications exclude the capital surplus oil exporters and the centrally planned economies.

<sup>/2</sup> See Annex 1, Table 1 for more details.

Table 2.1: THE STRUCTURE AND GROWTH OF PRODUCTION 1960-78  
(percentage)

	Distribution of Gross Domestic Product (at current prices)							
	Agriculture		Industry		Manufacturing /a		Services	
	1960	1978	1960	1978	1960	1978	1960	1978
Indonesia /b	54	31	14	33	8	9	32	36
Low Income Countries	50	38	17	24	11	13	33	38
Middle Income Countries	22	16	31	34	22	25	47	50
Industralized Countries	6	4	40	37	30	27	54	59

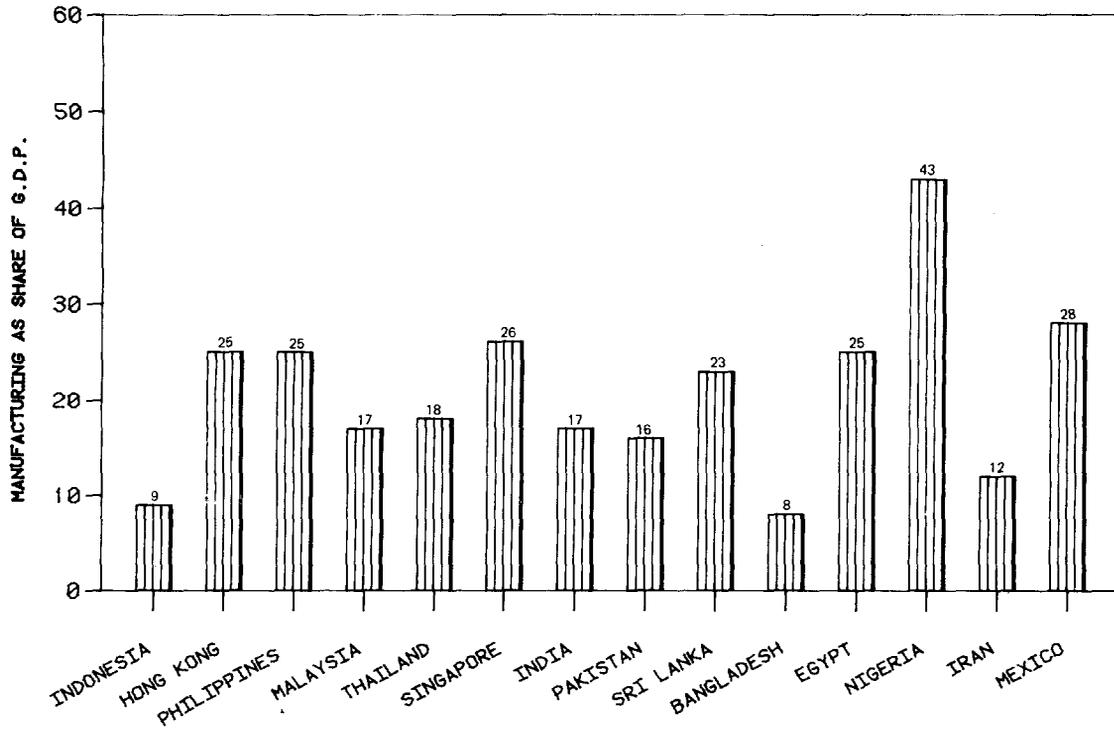
	Average Annual Growth Rate, 1960-78 (at constant prices)							
	Agriculture		Industry		Manufacturing /a		Services	
	1960-70	1970-78	1960-70	1970-78	1960-70	1970-78	1960-70	1970-78
Indonesia /b	2.5	4.0	5.0	11.2	3.3	12.4	8.0	8.7
Low Income Countries	2.5	2.0	6.1	4.5	6.6	4.2	4.4	4.3
Middle Income Countries	3.4	3.1	7.8	7.1	7.6	6.8	5.7	5.8
Industralized Countries	1.2	1.0	6.1	3.4	6.2	3.3	4.8	3.7

/a Manufacturing is a part of the industrial sector. The industrial sector in this table comprises mining, manufacturing, construction and electricity, water and gas.

/b Indonesia, at a per capita GNP of \$360 is classified as a low income country in the World Development Report, 1980.

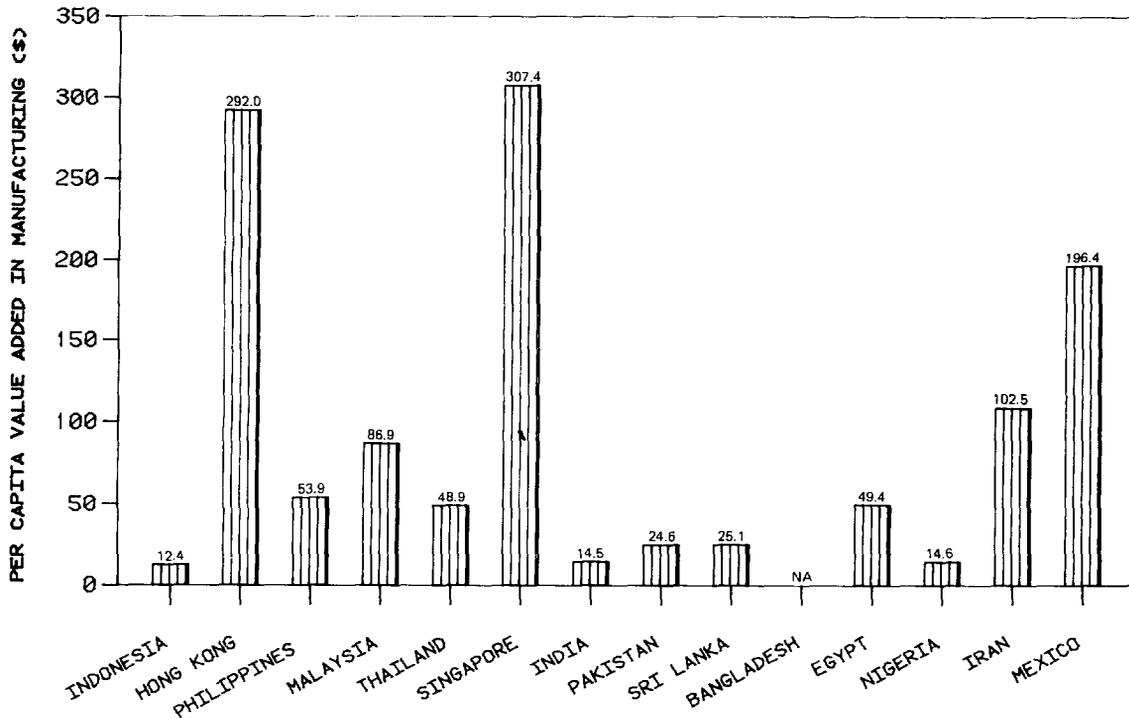
Source: World Development Report, 1980.

FIGURE 2.1 SHARE OF MANUFACTURING IN GDP:  
AN INTERNATIONAL COMPARISON; 1978



SOURCE: ANNEX I, TABLE I

FIGURE 2.2 PER CAPITA VALUE-ADDED IN MANUFACTURING:  
AN INTERNATIONAL COMPARISON; 1978



SOURCE: ANNEX I, TABLE I

2.04 Cross-country comparisons, however, must be interpreted with caution as the choice of policies and social objectives may differ across countries, as do their natural resource endowments, population and access to external capital. Nevertheless, countries with similar population and income levels show similar underlying trends in the development process and in the transformation of the industrial structure. An analysis of these patterns reveals "average" or "normal" growth paths for countries in the process of development. Such patterns provide a useful point of comparison for exploring the experience of individual countries./1

2.05 Figure 2.3 compares the actual structure of the Indonesian manufacturing sector with that of a typical country with Indonesia's population and per capita income level. As can be seen, the relative size of the Indonesian manufacturing sector is about half the "average" pattern. Value-added in manufacturing activities in Indonesia accounts for 9.3% of the GDP (1978) compared to an "average" level of 17.3% for a "similar" country; but for several sectors such as food, beverages and tobacco, leather and leather products, wood and wood products and rubber products, the actual share of value-added in total manufacturing for Indonesia exceeds the "average" level. The reverse, however, is true for other sectors such as textiles, clothing and basic metals./2

2.06 Over the period 1970-78, real output in Indonesia grew at 12.4% per year in the large- and medium-scale manufacturing firms,/3 while employment grew at an average annual rate of 11.8% over the period 1970-73 and 8.6% from 1974-77. In 1977, about 916,000 workers were employed in these firms, and this amounted to about 1.7% of the total labor force./4

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/1 For details, see H.B. Chenery (1980). Structural Change and Development Policy, Oxford University Press, New York; and H.B. Chenery and M. Syrquin, op. cit.

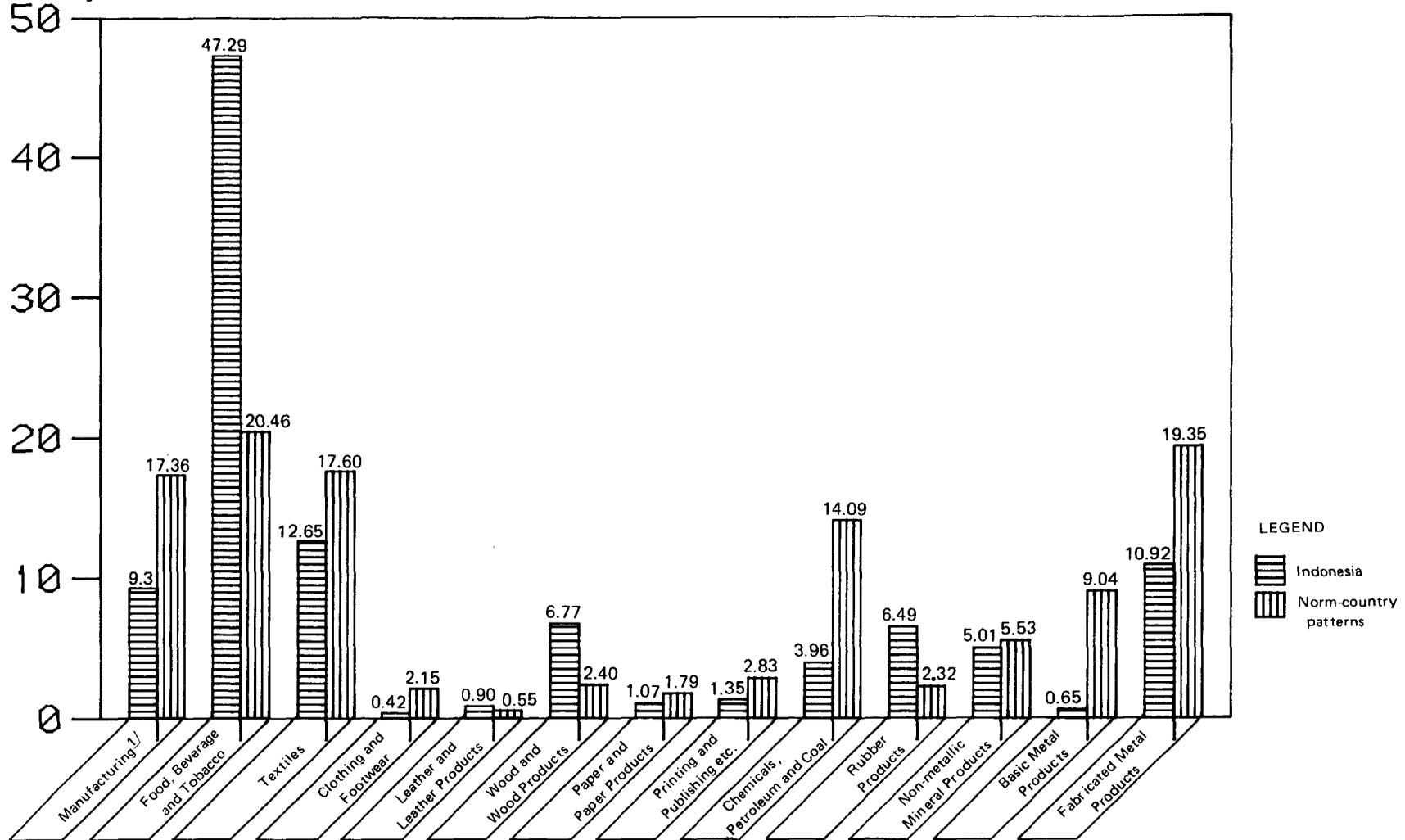
/2 Sectoral share data for 1978 are not available; the sectoral data presented in Figure 2.2 are for 1974/75.

/3 The definitions for large, medium and small firms are provided in the appendix to Annex 1.

/4 Current estimates indicate the size of the total Indonesian labor force to be about 54.3 million. There is some disagreement in academic circles regarding the growth of employment in the large- and medium-scale manufacturing sector and the consequent implications of employment growth in the small-scale and cottage sectors. The interested reader is referred to the references in Annex 1, Appendix para. 3. Also, for detailed annual, sectoral and regional employment data, See Annex 1 Tables 8 to 15. For a discussion of the quality of the data and data sources, see the appendix in Annex 1.

Share of Value-Added in Total Manufacturing

FIGURE 2.3 ACTUAL AND "AVERAGE" STRUCTURE OF THE INDUSTRIAL SECTOR



LEGEND  
 Indonesia  
 Norm-country patterns

1/ Manufacturing value added as a share of GDP in 1978. The sectoral specific shares are based on the Industrial Census of 1974/1975.

Source: V. Prakash: Intercountry Comparison of the Structure of the Indonesian Sector, April 4, 1979 (mimeo)

Three sectors - food, tobacco and textiles - accounted for about 65% of the total manufacturing employment. But three other sectors - wearing apparel, wood products and electrical goods - experienced average annual employment growth of over 20% over the period 1974-77.

#### Recent Growth in the Industrial Sector

2.07 Before the mid-1960s, the overall economic and political climate in Indonesia was highly uncertain and the industrial sector stagnated. In 1966, the new government introduced sweeping reforms in economic policy including changes in industrial policy which were a marked change over the situation which had prevailed in the latter years of the Sukarno Government's period in office.<sup>/1</sup> The general thrust of policy under the new government was to implement effective macroeconomic stabilization measures and decontrol the economy, but there were three particular aspects of policy that substantially improved the climate for industrial growth in the modern sector: the foreign trade regime was liberalized; preferential treatment of state enterprises was somewhat reduced and it became official policy to encourage the private sector; and new foreign and domestic investment laws were introduced in 1967 and 1968 respectively which were designed to stimulate investment in the private sector.<sup>/2</sup>

2.08 Largely as a consequence of these policies, broadly based industrial growth began for the first time since Independence. During 1966 and 1967, industrial output stagnated as a result of restrictive fiscal and monetary policies introduced by the Government to curb inflation; but in 1968 and 1969 sharp increases in output occurred in most of the important industries in the modern sector, and relatively rapid growth continued into the 1970s. Thus, the manufacturing sector which grew at only 1.9% p.a. in the period 1953-59, and 2.1% p.a. in the period 1960-65, increased to 8.2% p.a. between 1965-71 and accelerated to 13.7% p.a. between 1971-76, but then declined to 11.6% p.a. from 1976-78. Over the period 1973/74 to 1978/79, highest average annual growth rates were experienced by urea fertilizers

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<sup>/1</sup> A survey of the problems of the manufacturing sector in the 1950s and 1960s is in A.R. Soehoed, "Manufacturing in Indonesia", Bulletin of Indonesian Economic Studies, No. 8, October 1967. A survey of developments in the early 1970s is contained in Juergen B. Donges, and Bernd Stecher and Frank Wolter, Industrial Development Policies for Indonesia, Tubingen, J.C.B. Mohr (Paul Siebeck), 1974.

<sup>/2</sup> Chapter 3 analyzes the current trade regime and Chapter 6 discusses the policies towards foreign investment.

(65.4%), TV sets (54.2%), car batteries (41.7%) and cement (34.8%). Lower growth rates were experienced by other industries such as ammonium sulphate fertilizer (-1.1%), white cigarettes (3.5%), and radios (4.6%) over the same time period. As a result of the growth in the modern manufacturing sector, the share of manufacturing in GDP (in constant prices) rose from about 9% to 12% between 1970 and 1978 despite the impact of the oil boom which led, inter alia, to a sharp drop in the share of the GDP originating from agriculture; viz., from 47% in 1970 to 34% in 1978.

2.09 In retrospect, it appears that the period between about 1967 and 1975 provided especially favorable conditions for industrial development in Indonesia. One reason for this was that in the late 1960s there were shortages of many industrial products, and in the face of this large potential demand, domestic producers faced a sellers' market. Second, because of the under-utilization of capacity that existed in 1966 and 1967, there were few capacity constraints to hold back rapid increases in output. Third, the new laws relating to foreign and domestic investment encouraged an investment boom, especially in the extractive sectors of the economy, and the manufacturing sector benefitted from stimulus to activity.

2.10 Since 1975, there have been indications that industrial growth in some parts of the modern sector has slowed. The rate of growth of output in the textile industry has fallen from around 20% p.a. in the late 1960s and early 1970s to an average of 8.6% in the five years to 1978/79. Similar declines in growth rates have been observed in the manufacture of radios, paper, glass bottles and car tires. Furthermore, there have been many reports of excess capacity in a number of industries (automobile assembly, electronics, and concrete reinforcing bars); and, as mentioned before, the real rate of growth of the manufacturing sector, as recorded in national income statistics, has fallen somewhat since the mid-1970s from 13.7% p.a. (from 1971-76) to 11.6% p.a. (from 1976-78). Furthermore, though national income figures for 1979 were not available at the time the mission visited Jakarta, preliminary estimates suggest a sharp fall in the real rate of growth of the manufacturing sector during 1979 to around 9% for the year.

2.11 The problems that manufacturers have been facing naturally vary from sector to sector, but there appear to be a number of factors which account for the slowdown since 1975. One is the difficulties that the state-owned oil company Pertamina ran into in late 1974; many domestic entrepreneurs had come to depend, directly or indirectly, on orders and supplies of credit from Pertamina during the early 1970s, and the effects of the abrupt cessation of much of the domestic activity of the corporation

was substantial.<sup>/1</sup> Another is competition from imports because, despite high rates of domestic inflation in Indonesia after 1973, the exchange rate was held constant between 1971 and November 1978. Increasingly, Indonesian manufacturers producing tradeable goods found it difficult to compete with imported goods and pressed for increased protection through higher tariffs and outright bans on imports.<sup>/2</sup>

2.12 The basic difficulty that Indonesian non-oil tradable goods industries (including many manufacturing industries) are now facing is that the emergence of one particular strong export sector (oil) has changed the comparative advantage of the economy. The result of the strength in the balance of payments is that there is an upward pressure on the exchange rate, leading to an appreciation of the real exchange rate (trade weighted rate adjusted for relative inflation rates), which, in turn, makes it difficult for non-oil tradable goods industries to compete. Third, in some industries such as textiles, electronics and motor vehicles, the "easy" phase of import substitution may have already come to an end.

2.13 Nevertheless, in spite of these problems, by international standards manufacturing growth in Indonesia since the mid 1970s has held up well. In the five years 1971-76, real industrial output, as recorded in constant price GPD estimates, grew by 13.7% p.a. and continued to grow at a lower, but nevertheless a quite rapid annual rate of 11.6% between 1974 and 1977. The reason for the apparent paradox of continuing overall growth despite the problems that have been reported from some sectors appears to be that especially rapid growth has occurred in several industries. On the one hand, industries such as malt liquors, cigarettes (both kretek and white), textiles (spinning, weaving, batik and knitting), footwear and motor vehicle and motor cycle assembly did not fare especially well between 1975 and 1979, and were particularly affected by the large devaluation in November 1978. In these sectors, rapid import substitution took place in the early 1970s, and the scope for further import substitution is probably now quite limited.

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<sup>/1</sup> At the time, reports of the difficulties that domestic firms were running into because of the disappearance of Pertamina contracts were common.

<sup>/2</sup> For example, on January 1, 1977 the Government introduced a range of restrictive measures on trade which, according to one minister, would make it "almost impossible for businessmen" to import certain goods. The Government promised that further restrictive measures would be forthcoming if necessary to ensure protection for home industries. This issue is discussed in greater detail in Annex 2.

On the other hand, the Government's policies designed to encourage foreign investors in the timber industry to establish domestic sawmilling and plywood capacity induced fast growth (from a low base) in this activity, and the Government's large investments in fertilizers, cement and steel led to rapid increases in production of these commodities. Indeed, until recently, in the fertilizer and cement industries there has been temporary excess capacity over the requirements of the domestic market, and some exports have been made to neighboring Asian countries. Current indications are that domestic demand has increased to a sufficient level to necessitate imports of cement and fertilizers.

2.14 An important feature of the manufacturing sector is the low share of manufactured exports as a proportion of total exports. In 1977, this amounted to only 2%. Fuel, minerals and metals constituted 71% and other primary commodities the rest, 27% of total exports. Compared to other countries in Asia, Indonesia's share of manufactured exports is very low. For example, the corresponding share in 1977 for Sri Lanka was 12%, Malaysia 17%, Thailand 19%, Egypt 25%, India 56%, and Pakistan 59%. The Government has recently undertaken measures to expand manufactured exports. In the wake of a series of steps such as encouragement to large state enterprises (e.g. cement and fertilizer) to export, and increased activity on part of the National Agency for Export Development (NAFED) and stimulated by the large (33-1/3%) devaluation in November 1978, manufactured exports rose markedly in 1979./1

#### The Structural Characteristics

2.15 The structural characteristics of the manufacturing sector in Indonesia are consistent with the patterns which have been observed in many other countries. Typically, food processing is an important subsector in the early stages of development, but becomes less significant as incomes rise. On the other hand, sectors such as chemical products are typically "middle" stage sectors, while those such as metal products are the "late" sectors. Such a structural transformation is very noticeable in Indonesia. In 1974, the manufacturing sector was dominated by nondurable consumer goods; for example, food processing, tobacco and textiles together accounted for 56% of the output, 65% of value-added and 68% of total manufacturing employment. The intermediate and capital goods industries, however, were still in the infant stages; about 78% of the firms in the basic metals sector were established only recently - between 1970 and 1978 - while almost 67% of the firms in the food, beverage and tobacco sectors and 66% of the textile firms were established prior to 1969. The subsequent decline in 1977 in the share of value-added and employment in the food, tobacco and textiles sectors to 56% and 65% respectively, and the corresponding increases

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/1 See Chapter 3 and Annex 2 for details.

in the chemicals, nonmetals and fabricated metals sector testifies to the on-going transformation of the production structure./1

2.16 Within the industrial sector, the small and cottage firms are dominant, both in terms of numbers and in terms of employment. In 1974/75 there were over one million such firms compared to about 7,000 medium- and large-scale firms and about 87% of manufacturing employment originated in these small firms. It is, however, the large and medium firms that contribute to manufacturing value-added - 80% of the total - and their productivity is over twenty-five times that of the small and cottage firms; value added per worker, in 1974/75, in the large and medium firms was Rp 721,000 compared to Rp 28,100 for the small-scale and cottage sector.

2.17 The primary constraints on the growth and productivity of the small-scale sector that are determined by supply are poor management, inefficient production techniques, poor quality control and design, lack of market information and limited access to credit. Demand factors affecting the output of small-scale industries may also be important determinants of the growth of these industries. cursory evidence indicates that small-scale industries in Indonesia may be caught in a squeeze between a rapidly growing labor supply and a relatively stagnant market for their output. This implies, *inter alia*, the need to increase the rural purchasing power through appropriate investment and pricing policies in the agricultural sector. Moreover, the system of Government incentives and technical support has generally been oriented to the needs of the medium and large firms. At the same time, many small firms are not aware of those incentives that are available to them./2

2.18 Within the large and medium-scale sector, private domestic firms (in 1974/75) contributed about 59% of output, 54% of value-added and 70% of employment (Table 2.2). This dominance arises from the fact that, at that time, almost 88% of all firms in Indonesia were in the domestic private

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/1 See Annex 1 Table 7, 8, 23 and 24 for details.

/2 For a further discussion of the problems of small-scale industries see Indonesia: Cottage and Small Industry in the National Economy, (1979), Report No. 2490-IND, The World Bank, Washington, D.C.; P. McCawley (1978), Industrialization in Indonesia: Developments and Prospects, Occasional Paper No. 13, The Australian National University, Canberra; and D. Snodgrass (1978), "Small-Scale Manufacturing Industries: Patterns, Trends and Possible Policies," Discussion Paper No. 54, Harvard Institute of International Development, Cambridge, Mass.

sector. Given the increasing role of the Government since 1974/75, it seems likely that the relative share of the state enterprises in output and value-added has increased substantially. Furthermore, the average size of the domestic private firms is small relative to government and foreign firms. The state-owned firms tend to be the largest - almost 3-1/2 times the size of private domestic firms (Table 2.2) - and are also the oldest; nearly 30% of wholly state-owned firms were established before 1940 compared to 5% of the domestic private sector firms and 7% for the manufacturing sector as a whole. The passage of the 1967 foreign investment law led to a remarkable increase in foreign joint-venture firms with domestic partners; 70% of such firms were formed in the period 1970-74./1

Table 2.2: THE OWNERSHIP STRUCTURE - 1974/75

	Domestic private	Government	Foreign
Number of firms (%)	87.7	8.1	4.2
Output (%)	59.3	19.5	21.2
Value-added (%)	54.2	22.8	23.0
Employment (%)	69.8	19.8	10.4
Size (employees/firm)	80	276	175
Productivity /a	0.63	0.93	1.79
Energy intensity /b	0.11	0.25	0.22
Capital intensity /c	9.70	14.16	16.35
Skill intensity /d	0.18	0.33	0.34
Capacity utilization /e	0.27	0.36	0.33

/a Productivity is defined as value-added in Rp millions per employee.

/b The proxy for energy intensity is the rupiah value of total energy input per man-day.

/c The proxy for capital intensity is Kwh per man-day.

/d The proxy for skill intensity is the ratio of nonproduction workers to production workers.

/e The proxy for capacity utilization is the proportion of the time production workers are employed in the plant.

Source: Annex 1, Table 18

/1 For a discussion of the legal status of firms and the age profile of firms by ownership see Annex 1.

2.19 State-owned firms, however, are not the most productive in terms of value-added per employee; foreign firms are about twice as productive as government firms and about three times as productive as domestic private firms (Table 2.2). There are some indications also that state-owned enterprises are not very efficient and have suffered financial losses; a parliamentary report in February 1980 reported that a number of industrial enterprises had turned in disappointing results in 1975, 1976 and 1977. In 1977, the combined losses of three particular firms (P.T. Petrokimia Gresik, P.T. Krakatau Steel, and P.T. Dayaza) were Rp 111.7 billion (\$269 million). The overall results for the state enterprises grouped under the authority of the Department of Industry for 1975, 1976 and 1977 were a profit of Rp 44.7 billion (\$108 million), a profit of Rp 11.6 billion (\$28 million), and a loss of Rp 87.0 billion (\$210 million) respectively./1

2.20 State-owned firms, however, tend to be the most capital-, energy- and skill-intensive, while the domestic private firms rank the lowest in these measures of intensity (Table 2.2). This is not surprising since state-owned firms tend to dominate the large-scale, capital-intensive sectors such as cement, pulp and paper, and chemicals, whereas the domestic private sector dominates the textiles, tobacco and wood products sectors. It should, however, be noted that in most sectors, all forms of ownership exist; it is only the relative distribution that varies./2

2.21 At the beginning of the 1970s, the regional distribution of manufacturing industry in Indonesia largely reflected the pattern of industrial development during the colonial era. As of 1974/75, about 85% of total manufacturing employment and of all large and medium firms were located in Java. The reasons for this distributional pattern which are much the same as in many other countries are: access to senior government officials, the location of financial institutions, superior infrastructural facilities, and the large population of Java. Even after adjustments for population are made, Java at 7.4 manufacturing employees per thousand of population remains the most industrialized, followed by Kalimantan (2.7), Sumatra (2.4) and then Sulawesi (0.97) (Table 2.3). In Java, half of those employed are in the five main industries which had been important before Independence. Three of these industries - tea processing, sugar refining

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/1 Commenting on this performance, the Minister for Industry said that the majority of factors causing the losses were outside the control of the management of the enterprises, and cited such problems as the history of the enterprises, the capital structure of the firms, and the fact that some of them are expected to play a role as price stabilizers in the markets for certain goods. See Kompas, February 25, 1980.

/2 See Annex 1 Table 16 for details.

and rubber remilling - are natural resource-based and their location was largely determined by the proximity of the agricultural plantations; the location of the other two - weaving and kretek - seems to be a result of historical accident./1

Table 2.3: THE GEOGRAPHICAL DISTRIBUTION OF INDUSTRY - 1974/75

Area	Firms % of total	Employees % of total	Average size (employees per firm)	Manufacturing employees per thousand population
Sumatra	8.1	8.0	100	2.42
Java	84.8	86.7	103	7.36
Jakarta (DKI)	12.6	12.9	103	16.20
West Java	23.0	17.1	75	5.16
Central Java	22.8	22.2	99	6.62
Yogyakarta	2.2	2.1	94	5.41
East Java	24.2	32.3	135	8.24
Kalimantan	2.3	2.2	96	2.74
Sulawesi	2.4	1.3	54	0.97
Others	2.4	1.8	75	1.31
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>101</u> /a	<u>5.37</u> /a

/a All Indonesia average.

Source: Annex 1, Tables 9 and 11.

2.22 One important objective of industrial policy in the early 1970s was to alter this regional concentration, both by providing tax and investment incentives to invest in the Outer Islands, and by encouraging new industries to locate in rural areas. Under the Foreign and Domestic Investment Laws (1967 and 1968, respectively), special incentives were provided to manufacturers to establish new factories outside Java, and various concessions continue to be granted under the most recent (1980) Investment Priority List. In practice, however, it is difficult to discern any significant change in the regional distribution of manufacturing industry in recent years; current data from the Investment Coordinating Board shows that throughout the period since the new Investment Laws came into effect, about 70% of approved projects have been for planned investment in Java.

/1 For the geographical distribution of sectors see Annex 1.

Government Objectives and Policies for Industrial Development

2.23 In the pre-Soeharto era, Government policies in the industrial sector were strongly interventionist and inward-looking. Shortly after coming to office in 1966, the new Soeharto government emphasized, in its initial economic policies, a liberalization of the foreign trade regime, the need for state enterprises (including state industrial enterprises) to operate without the large subsidies provided in the early 1960s, and the importance of the private sector. By 1969, however, the Government reverted to the more traditional interventionist policies which then continued throughout the 1970s. Since 1969, industrial objectives and policy in Indonesia have been defined in the various Five-Year Plans of the Government starting with Repelita I (1969/70-1973/74) which identified selected industrial sectors for special support; the most important of these were several basic industries (fertilizer, cement and chemicals), textiles, and pulp and paper. At this time, small and cottage industry was given relatively low priority.

2.24 During the Repelita I plan period, industrial development priorities, as reflected in official statements, underwent a shift in emphasis. Throughout the early 1970s, there was increasing discussion about the problems of small and cottage industries, and several policy measures were announced to assist these firms.<sup>/1</sup> In January 1974, higher priority was given to such issues as unemployment and the role of foreigners. Subsequently, a range of more inward-looking policies was announced, including more restrictions on the imports of manufactured goods designed to protect domestic industries, more stringent rules governing foreign investment, and steps designed to favor the economically weak entrepreneurs.

2.25 The industrial objectives stated in Repelita II (1974/75-1978/79) were almost identical to those mentioned in Repelita I. The main difference was a reordering of priorities; in Repelita II employment creation was raised to first place. During this plan period, a combination of industrial policies became discernible. On the one hand, the trend towards inward-looking policies became stronger as the Government imposed even more restrictions on manufactured imports, there was increasing state intervention in the credit market, and new regulations were imposed to direct domestic and foreign investment. On the other hand, the Government underscored the desirability of promoting manufactured exports and continued to emphasize that, as a general rule, foreign capital was welcome in Indonesia. Thus, in some respects, industrial policy seemed to be becoming more interventionist at the end of the decade, while in others, there were new elements of an outward-looking policy.

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<sup>/1</sup> Two government institutions - P.T. Bahana and P.T. Askrindo - which were intended to provide financial support for small firms were established in 1973, and the BIPIK small-scale industry promotion scheme was developed in 1973 and 1974.

2.26 This is the background against which the industrial policy objectives set out in the Repelita III (1979/80-1983/84) document need to be considered. The objectives, although not explicitly listed, are much wider than the objectives set out in the earlier two plans. As a guiding principle for Indonesia's development strategy, the Third Five-Year plan adopts the Development Trilogy of equity, growth and stability./1 A survey of recent policy pronouncements and decisions suggests that out of all the stated objectives, five have tended to be of paramount importance since the 1978 devaluation; viz., the protection of the economically weak entrepreneurs; the promotion of "orderly" industrial development; the generation of employment opportunities; the development of a broad industrial base at home; and the promotion of labor-intensive, manufactured exports. For the last objective, Repelita III requires the expansion of the private sector; the Government has taken the view that the attainment of the last objective will contribute to income and employment growth, particularly in the period after growth in the oil sector has slowed down. There is, however, no recognition of the need for Indonesian industry to operate more efficiently, nor of the relationship between industrial policies and the overall economic climate within which the desired objectives could be achieved.

2.27 To attain the stated objectives, a wide range of industrial policy tools is used. These tools are manipulated by authorities at the national and the regional level./2 The major policy tools include industrial

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/1 A close reading of the chapter on industry in the plan document indicates that at least ten goals are mentioned: (a) expansion of employment opportunities; (b) production of low-priced mass-consumption goods; (c) reduction of dependence on imports, and the guarantee of supply of goods to the domestic market; (d) promotion of exports; (e) regional dispersion; (f) protection of the "weaker economic group" (golongan ekonomi lemah) and promotion of entrepreneurship; (g) economic growth; (h) restriction of the consumption of luxury goods; (i) support for other sectors of the economy, both through (i) the production of inputs for other sectors such as agriculture (fertilizer, insecticides), and (ii) processing of output so that semiprocessed goods are produced rather than unprocessed goods (sawn timber, furniture); and (j) conservation of the environment and nonrenewable natural resources, especially energy resources.

/2 Quite a few of the measures, said to be intended to promote industry, currently appear to be ineffective. Such measures include, as an example, rural electrification programs; although rural electrification is said to be intended to encourage small-scale industry in rural areas, there is no evidence that the provision of electricity to villages has had this effect. Surveys of electricity use in rural areas indicate that nearly all electricity is used for lighting. This situation may change, but for the time being, rural electrification is not an effective tool of industrial policy.

licensing, controls over the allocation of credit, protection against import competition, domestic procurement policy, and direct Government investment in industry. Besides these instruments, the Government is also actively involved in providing export incentives and assistance, promoting small-scale industry and establishing industrial estates including "mini estates."/1

2.28 Other steps taken to encourage industrial development include support for various industrial design and technology centers, the establishment of national standards for an increasing number of industrial products,/2 attempts to simplify licensing and other bureaucratic procedures, introduction of a "reservation" scheme similar to schemes in India which reserve the production of specified commodities for small firms,/3 and the recognition and support of a large number of producer organizations with branches at both the national and the regional level.

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/1 The best known small-scale industry promotion scheme is BIPIK, a program run through the Department of Industry, which provides advice to small firms on a range of technical and managerial matters. In addition, recently, there has been increasing attention shown to the possibility of expanding the system of bapak angkat firms (foster father firms) which help channel raw materials to smaller firms and assist them with the marketing of their output; bapak angkat firms are seen, to some extent, as playing a similar role to trading houses. The bapak angkat system has been initiated with the support of the Department of Industry. Other methods of channelling inputs to small firms which might be tried include setting up service centers for small firms and establishing "mini industrial estates." Several industrial estates have also been opened, the oldest of them being Pulo Gadung to the east of Jakarta. For small-scale industry, there are plans to open a number of "mini-industrial estates" of about 7 to 10 hectares each; initial plans are to establish one estate in Medan, one in Jakarta and one in Surabaya, while two mini-estates are planned for Yogyakarta.

/2 It is expected that at least 500 industrial standards will be set by the Department of Industry during 1980/81 (Indonesian Times, March 6 1980). Over 200 industrial standards have already been announced by the Government, although only 10 of these have been fully implemented (Indonesian Times, February 18, 1980). The intention of the Government is to guarantee product quality and assist government departments to purchase Indonesian-made goods, as well as to improve the competitiveness of Indonesian products in international markets.

/3 According to the Director General of Small Industries in a report to the Indonesian Parliament, the Department of Industry has prepared a list of 60 manufactured goods which may only be produced by small-scale firms, and the list is expected to increase to a total of about 300 items (Indonesian Times, February 19, 1980).

2.29 The existence of a multiplicity of both objectives and tools of policy naturally gives rise to a problem of consistency in policy implementation; this problem is severely compounded, as will be seen later, by the fact that a number of different government agencies in Jakarta formulate industrial policy and often do not integrate the measures that they announce; the result is an uncoordinated mixture of signals to the firms. Furthermore, numerous regional agencies have considerable influence over the day-to-day implementation of policy at the local level, and the personal interpretation of regulations by local officials can lead to further complications in the implementation of industrial policy. The experience of many other developing countries has shown that problems of this sort are inevitable when official policy is strongly interventionist and administrative skills are in such short supply as is the case in Indonesia.

2.30 This interventionist role of the Government manifests itself in the fact that state enterprises have an important role in the manufacturing sector. Despite the initial policies of the Soeharto Government in the mid-1960s, which were to de-emphasize the public sector and to give more emphasis to the private sector, substantial investments were made during Repelita I and Repelita II, and are continuing to be made, in basic industries in the public sector. Fertilizer, cement, chemicals and paper production is largely in the public sector, and steel production (at the Krakatau Steel plant to the west of Jakarta) is now virtually a state monopoly.

2.31 As a result of the Government's role, the distribution of investments in Indonesia is now biased towards capital-intensive projects. It has been estimated that, over the period 1977-79, about 68% of total investment spending would be represented by large-scale, capital-intensive projects.<sup>/1</sup> Thus, despite the official emphasis given to job creation in Repelita III and the desire of the Government to promote small-scale industries and mini-industrial estates, employment generation, in practice, appears to have received low priority. Several major capital-intensive projects are currently under construction or consideration.<sup>/2</sup> Some of these will be completed towards the end of Repelita III and will lay a large claim on

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<sup>/1</sup> Problems and Prospects for Industrial Development in Indonesia, Report No. 1647-IND, the World Bank, May 25, 1978.

<sup>/2</sup> Such projects include the Krakatau steel mill and its expansion, the Asahan aluminum project, fertilizer and cement factories, petroleum refineries and LNG manufacturing and loading facilities. Those currently being considered include the Bintan bauxite/alumina project, the Dumai refinery hydro-cracker, and the Batam refinery. Repelita III also includes the development of the sheet/flat glass industry, the pulp and paper industry, chlorine and caustic soda production, the expansion/development of industries in the basic metals and the engines and heavy equipment group, the production of public transport vehicles, and the development of shipbuilding and aircraft industries.

public resources. Many of the resource-based projects may be justified on efficiency grounds and should obviously be undertaken. Others, however, may represent poor choices and may be inconsistent with Indonesia's resource endowment. In such cases, the total resource cost to Indonesia of such a large investment portfolio may significantly exceed the expected benefits. It is also expected that four major petrochemical industries /1 will be built during Repelita III as joint ventures with foreign capital. In such projects, the Government was considering the possibility of encouraging foreign participation without government guarantees, although, more recently, some senior officials have indicated that explicit government support in the form of guarantees might, on balance, be best./2

2.32 One recent estimate indicates that the major investment programs of the Government in the industrial and mining sectors amount to 28 projects whose total cost is expected to be around \$20 billion; \$15 billion is expected to be financed through public and private loans and equity participation over the next five years. These projects are currently in various stages of planning, ranging from early consideration to partially completed construction.

2.33 Thus, Repelita III clearly lays the basis of an ambitious program to establish a heavy industry base. This plan envisages an average annual growth of the industrial sector at 11%, compared to 12.3% actually achieved during the entire Second Plan period. By the end of Repelita III (1983/84), manufacturing's contribution to GDP is projected in the plan to rise to 12.6% from 9.3% at the end of Repelita II. Given the strong emphasis on capital-intensive projects in Repelita III, and the recent decline in the growth rate, the objective of the Government to expand employment opportunities through rapid growth in the manufacturing sector indicates the potential for conflict; very specific policies need to be designed to stimulate the growth of labor-intensive industries in which Indonesia, because of her abundant labor supply, has comparative advantage. Moreover, since the risks and financial requirements associated with such industries are relatively smaller than those associated with capital-intensive ones, as stated in Repelita III, the private sector appears to be the appropriate vehicle to develop the labor-intensive sectors.

2.34 It is against this background that the employment implications of industrialization in Indonesia must be considered. During the period 1970-77, real value-added in the manufacturing sector has grown at around 13% p.a., but during the past few years, it has been falling to the 10% p.a. level. Given the historical pattern of capital and labor intensity, a future 10% p.a. real value-added growth rate for the large- and medium-scale

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/1 These are: an Olefin Center at Arun (Aceh province), an Aromatic Center in Plaju (South Sumatra), Methanol industry on Bunyu Island (off East Kalimantan), and a Carbon Black Plant at Dumai.

/2 There are some indications that given the current external resource position of Indonesia, and if the non-recourse borrowing strategy leads to unacceptable delays, the Dumai refinery, and the Methanol, Aromatics and Olefins complexes may be financed from domestic sources.

sector suggests that manufacturing employment will increase at about 7.8% p.a. implying that about 78,000 new jobs will be created at the end of the first year. This is only about 5% of the annual increase in the total labor force. If, however, the real manufacturing value-added growth rate approximates 15% p.a., manufacturing employment will grow at about 12% p.a. In this case, at the end of one year, 117,000 new jobs will be created which is equivalent to about 8% of the annual increment in the Indonesian labor force.<sup>/1</sup> At the end of ten years, the impact of manufacturing employment on the total labor force will, of course, be much larger; viz., 16% of the new entrants to the labor market will find employment in the manufacturing sector. This suggests that to have a significant impact on the long-run growth rate of manufacturing employment and to create increased employment opportunities in the large- and medium-scale firms, higher growth rates than those of the recent past and much more labor-intensive technologies will be needed.

2.35 The discussion above, therefore, suggests that even if employment in the large- and medium-scale manufacturing sector were to grow annually at 12%, because of the current low employment base, the manufacturing sector will not, in the short-run, mitigate significantly the unemployment problem in Indonesia; there are still strong arguments for absorbing new entrants to the labor force into agriculture, services, public works and construction.<sup>/2</sup> But, in the long-run, growth in the manufacturing sector, together with growth in other sectors, will aid in alleviating the unemployment situation. Consequently, in order to take advantage of Indonesia's relatively cheap labor and natural resource endowments, steps must be taken in the short-run to lay the foundations of an efficient manufacturing base; an efficient manufacturing sector will not only absorb much more labor than an inefficient one, but it will also optimize the allocation of scarce resources in Indonesia. Furthermore, the fact that the private sector has been constrained from rapid expansion in the past indicates that Indonesia clearly has the future potential to realize much higher value-added growth rates in the manufacturing sector; with an appropriate policy climate, 15-20% annual growth rates should be attainable in the 1980s. It is, therefore, important to provide the proper policy environment to stimulate labor-intensive industries in the private sector, develop an efficient industrial base which emphasizes an appropriate mix of labor and capital-intensive, natural resource-based sectors, and to reverse the current declining trend in the growth of the manufacturing sector. These are the issues addressed in the remainder of this report.

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<sup>/1</sup> Current employment in the large and medium-scale manufacturing sector is relatively low, about 1 million employees, whereas the annual increase in the Indonesian labor-force is about 1.5 million. Given the quality of the data and the uncertainty associated with all forecasts, the figures in the text are intended to be indicative only. See Annex 1 for higher and lower manufacturing growth rates and the implications of and the assumptions behind these estimates.

<sup>/2</sup> In 1978, the share of the Indonesian labor force in agriculture was 60%, in industry 11%, and services 29%. The definition of industry here subsumes manufacturing; see footnote (a) in Table 2.1.

### 3. THE INCENTIVE STRUCTURE AND THE TRADE REGIME

#### Introduction

3.01 The expansion of the private sector, particularly in labor-intensive industries, is one of the many objectives that the Government wishes to achieve during the Repelita III plan period. This has stemmed from the Government's concern with increasing employment in the industrial sector and promoting the exports of labor-intensive manufactured products. The Government has, therefore, created an economic environment which consists of various policy measures designed to simultaneously stimulate and control private sector activity. Consequently, a complex incentive structure governs the behavior of private entrepreneurs in Indonesia.

3.02 The system currently in force includes numerous price and nonprice interventions which affect production for both domestic and foreign markets. The main features of this system include: import and export check prices; import sales taxes; customs duties (which are both of an ad valorem and specific nature); domestic sales and excise taxes; corporate taxes; withholding taxes; firm-by-firm and specific commodity exemptions from import tariffs; quantitative restrictions on imports; import prepayment requirements; specific tax exemptions granted from the BKPM; normal and additional export duties; export quotas; a duty drawback and export certificate scheme; export credits; and subsidies for certain inputs such as energy. In addition, the private sector is subject to a variety of regulations and controls regarding investments, output and accessibility to credit.<sup>/1</sup> The combined effect of all these domestic and foreign trade policy instruments has an impact on several decisions made by the private sector regarding new capacity expansion, the distribution of investments, production for the domestic and export markets, and the choice of technology. These issues are addressed below and in the subsequent chapters.

#### The Trade Policy Bias

3.03 The adoption of the various regulations, incentive schemes and complex instruments of protection are perceived by the Government as a means of accelerating industrialization by "controlling" competition not only with imports, but also with expanding domestic production. Such a policy regime may have been justified in the early stages of industrialization; certainly many countries have undergone at least an initial phase of protection and import substitution and then progressed to the promotion of manufactured exports after the creation of an industrial base; examples include those such as the economies of Brazil, Colombia, Korea, Singapore and Taiwan. But the industrial base at the time of the policy change in many countries was quite small.<sup>/2</sup> As discussed earlier (para. 2.03), the industrial base in Indonesia is also small, but it appears that the incentive regime has taken on a life of its own and has, in the latter half of the 1970s, become

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<sup>/1</sup> The details of the incentive system are described in Annexes 2, 3, 4 and 5. Because of their importance, the issues related to regulations and credit are analyzed separately in Chapters 4 and 5, respectively.

<sup>/2</sup> For example, Korea's industrial base in 1964 had a value-added of \$400 million (in 1964 prices).

even more restrictive and protectionist in nature. In many cases, the adoption of many policy instruments appears to be an ad hoc response to requests from private firms and manufacturers' associations. The Government has often protected domestic production from competing imports if convinced, by the firms, that domestic capacity is sufficient to meet local demand: consequently, import bans have been imposed on canvas fabrics, corrugated boxes, aluminum extrusion products, radios, televisions, completely assembled cars and weaving yarns.

3.04 As a result, trade policy in Indonesia has been biased towards import-substitution. It now seems, however, that the limits of "easy" import substitution have been reached (para. 2.12) and the process of industrialization has begun to slow down. Many private firms have strongly supported and continue to advocate such a policy bias, partly because most of them were established as a result of these policies, and partly because their own vested interests would be protected through a continuation of such policies. This is evidenced by the constant concern expressed by private firm managers about the dangers and disadvantages of "excessive competition" and of "unfair dumping policies" of competing neighboring countries.

3.05 From a social, as opposed to a private point of view, there are many disadvantages associated with such policies if they are needlessly prolonged; this is particularly true if industries within the manufacturing sector singled out for protection have not been carefully selected and if there is considerable variation in protection among the various industries, as happens to be the case in Indonesia. For example, in 1975, the effective protection rate for tires and tubes was estimated to be 4315%; for motor vehicles, 718%; for knitting industries, 332%; for drugs and medicines, 151%; for spinning industries, 56%; for tanneries and leather finishing, 2% and for batik industries a negative rate of 35%./1 This variance in protection

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/1 The effective protection calculations are based on the sectoral aggregation of the latest 179 sector 1975 input-output table. Eighty four of these sectors were labeled as manufacturing by the table. See Annex 2 for the effective protection rates for these sectors. The concept of effective protection, though relatively new to economic policymakers, has long been known to businessmen who are aware that the protection of their processing activity is not only affected by nominal tariffs on the product and its inputs, but also by the share of the processing margin (value-added) in the product price. Effective protection measures are useful in indicating the distribution of the subsidy provided by differential nominal rates of protection among the various stages of production, the discriminatory effects of the system of protection on the imports of processed goods, the relative incentives provided to particular industries, and the relative incentives provided to import-substituting and export activities in protected industries. It should, however, be mentioned that the description of the tariff structure in effective tariffs, raises several conceptual and empirical difficulties. In particular, it is not possible to use the effective tariff rates to indicate the unambiguous direction of change in resource allocation that results from the tariff system. It is, therefore, best to regard these estimates as essentially descriptions that, only in a very basic way, indicate the differential nature of incentives that exist in the economy due to the tariffs, quantitative restrictions and domestic subsidies and taxes. They must, therefore, be interpreted with caution.

permits some import-substituting industries to use more domestic resources to save a unit of foreign exchange than others, including those that may be able to export and earn a unit of foreign exchange using fewer domestic resources; this implies a waste of resources and a loss in overall productivity. These variations, however, are not the result of a conscious policy, but are more the unintended results of a maze of complex instruments whose side-effects are not easily perceived by policy-makers. The situation has been exacerbated by the use of quota protection rather than tariff measures, and the attempt to use quotas to accomplish several objectives.

3.06 One important unanticipated effect of the restrictive policies followed in the 1970s is the current excess capacity in many industries such as canvas fabrics, corrugated boxes, cables, furniture, car assembly and pharmaceuticals. The erection of trade barriers provided strong incentives to invest in these protected sectors. Moreover, the absence of any effective competition from imports also contributed to higher domestic prices; for example, the total ban on canvas imports resulted in domestic prices exceeding world prices by about 50%. This has led to substitution effects where consumers of canvas fabric products, mostly in the agricultural sector, have switched to cheaper jute and plastic substitutes. This has further exacerbated the "over-investment" problem as the canvas industry's output has declined precipitously in the last two years.

3.07 Another important effect of trade policy has been a misallocation of resources toward production for the domestic market rather than exports and towards capital-intensive sectors rather than labor-intensive ones. Though the average level of effective protection in 1975 for all tradeable sectors was relatively moderate (about 30%), as Table 3.1 shows, negative effective protection rates were determined for the aggregate class of exportable sectors (-6.4%); out of the 15 exportable sectors considered, 11 had negative protection. This clearly indicates that the combined effect of different policies is a strong disincentive to export. Not surprisingly, the highest weighted average protection (61.0%) was afforded to the import-competing sectors. Moreover, six sectors had negative international value-added and all of them were import-competing ones.<sup>/1</sup> This bias against exports encourages the development of the manufacturing sector in the direction of industries without comparative advantage; this, in turn, raises the domestic resource costs of import-substitution and of the manufacturing sector as a whole. This bias, if prolonged, could result in an inefficient industrial structure which could eventually lead to industrial stagnation. Table 3.1 also shows that import-competing activities account for 65% of total domestic value-added, compared to only 31% for exportables. At international prices, however, the share of value-added in the exportable

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<sup>/1</sup> These sectors were meat preserving and canning, canning and preserving of fish and other sea foods, wheat flour milling, soap and cleaning products, other petroleum and coal products, and glass and glass products. Negative international value-added indicates that these protected, import-competing sectors were inefficient at world prices. See Annex 2, Table 1 for sector-specific details regarding effective protection rates.

sectors increases by about one-third to 43.5% and that of the import-competing sectors declines to 53%. All these results are similar to those arrived at using 1971 data; thus, the trade regime in 1975 has retained its definite protective bias in favor of import-competing activities. Moreover, as Table 3.2 shows, Indonesia exhibits a pattern of escalating protection; nondurable consumer goods are the least protected (8.56%), followed by capital goods (15.28%), intermediate inputs (48.96%), and, finally, durable manufactured consumer goods which are the most highly protected (223.71%). Neither the trade bias nor the pattern of escalating protection are unique to Indonesia. Many developing countries have instituted similar policies and the implications have been the same in all cases. Consequently, many countries have begun to alter their trade policies (para. 7.15)./1

3.08 An analysis of effective protection in 1978 for 11 sectors shows a positive development; viz., some reduction in the variance of effective protection rates; six sectors with low protection in 1975 had increased protection in 1978 and four with high protection showed declines (Figure 3.1). All sectors that registered declines, however, still had effective rates in excess of 100%. The increase in the international value-added in the weaving sector since 1971, combined with the decline in the effective protection since 1975, is of some interest as it may indicate a relationship between the level of protection and an increase in the efficiency of this sector since 1971.

Table 3.1: DISTRIBUTION OF EFFECTIVE RATES OF PROTECTION (ERP) IN INDONESIAN MANUFACTURING, 1975

	Weighted average ERP (%)	Share of Domestic value-added (%)	Share of International value-added (%)
All tradeables /a	29.7	100.0	100.0
Importables	57.6	68.6	56.5
Import-competing sectors	61.0	65.4	52.7
Noncompeting imports	9.2	3.2	3.8
Exportables	-6.4	31.4	43.5

/a Excludes all petroleum refining sectors and fertilizer. See Annex 2, Table 11 for all sectors included in these trade classifications.

Source: Annex 2, Table 1.

/1 The import-substitution bias of trade policy and escalating effective protection in Indonesia were also discussed briefly in Indonesia: Growth Patterns, Social Progress and Development Prospects, The World Bank, Report No. 2083-IND, February 20, 1978. In many countries, and probably also in Indonesia, the protection of manufactured goods has led to resources moving out of the agricultural sector leading, in turn, to a decline in the income-earning opportunities of the farmers and, thus, precluding an adequate generation of domestic demand for manufactured goods.

Table 3.2: ESCALATING EFFECTIVE RATES OF PROTECTION (ERP), 1975

	Weighted average ERP (%)	ERP Range (%)
Durable consumer goods	223.71	4,315 to 36
Intermediate goods	48.96	534 to -11
Capital goods	15.28	45 to -24
Nondurable consumer goods	8.56 /a	623 to -35

/a The low weighted average effective protection rate for nondurable consumer goods arises from the numerous sectors in this group receiving negative protection. See Annex 2, Table 2 for sectors included in the above classifications.

Source: Annex 2, Table 2

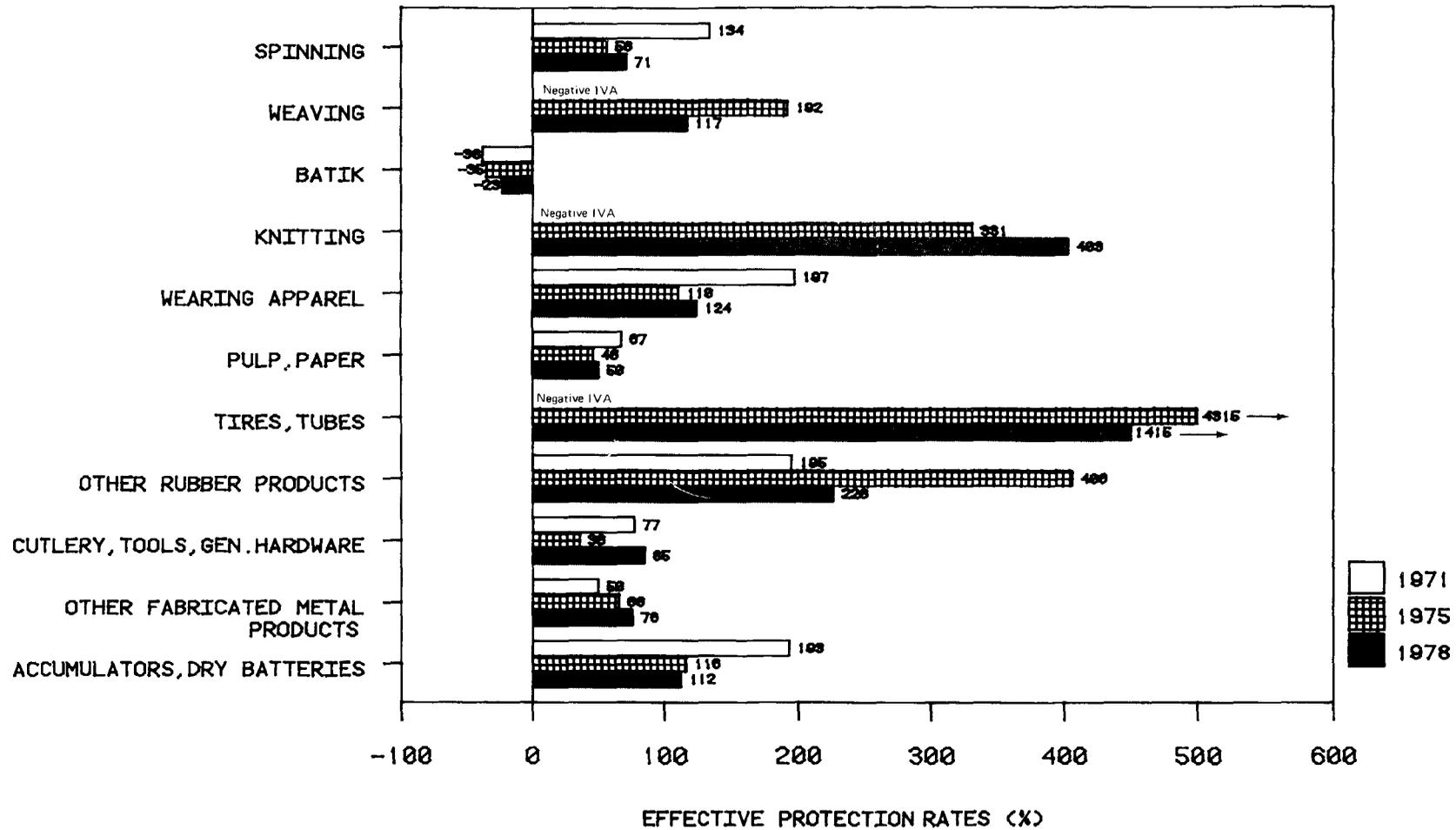
3.09 Admittedly the sector coverage for 1978 is not large enough to make broad generalizations about trends in protection. These estimates, however, along with other evidence provided by sectoral rates of tariff and import sales tax collections and firm level interviews, strongly suggest that protection has increased between 1975 and November 1978; approximately twice as many sectors recorded increases in tariff collection rates in 1978 as those that recorded declines (Figure 3.2).<sup>/1</sup> Furthermore, of the 40 firms interviewed by the mission, 39 had protection on their final products increased in the 1970s, at least until the devaluation in November 1978. This increased protection was afforded in the form of increased tariffs (shoes and garments), quantitative restrictions in addition to tariffs (bus and truck bodies), and a total ban on competing imports (canvas fabrics, corrugated boxes). This conclusion that protection has increased is also confirmed by the relative changes, after 1975, in the effective exchange rates for imports of final and intermediate products discussed later in the chapter (para. 3.27).

3.10 After November 1978, the devaluation and the accompanying policy package of reduced tariffs, liberalized import prepayment requirements, and the export certificate scheme appear to have reduced, in the short-run, the import-substitution bias. For many commodities, the large increase in the

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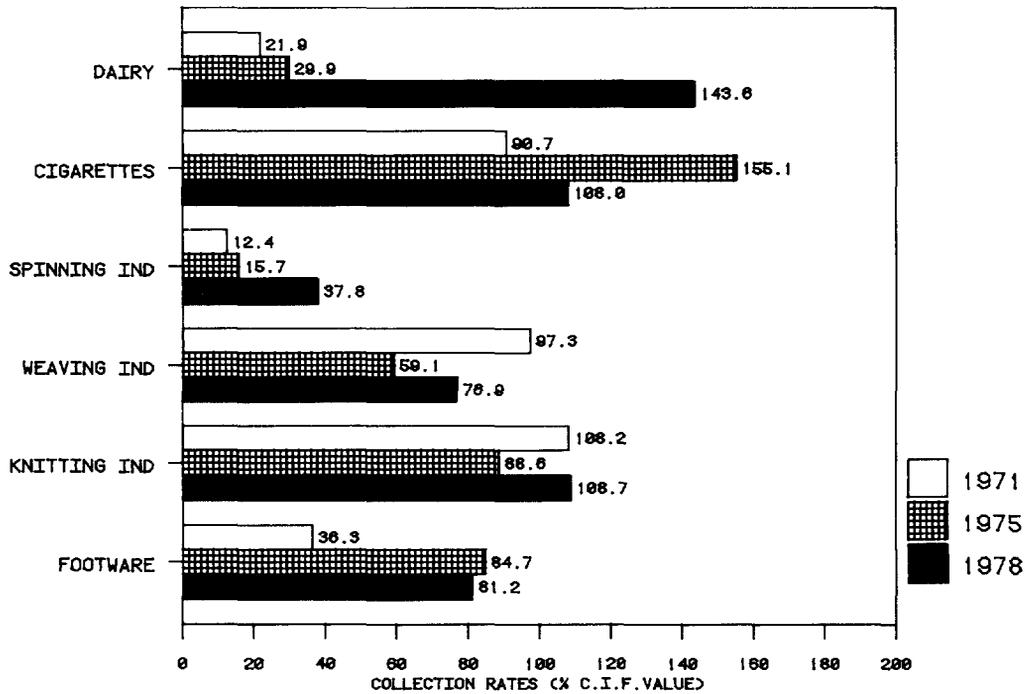
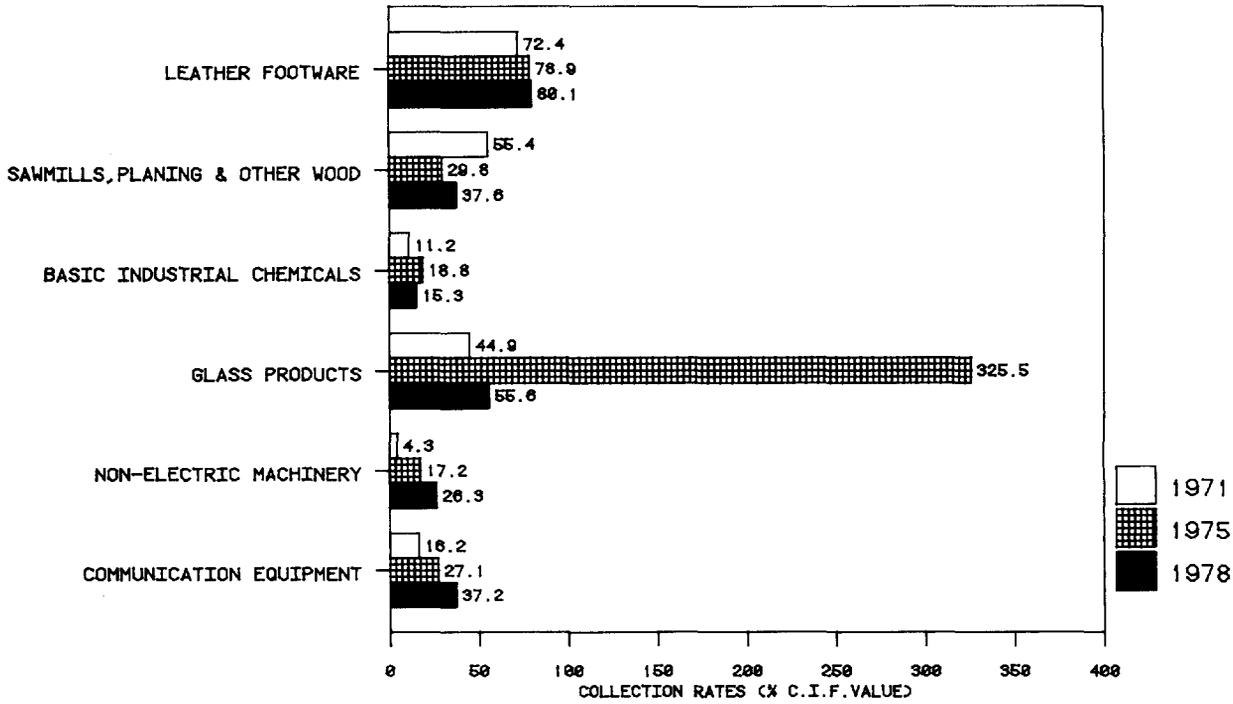
<sup>/1</sup> See Annex 2, Table 16 for sector-specific details. From April 1, 1980, customs duties and import sales tax collections have been based on the Customs Cooperation Council Nomenclature (CCCN) rather than the Brussels Tariff Nomenclature (BTN). The implications of this change are not clear, except that since the CCCN has one more digit than the BTN to classify commodities, there may be increased fine-tuning of customs duties and import sales taxes than before.

FIGURE 3.1: A COMPARISON OF EFFECTIVE PROTECTION RATES FOR SELECTED SECTORS, 1971-78 (PERCENT)



SOURCE: ANNEX 2, TABLE 5

FIGURE 3.2: IMPORT DUTY AND SALES TAX COLLECTION RATES FOR IMPORTANT MANUFACTURING SECTORS 1971-78 (PER CENT OF DECLARED C.I.F. VALUE)



SOURCE: ANNEX 2, TABLE 6

effective exchange rate for exports relative to that for imports resulted in increased export activity (para. 3.28). But within the business community there remains considerable uncertainty about the extent to which the post-1978 policies have permanently reversed the historical protectionist trends. Many firms believe that their continued growth prospects depend, to a large extent, on their being successful exporters; thus, many (75% of those interviewed) have sought the benefits of the export certificate scheme. Those that have not done so appear to have no comparative advantage; these include firms producing bus and truck bodies, components of textile machinery and wires.

3.11 There are, however, signs that in the post-devaluation period, effective protection may be increasing for individual firms on an ad hoc basis. Several firms whose domestic demand for their products was reduced after November 1978 asked for and obtained "temporary relief" from duties on their imported inputs; these, in many cases, amounted to 50% of the normal rates, thereby increasing effective protection for these firms. This has led to conflicts with the domestic input-producing firms, such as those producing wires, wood implements and cables, whose nominal protection had declined as a result of the earlier decisions. These firms, in turn, have begun petitioning the Ministry of Industry to have the old rates restored. Many firms' requests have been approved by the Ministry of Industry; they must now await final action by the Ministry of Finance. This example serves to highlight not only the potential for increasing the import-substitution bias after the devaluation and, thus, negating the benefits of the devaluation policy package, but also the continuing and unpredictable nature of ad hoc decision-making that has characterized foreign trade policy in the past and which has led to the large variance in effective protection rates discussed earlier.

#### Implications for Labor-Intensive Industries

3.12 It has been stated (para. 3.07) that the types of policies being instituted were misallocating resources to the capital-intensive sectors. This is shown below in Table 3.3 which indicates that the highly protected import-competing sectors also use significantly less labor and more capital and skills than the least protected sectors; the labor requirements per unit of domestic value-added in exportable activities is more than double that in import-competing activities. Moreover, the capital-intensity of the import-competing sectors is, on the average, over four times that of the exportable sectors. Current policies protecting and encouraging import-competing sectors, thus, slows the growth of productive employment. These conclusions (based on the 1975 input-output table) are similar to those arrived at using 1971 data, indicating that the capital-intensive bias has changed little over time. Moreover, this capital-intensive bias is reinforced by current Government policies providing subsidized credit, and various corporate tax incentives such as investment allowances, various tax exemptions and holidays, and accelerated depreciation allowances./1

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/1 See Annex 5 for the specifics associated with the tax incentives administered by the BKPM to domestic and foreign firms.

Given the degree of protection offered to most firms and the difficulties associated with obtaining licenses, many domestic firms have, however, chosen to by-pass the BKPM and to forego the tax and investment incentives. Compared to trade policy, these incentives may, therefore, have only a limited impact on investment decisions and, thus, on the choice of technology.

Table 3.3: LABOR AND CAPITAL REQUIREMENTS IN INDONESIAN MANUFACTURING BY TRADABLE CATEGORY, 1975  
(Per million Rupiahs of Domestic Value-added)

	Exportable	Import- competing
Labor requirements /a	1,539	715
Skill-days /b	175	212
Capital requirements /c	23.17	47.03
Skill-days/per thousand man-days	113	296
Capital requirements per man-day	15.0	65.8

/a Labor requirements are measured in man-days and reflect the labor used by all firms, i.e. household, cottage small, medium and large size establishments.

/b The measure of skill used is the product of the proportion of the daily average wage which exceeds the unskilled wage (Rp 250/day) and the labor requirement per unit of domestic value-added.

/c The proxy for capital requirements is kilowatt-hours.

Source: Annex 2, Table 12.

3.13 In addition, the energy subsidies provided to industry tend to bias the modes of production towards energy-intensive sectors, which are also very capital-intensive (e.g. cement), and distort the use of valuable energy resources. On the other hand, these energy subsidies also provide substantial positive protection to energy using industries such as cement and fertilizer. For example, there are indications that energy subsidies provided to the cement sector increase domestic value-added by at least 10%. There is merit in providing positive protection to exports, but given the distortionary effects of energy subsidies, they are not the proper instruments with which to do so.

3.14 The resource misallocation created by the considerable dispersion and unpredictability of the protective structure in Indonesia is also

indicated by the dispersion of domestic resource costs. The rank correlations between the estimated effective protection rates and various measures of domestic resource costs are extremely high indicating that the most protected sectors are also relatively more inefficient than those facing lower protection.<sup>/1</sup> Most of the exportable sectors, such as sawmills and wood processing, wood products, tanneries and leather finishing and batik industries, which are the least protected, have domestic resource costs significantly below the average for the manufacturing sector; the opposite is true for the highly protected import-competing sectors.<sup>/2</sup> There are indications that Indonesia currently has a comparative advantage in several labor-intensive industries, such as wood and cork products, sawmilling and wood processing, tanneries and leather finishing, processed tobacco, kretek cigarette production and certain classes of textile products. Designing trade policies to reduce the import-substitution bias would, therefore, lead to an expansion of these sectors and, thus, of productive employment and exports.

3.15 Indonesia is also fortunate in being well-endowed with potentially rich mineral resources. The off-shore and on-shore deposits of petroleum with their low sulphur content provide significant opportunities for the development of an efficient petroleum-based industry. Indonesia may, therefore, also have comparative advantage in certain capital-intensive, natural resource-based industries such as fertilizers, petroleum refinery products and the LPG industry. Other natural resources which point to Indonesia's potential in efficient capital-intensive sectors include natural gas, tin, nickel, copper and bauxite. Thus, the formulation of policies that will channel investment resources into the further processing of domestically available agricultural, mineral and forestry products would also contribute to direct and indirect productive employment opportunities.

3.16 Technical - i.e., managerial and entrepreneurial - inefficiency currently existing in Indonesia raises the domestic resource costs of production in many sectors. For example, the weaving industry, which is labor-intensive and also highly protected, registered a very high domestic

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<sup>/1</sup> Domestic resource costs indicate the social rates of return to production in alternative manufacturing activities; the higher the domestic resource costs the more inefficient is the activity. Three different measures were estimated under differing assumptions of the shadow prices of unskilled and skilled labor and capital. See Annex 2, Table 13. These are aggregate measures based on the 1975 input-output table. Because of the empirical problems associated with such aggregations, the latest and better estimates using firm-level data will be obtained under an on-going World Bank research project entitled "A Statistical Analysis of the Efficiency of the Indonesian Manufacturing Sector." This research will permit the identification of sectors with and without comparative advantage and the reasons for intra-sectoral variations in efficiency.

<sup>/2</sup> See Annex 2, Table 13.

resource cost in 1975; the weaving sector used twice as many domestic resources per unit of international value-added as the weighted average for the manufacturing sector as a whole. An important reason for the underlying economic inefficiency in this industry was found to be technical inefficiency.<sup>/1</sup> There are also indications that managerial and entrepreneurial inefficiencies and the low productivity of labor may be significant contributing factors to the economic inefficiency existing in other sectors such as leather footwear and products, radio, television and communications equipment and knitting industries which also registered high domestic resource costs.<sup>/2</sup> Such forms of inefficiency may, therefore, nullify, in some sectors, the inherent comparative advantage that Indonesia derives from her cheap labor and plentiful natural resources.

### Current Obstacles to Exports

3.17 Despite the 1978 devaluation and the export certificate scheme which have, in the short-run, provided incentives to exporters, domestic firms still face various difficulties in exporting their products. The customs and loading procedures at the ports remain a major obstacle to exports; the long delays raise the costs of exports significantly. These increased costs arise from the storage of exports in harbor warehouses, which are expensive, and from the increased holdings of inventories which result from long delays in customs clearance of imported inputs.<sup>/3</sup> Furthermore, there are unofficial costs and illegal payments associated with the processing of exports through ports and customs; these contribute further to making Indonesia's exports noncompetitive. The Government has recognized the importance of simplifying the export procedures and has made significant efforts to speed up the clearance and shipment of export commodities. But part of the difficulties also arise from the fact that exporters, attempting to benefit from the export certificate scheme, mislabel or provide inaccurate information to the Government officials. The resulting suspicion impedes the flow of exports.

3.18 Another disadvantage faced by exporters is the high cost of inter-island and international transport, particularly for sea-borne trade. These high costs stem largely from the Government's decision to protect the ailing state-owned shipping industry from competition. The inter-island shipping line has an inadequate schedule and charges high nominal rates. Furthermore, its composition, size and age makes it unsuitable for local traffic. Exporters' needs have not been taken into account in policy formulation for inter-island shipping which has adversely affected the costs of exporting goods transhipped onto other shipping lines at other Indonesian ports.

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<sup>/1</sup> See M. Pitt and L. Lee (forthcoming) "The Measurement and Sources of Technical Inefficiency in the Indonesian Weaving Industry". Journal of Development Economics. The authors found that technical inefficiency in the weaving sector in the early 1970s was as high as 38%.

<sup>/2</sup> See Annex 2, Table 13.

<sup>/3</sup> The issues related to customs procedures at ports is discussed in greater detail in Chapter 4.

3.19 The high costs of international transportation stem from the fact that Indonesia has not only established conference lines to most large international markets, but it has also restricted the access to Indonesian ports to conference ships only; non-conference ships do not have access to Indonesian ports. The delay in the development of container facilities at these ports also protects the state-owned industry from foreign-owned ships. The domestic industry, currently, is unable to handle containers; as a result, during the 1979/80 period, exporters paid about an average 30% premium for shipping goods from Indonesia to the world markets compared to shipping them from Singapore and Hong Kong. Furthermore, the premium varies by commodity, foreign destination, season and port of origin. In many cases, it has been large enough to make even transshipment to Singapore a profitable proposition. Clearly, a reduction in these high external shipping costs would generate additional exports, but this, in turn, would exacerbate the existing congestion problems at Indonesian ports. This, therefore, emphasizes the importance of reducing and eventually eliminating the ports and customs clearance delays which remain a fundamental bottleneck facing Indonesian exporters.

3.20 Finally, one administrative problem that has slowed the growth of exports in the post-devaluation period is associated with the export certificate scheme. This system is the most innovative action undertaken by the Government in recent years to increase manufactured exports. But firms still have difficulty in obtaining export certificates. Currently, the length of time necessary to add an item to the export certificate list runs from one to four months. The problem is basically one of documentation as the Ministries of Industry, Finance and Trade define the items rather too carefully in their efforts to rebate the exact level of duties paid on imports. This stems from the Government's desire to avoid over-compensating exporters for import taxes paid. For example, the extent of the detail is shown by one item on the export certificate list defined as Radio Cassette trademark "National Global", type RQ 458 TS, AC/DC 4 Band, SW/MW, 6 Volt. There are many other such finely defined items. In addition, the export certificate percentages are set with one-hundredth of 1% accuracy. (Table 3.4).<sup>/1</sup> It is this detailed documentation required for proper "accuracy" and "precision" that has slowed down the process of gaining access to export certificates. But once access to these certificates has been obtained, the procedures for rebates are very efficient.

#### The Devaluation of November 1978

3.21 On November 15, 1978, the Government undertook a major policy step by devaluing the rupiah from Rp 415 to Rp 625 per US dollar. The decision formally involved rupturing the tie between the rupiah and the US dollar, which had existed since August 1971, and establishing a managed float against an unspecified basket of currencies at the new rate. The rationale behind

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<sup>/1</sup> See Annex 2, Table 10 for all commodities eligible for export certificates and their effective export exchange rates.

this devaluation was the Government's desire to encourage the development of the nonoil tradeable goods sector to lay the foundations of a long-run structural change. This was to be brought about by growth in primary nonoil exports, protection of the manufacturing sector from imports and the encouragement of manufactured exports. Furthermore, by making imported capital equipment more expensive, labor-intensive modes of production were to be encouraged which would provide the basis for a higher growth rate of employment. As part of this devaluation package, a 50% reduction was made in tariffs, import sales tax and the withholding tax (MPO) on imported raw materials and intermediate components used in manufacturing. The export certificate scheme, discussed earlier, was also introduced. The explosion of oil and mineral wealth in Indonesia was, thus, viewed as a transitional phenomenon and the devaluation, with the accompanying policy package, was seen as the catalyst for restructuring the Indonesian economy.

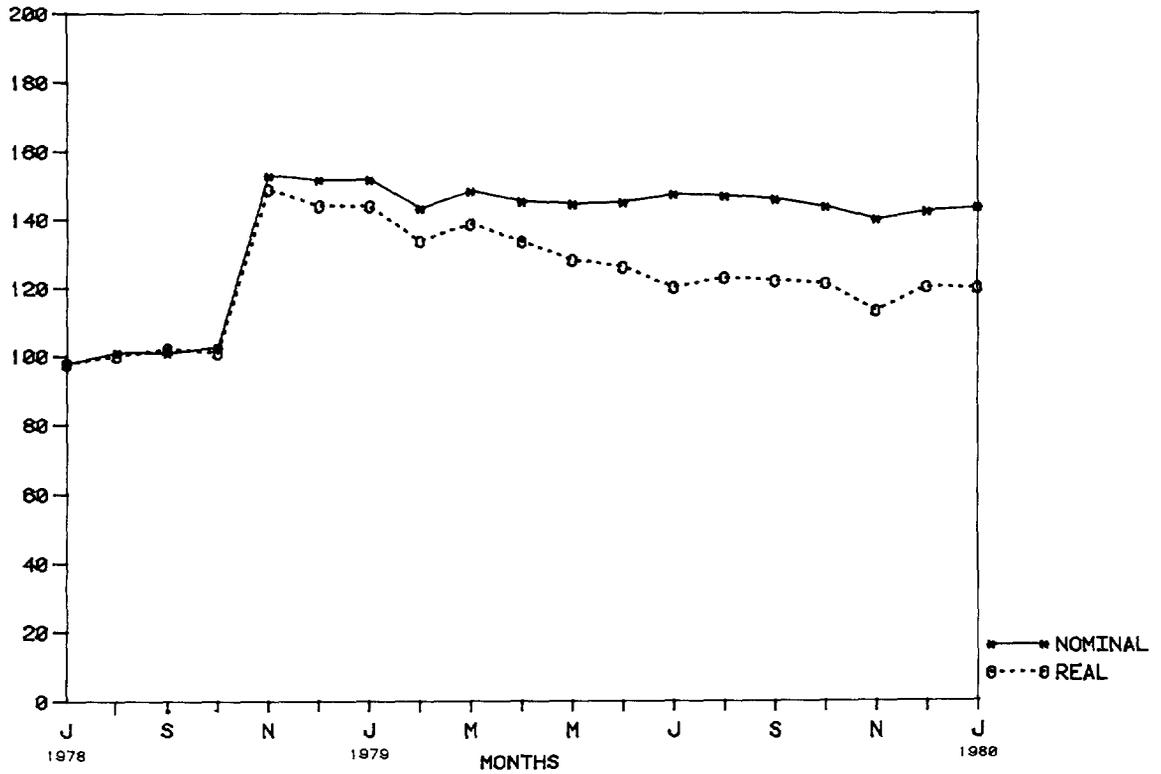
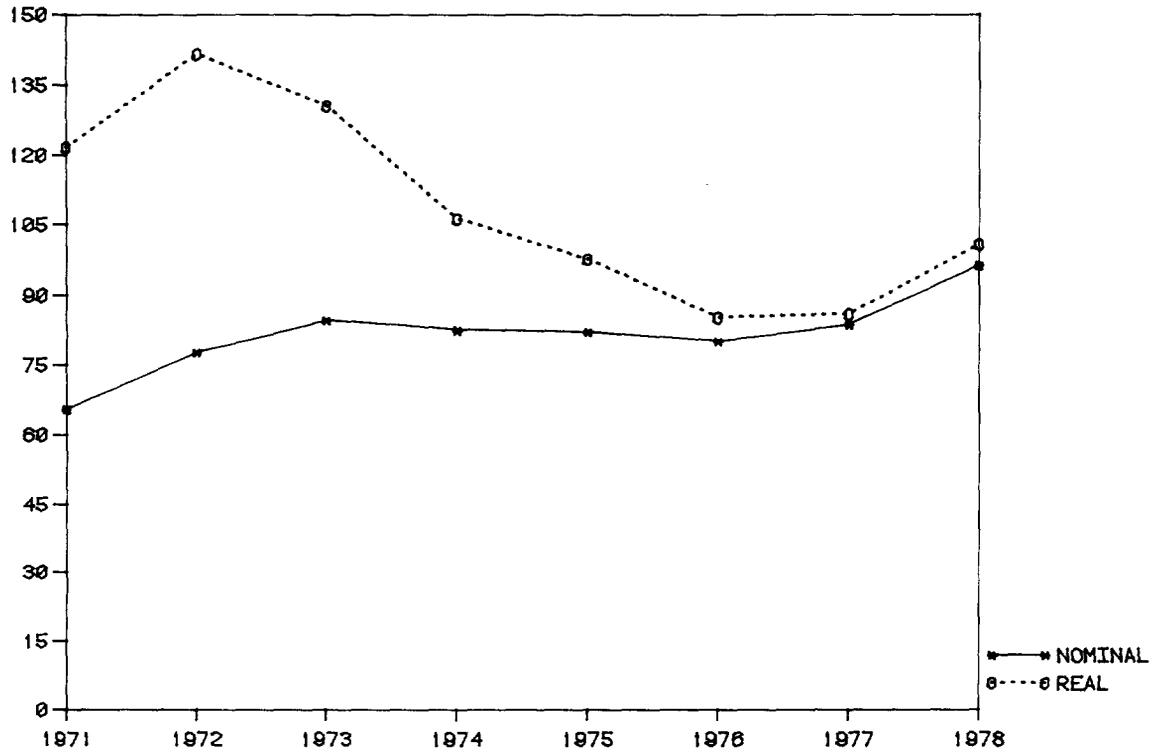
3.22 The timing of this devaluation was particularly favorable; the Jakarta cost of living index (3.1% increase for the preceding 10 months) was the lowest since 1971. At the same time, Bulog held record stocks of 1.6 million tons of rice and there were predictions of a bumper crop of 17.5 million tons. Moreover, there was a surplus in the balance of payments with international reserves at around \$2.5 billion. The decision to devalue under such propitious circumstances is in marked contrast to devaluations instituted in some other countries under import-starved conditions in a near crisis atmosphere brought about either by severe balance of payments problems (Turkey, 1970), or by droughts and poor harvests (India, 1966). In almost all such cases, the devaluations have had very limited success.

3.23 The magnitude of the Indonesian nominal devaluation has been explained on the basis of the purchasing power parity doctrine;<sup>/1</sup> the Government acted to restore the purchasing power of the rupiah relative to the dollar to the August 1971 level of Rp 415. This devaluation resulted in the highest real exchange rate of the decade - it was about 5% higher than the rate that prevailed in 1972 after the August 1971 devaluation (Figure 3.3). It is, however, not clear that the 1971 parity was or remains the appropriate one for Indonesia. It seems reasonable to believe that this large magnitude was appropriate to meet the Government's long-range objectives regarding the manufacturing sector. Experience in other countries, such as India (1966), Brazil (1957) and Chile (1956, 1959 and 1965), has shown that an inadequate devaluation has always had only a limited, short-run impact on exports. On the other hand, countries such as Brazil (1967), Colombia (1967), Israel (1962) and South Korea (1964)

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<sup>/1</sup> The devaluation measured as the change in the price of rupiah in terms of foreign currency amounts to 33-1/3%; if it is measured as the change in the price of foreign currency in terms of the rupiah, it is 50.6%.

FIGURE 3.3 INDEX OF NOMINAL AND REAL EXCHANGE RATES  
 RUPIAH PER BASKET OF TRADING PARTNER CURRENCIES  
 (JULY/SEPTEMBER 1978=100)



SOURCE: ANNEX 2, TABLE A-1.

sustained long-run export growth after devaluation by devaluing by a sufficiently large margin, and also by maintaining the real exchange rates and by ensuring approximately equal incentives for exports and import-substitution.

3.24 In Indonesia's case, the magnitude of the devaluation has clearly been sufficient to generate export growth in several industries in the short run (para. 3.29). But due to continued differences between Indonesian and foreign rates of inflation and the appreciation of the dollar since November 1978, the real exchange rate and the incentives to exports have not been maintained. Expressing the exchange rate in rupiahs per basket of trading partner currencies shows that the index of the real exchange rate has declined from 150.6, as of November 1978, to 116 by March 1980. Moreover, as indicated earlier (para. 3.07), current trade policy is biased towards the domestic market; the Government does not provide approximately equal incentives for exports and import-substitution. Consequently, based on the experience of the other countries mentioned above, unless major trade policy changes are undertaken to reduce the current import-substitution bias, the prognosis for long-run export growth and the desired structural transformation does not look very promising./1

#### Changes in Effective Exchange Rates

3.25 Changes in the real exchange rate do not capture all the domestic price effects of associated trade policy interventions, such as taxes, subsidies, quantitative restrictions and import prepayment requirements that were undertaken at the same time or shortly after the devaluation. It is important to incorporate such interventions as they determine, together with the nominal devaluation, the actual returns to exporting. These forms of intervention are commodity-specific, so that each commodity has its own effective exchange rate (EER); this is defined as the amount of rupiahs paid or received for one unit of foreign currency's worth of imports or exports./2

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/1 See Chapter 7 for a detailed policy discussion.

/2 Effective exchange rates are exchange rates for each separate commodity. They incorporate into the official exchange rate, import tariffs, export subsidies and other trade interventions that are specific to each commodity. Consequently, these exchange rates are the actual amounts of rupiahs paid by an importer or received by an exporter for one dollar's worth of imports or exports. Real effective exchange rates are exchange rates for specific commodities which net out the impact of inflation. It should, however, be noted that in the immediate post-devaluation period, effective exchange rates may be imperfect measures of the domestic price effects of the devaluation and the accompanying policy package because they fail to measure changes in tariff redundancy, the premia resulting from quantitative restrictions and the price controls enacted on certain commodities by the Government in the aftermath of the devaluation.

3.26 Figures 3.4 and 3.5 show the effective exchange rates for the imports of textiles and other selected items.<sup>/1</sup> For textiles, it can be seen that substantial devaluation of the effective exchange rates had already taken place prior to November 15, 1978. In all cases, the effective exchange rate before that date was greater than it was in 1975 by amounts that ranged from 10% (for polyester yarn of continuous fibers) to 34% (for polyester fibers for spinning). On the other hand, for the eight non-textile items, the pattern was mixed. In one case (milk powder), the effective exchange rate declined and for some products (caustic soda, synthetic organic dyestuffs) there was very little change.

3.27 In all the cases investigated, the effective exchange rates for imports of course, increased further as a result of the November devaluation. But in all cases, the net devaluation was smaller than the gross devaluation of 50.6%.<sup>/2</sup> For the textile items, the net devaluations varied from 29% to 46% and for the non-textile items the range was from 25% to 44%. The differences between the net and gross devaluations reflect the impact of other commodity-specific trade interventions that were instituted at the same time or shortly after the devaluation. These included a 50% tariff reduction for intermediate goods (November 15, 1978), liberalization of the import prepayment requirements (December 13, 1978), a 50% tariff exemption for certain commodities such as cigarette paper, and certain angles, shapes and sections of iron (March 1979), a new domestic sales tax schedule (April 1979), introduction of specific tariffs (April 1979) and further tariff reductions for certain intermediates such as caustic soda (September 1979).<sup>/3</sup> The general pattern that emerges is for final output effective exchange rates to increase relative to those for intermediate goods, thereby increasing the effective protection to final goods.

3.28 For exports, the effective exchange rates, after the devaluation and the introduction of the export certificate scheme, also increased substantially, ranging from a low of Rp 633 per dollar for monosodium glutamate to Rp 900 per dollar for men's jeans (Table 3.4). The net devaluations, therefore, ranged from 53% to 117%. But many commodities with export certificates had and continue to have very high effective exchange rates for imports. Some of these commodities, such as urea, dry batteries, and tires, were protected by import prohibitions on Government control of trade; many others, such as most textiles, were subject to special prepayment requirements, and most others had redundant protection resulting from high

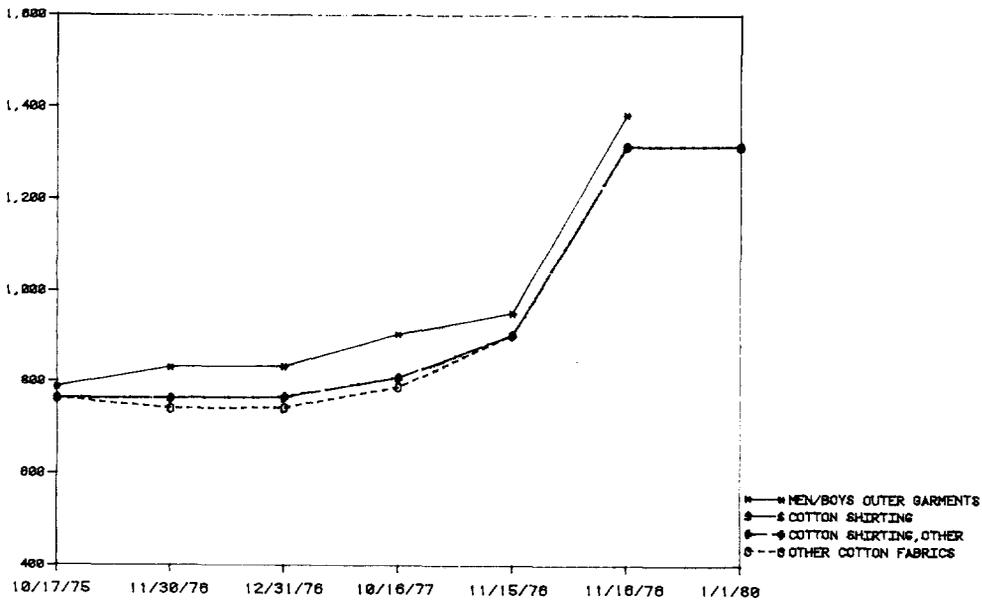
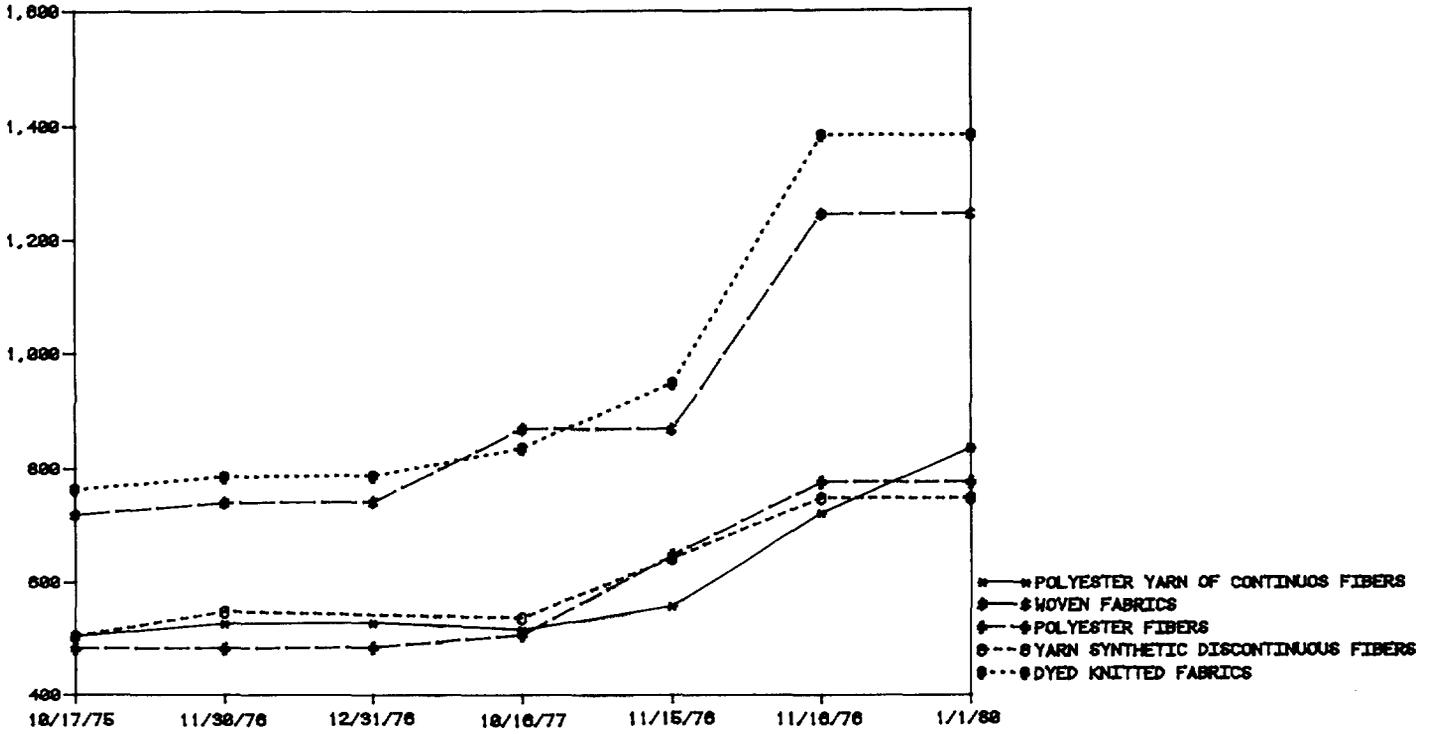
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<sup>/1</sup> Effective exchange rates for imports have been calculated for 52 commodities; 17 have been presented in Annex 2. See Annex 2 for details related to these calculations. For those commodities analyzed, all effective exchange rates have been calculated at the six-digit BTN classification level.

<sup>/2</sup> The gross devaluation is the official devaluation and is analogous to the official exchange rate, while the net devaluation is analogous to the effective exchange rate in that it incorporates all commodity-specific import tariffs and export subsidies.

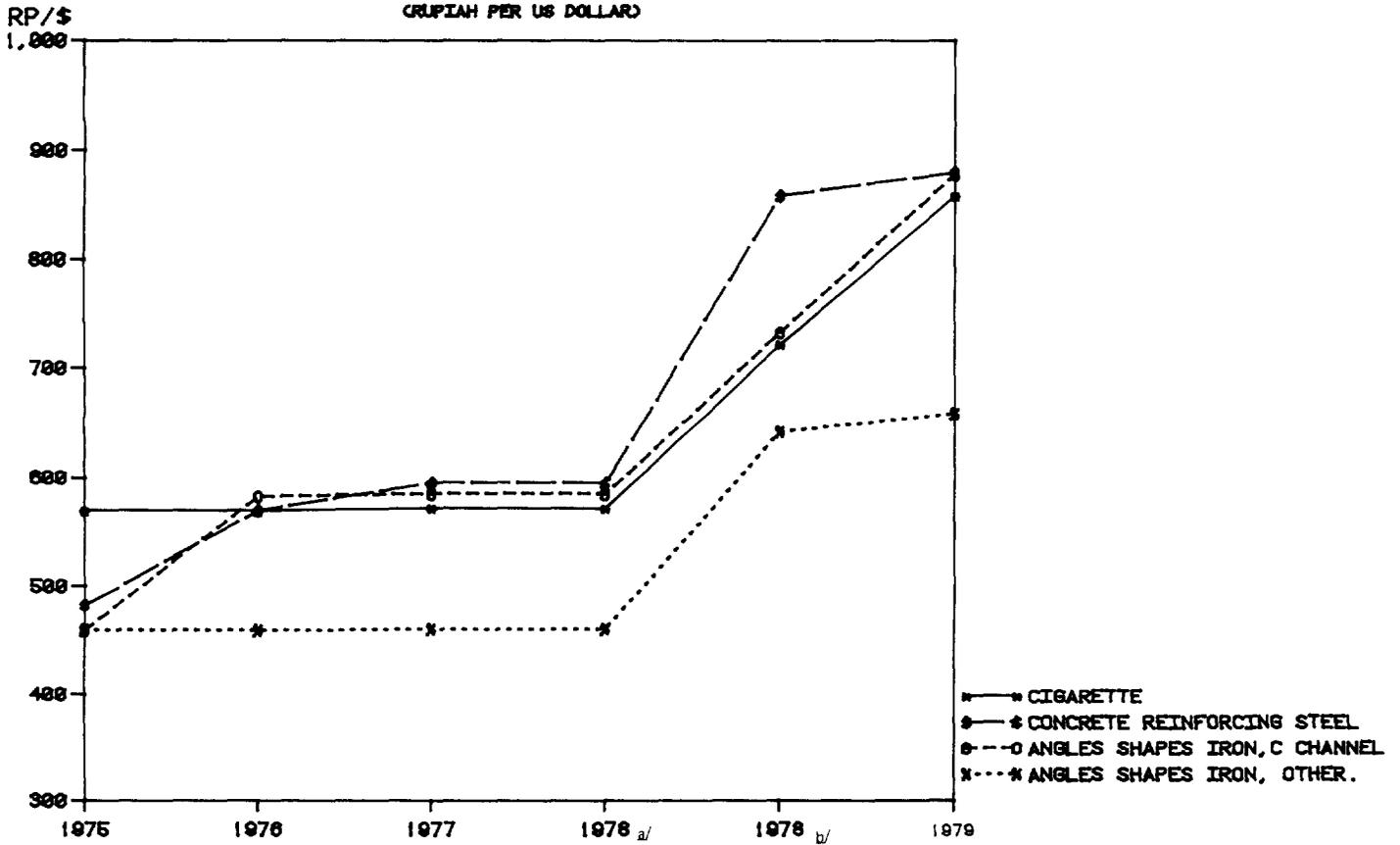
<sup>/3</sup> See Annex 2 for details.

FIGURE 3.4 EFFECTIVE EXCHANGE RATES FOR TEXTILES  
(RUPIAH PER US DOLLAR)



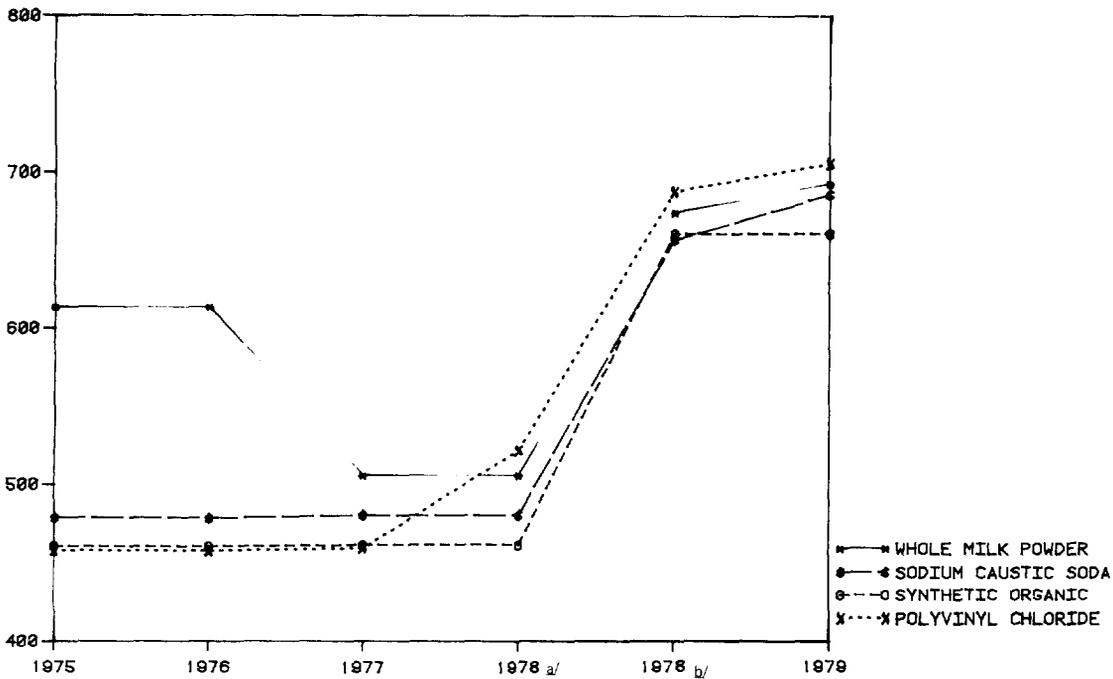
SOURCE: ANNEX 2, TABLE A-3

FIGURE 3.5 EFFECTIVE EXCHANGE RATES FOR SELECTED ITEMS  
(GRUPIAH PER US DOLLAR)



a/ Upto November 15, 1978

b/ Beginning November 16, 1978



a/ Upto November 15, 1978

b/ Beginning November 16, 1978

Source: Annex 2, Table A-4

Table 3.4: EFFECTIVE EXCHANGE RATE FOR EXPORTS OF SELECTED ITEMS

Item	Export certificate rebate (%)	Effective exchange rate (Rp/\$)
Monosodium glutamate	1.28	633
Veneer panel layered 4" thick	2.57	641
Glass bottles, brown	2.57	641
Urea fertilizer	2.59	641
Cement	3.91	649
Iron pipe API standard diameter less than 2"	11.86	699
Flashlight batteries Vm <sup>2</sup> (medium)	13.35	708
T/C cloth, gray	18.47	711
T/C cloth, semi-bleached	17.44	740
Cassette recording tapes BASF brand, type C 60-2M	19.94	750
Radios with cassette tape players, National Global brand, type RQ 458 TS, AC/DC SW/MW, 6 volts	23.12	770
Piece goods, batik	33.19	832
Men's long-sleeved shirts (cotton), 1/2 fine	37.48	859
Men's jeans, coarse	41.13	882
Men's long-sleeved shirts, (cotton), fine	43.25	895
Men's jeans	43.96	900

Source: Annex 2, Table 10.

tariffs and import sales taxes. Prior to the devaluation, many of these commodities behaved as non-tradeables; the domestic price exceeded the effective exchange rate for exports but was less than (or equal to) the effective exchange rate for imports. After the devaluation, for many commodities, the effective exchange rate for imports rose less than the gross devaluation of 50.6%, while the effective exchange rate for exports increased significantly more than 50.6%; as a result, in the short-term exports became more profitable.

3.29 This increase in incentives is reflected in the large increase in many manufacturing exports as shown in Table 3.5. For example, over the 1978/79 period, cement, lime and prefabricated building materials exports increased by 1371%; woven cotton fabrics exports by 684%; clothing exports by 341%; furniture exports by 104%; and wood products exports by 82%. For the 39 six-digit (BTN classification) commodities identified in Annex 2, exports increased in 1979 by 260% over 1978, and by 92 times over exports in 1975. Most of the increase has taken place in the labor-intensive sectors which were also important in the successful export-led growth of other countries in the region. Many firms producing garments, leather products, textiles, cement, dry cell batteries and shoes and sandals began exporting for the first time in 1979 in response to the favorable export environment. But it should be emphasized that this boom in exports has taken place from a small base and is only a short-run observation brought about, in many cases, by the presence of excess capacity (textiles, and iron and steel) and earlier decisions to add capacity ahead of demand (urea and cement). The emergence of an underlying structural transformation awaits confirmation.

#### The Real Price Effects of the Devaluation

3.30 In analyzing the impact of the devaluation, effective exchange rate measures can be usefully augmented with information on the real price movements of manufactured goods. That the devaluation had a pervasive effect on domestic prices is very apparent. Over the period October 1978 to December 1979, Indonesia's general wholesale price index increased by 76.7%, while the export component of this index rose by 161.2% (119.2% excluding price increases of petroleum), the import component by 53.4% and the domestic manufacturing component by 30.5%. Furthermore, in the period immediately following the devaluation (November 1978 to January 1979), 34 out of 36 manufacturing subsectors experienced real price increases.<sup>/1</sup> The two exceptions were fertilizers and petroleum products, both of which were subject to price control. The weighted average increase for the entire manufacturing sector amounted to 7.2%, but this index includes certain commodities with administered prices such as important foodstuffs, fertilizer, cement and petroleum products. An adjusted price index, representing only the uncontrolled sectors, indicates a real price increase of more than

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<sup>/1</sup> Real price changes are defined to be the nominal change in the price of individual commodity groups deflated by the Jakarta consumer price index.

Table 3.5: THE GROWTH OF SELECTED INDONESIAN MANUFACTURED EXPORTS, 1975-79  
(US\$ '000)

Manufactured Exports	1975	1978	1979	% increase 1978/79
Fertilizers, manufactured	177	28,753	36,802	28.0
Veneers, plywood and other wood	360	21,830	39,494	80.9
Wood manufactures, NES	723	2,322	4,236	82.4
Paper and paperboard	165	1	4,773	very high/a
Textile yarn and thread	24	1,814	3,931	116.7
Cotton fabrics, woven	358	434	3,403	684.1
Textile fabrics, woven	106	219	33,080	very high/a
Made-up textile articles, NES	239	1,114	3,107	178.9
Floor coverings, etc.	1,209	2,344	6,798	190.0
Cement, lime and fabricated building materials	1	1,652	24,296	1,370.7
Iron and steel bars, rods, etc.	96	1,067	25,790	2,317.1
Tubes, pipes and fitting of iron/steel	219	2,354	20,175	757.1
Iron and steel castings and forgings	10	9	2,519	very high/a
Electrical power machines and switch gear	6,212	7,944	6,091	-23.3
Telecommunications apparatus	1,709	1,743	5,024	188.2
Other electrical machines and apparatus	4,736	23,727	75,790	219.4
Furniture	217	849	1,728	103.5
Clothing	2,432	14,984	66,107	341.2
Footwear	219	1,088	1,066	-2.0
Musical instruments and accessories	439	2,413	5,851	142.5

/a The very high percentage increase is indicative of the low export base in 1978.

Source: Annex 2, Table 9.

double that of the manufacturing index - 16.6%. In the ten months following (February 1979 to October 1979), the manufacturing index increased at a lower rate (2.3%), while the adjusted index registered a small decline (-1/2%). Nevertheless, over the entire period January 1978 to October 1979, the manufacturing index and the adjusted index both registered real price increases of 11.6% and 18.9% respectively (Table 3.6).<sup>/1</sup>

Table 3.6: REAL PRICE CHANGES OF DOMESTIC MANUFACTURING,  
IMPORTS AND EXPORTS  
(% increase at end of period over beginning of period)

	Jan 1978 to Oct 1978	Nov 1978 to Jan 1979	Feb 1979 to Oct 1979	Jan 1978 to Oct 1979
All manufacturing	2.5	7.2	1.6	11.6
All manufacturing except agricultural products and beverages	1.6	10.7	2.3	15.1
All manufacturing (adjusted) <sup>/a</sup>	3.3	16.6	-1.2	18.9
All imports	0.3	19.8	-0.8	19.2
All imports except agricultural products and beverages	-0.1	22.4	-3.4	18.1
All imports (adjusted) <sup>/a</sup>	0.3	22.2	-3.5	18.4
All exports	0.4	51.1	20.2	82.2
All exports excluding petroleum	6.2	56.3	8.4	79.6

<sup>/a</sup> Excludes agricultural products, beverages, fertilizer, petroleum refining and cement.

Source: Annex 2, Table A-8.

<sup>/1</sup> See Annex 2 for specific details regarding real price movements over time for each manufacturing subsector.

3.31 Similar to the price effects experienced by domestic manufactured goods, all import subsectors were also affected by real price increases in the immediate post-devaluation period ranging from 1.5% (food products) to 56.1% (mining and quarrying); the exception again was fertilizers. The increase in the import price index over this period amounted to 19.8% almost three times the manufacturing index. But comparing the adjusted indices for both (i.e., excluding the price controlled sectors) shows that the increase in import prices (22.4%) exceeded that for domestic manufactures by only 30%. This difference is accounted for by the relatively larger share of goods in the domestic manufactured goods price index that are protected by quantitative restrictions and prohibitive tariffs. As would be expected, the greater part of the total increase for the export price index (excluding petroleum) occurred during the three months immediately following the devaluation - 56.3% from November 1978 to January 1979, compared to 8.4% from February 1979 to October 1979 (Table 3.6). This is consistent with the fact that the export component of the wholesale price index experienced a larger increase than the imports or the domestic manufacturing components, and that the real returns to exporters have been declining since the devaluation./1

3.32 The 1978 devaluation has provided significant opportunities to Indonesia to increase manufactured exports and to increase the efficiency of the industrial sector. In order to take advantage of these opportunities, certain reforms in trade policy are essential. The Government is currently considering changes in the foreign trade regime that will reduce the import-substitution bias and increase manufactured exports. Chapters 7 and 8 of this report discuss the potential benefits of such a change and present a gradually phased program that will facilitate the transition of Indonesia from an import-substitution biased policy towards a more outward-looking one.

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/1 The absence of a reliable time-series on manufacturing wages in the post-devaluation period precludes its discussion here. Annex 2, however, reports on the real wages of construction workers covering the period February 1977 to August 1979 for salaried skilled employees, skilled daily employees and unskilled daily employees in Jakarta, Java (excluding Jakarta) and Sumatra. The annex shows that the real wages for almost every type of worker in each geographic area considered fell in the post-devaluation period, except for unskilled daily employees in Jakarta and for skilled salaried employees in Sumatra. It is, nevertheless, still too early to draw conclusions on the ultimate level of real wages. There is some evidence that in many enterprises, employees have already regained pre-devaluation real wages.

#### 4. THE REGULATORY ENVIRONMENT

##### Introduction

4.01 The expansion of the private sector is an important element in boosting manufactured output and exports. The previous chapter discussed the incentive and trade regime and its implications for industrial growth. The purpose of this chapter is to focus on another key policy area, viz., the current regulatory environment as this, if efficiently operated, could permit the expansion of industrial output and exports. Like many countries, Indonesia regulates industry and related economic activities through a number of administrative controls and licenses. The regulatory environment in Indonesia, however, deserves special attention because of the large number and the qualitative significance of these controls; this regulatory system stands in sharp contrast to the remarkably free exchange control regime currently in existence./1

##### The Types of Regulations

4.02 Manufacturing firms in Indonesia are subject to a number of regulations and licenses covering their activities. For example, there are very specific licenses required for investment and capacity which vary by product and by region. Firms are also subject to ownership and cooperative arrangements and require several licenses governing marketing and transportation, exports and imports - in particular machinery imports - pollution, labor wages, working conditions and foreign personnel. In addition to the above, firms are subjected to a number of other regulations some of which are regionally specific./2 In principle, these licensing requirements apply to all industrial enterprises, although, in practice, cottage establishments tend to be exempted.

4.03 The Indonesian legal system, which forms the basis of these regulations, is largely derived from the Dutch system. Under this system, broad legislation passed by Parliament allows for numerous clarifying regulations to be issued by ministers or officials appointed to implement the broad policy. As a result, the regulations governing industrial policy can be found in: (a) the Broad Outline of National Policy (GBHN) statement which is formulated every five years; (b) laws passed during the colonial period and since independence; e.g., the Company Regulations Ordinance of 1934 (the BRO law); (c) government regulations; (d) Presidential decisions; (e) Ministerial decisions; (f) Director-Generals' decisions; (h) various other documents issued by the Central Government; (i) Regional Governors' decisions; and (j) Regional Bureau Heads' decisions. Consequently, there are about 60,000 Central Government regulations and about 30,000 Regional Government regulations affecting different aspects of industrial policy; the Ministry of Industry alone puts out about 3,000 new regulations each year. Furthermore,

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/1 The nature of the regulatory environment and administrative controls were also highlighted in Indonesia: Growth Patterns, Social Progress and Development Prospects, The World Bank, Report No. 2093-IND, February 20, 1979.

/2 See Annex 3 for details and specific examples of the issues discussed in this chapter.

there is no legal requirement for these regulations to be published in any official government newsletter before they can go into effect. Currently, a private company, Cafi, has the license to publish all Government decrees and regulations in both English and Bahasa Indonesia. This has worked well for 28 years and is an excellent example of how public and private sector initiatives can complement each other. In addition, a Government gazette, Berita Negara, does the same in Bahasa Indonesia. There, however, remains the absence of a legal requirement for these regulations to be published before they can go into effect.

4.04 For investment licensing purposes, manufacturing firms can be classified into three categories: the BKPM sector, the BRO sector and the unlicensed sector. Most of the large, medium and small firms, which amounted to over 55,000 in 1974/75, fall under the first two categories, whereas the cottage firms, of which there are over 1 million, fall into the third.<sup>/1</sup> The BKPM sector covers all manufacturing firms with any degree of foreign equity. These firms must obtain the many licenses for their operations from the Investment Coordinating Board (BKPM), and, in addition, obtain a range of other licenses (such as an Environmental License) from various other government agencies. Domestic firms which opt to take advantage of the Government's taxation and investment incentives must also register with the BKPM to obtain their main licenses. Those that choose not to take advantage of these incentives may obtain licenses under the BRO provisions which are administratively simpler.

4.05 The BKPM was established to implement the laws on foreign and domestic investment which came into effect in 1967 and 1968 respectively. The principal functions of this Board are to formulate investment priorities and policies and the incentives required to attract investment; to review investment applications; to issue licenses; and to supervise and control the implementation of projects. The BKPM does not issue licenses on its own authority, but on the authority of the various Ministries responsible for different activities. A major tool used by the BKPM to conduct its business is the Investment Priority List (Daftar Skala Prioritas, or DSP). In February 1980, a new DSP for foreign and domestic investments was published and it contained the first major changes since the list was originally published two years earlier.<sup>/2</sup> The DSP for domestic investment lists 526 subsectors which include 389 industrial subsectors; the respective numbers for the foreign investment DSP are 339 and 267. This represents a reduction in the number of subsectors listed in 1978. This has been accomplished partly through consolidation of subsectors and partly through the omission of industries that are either closed for investment or for which a decision on incentives has yet to be made. The granting of an investment license and

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<sup>/1</sup> According to strict interpretation of the law, cottage firms should at least be registered with local government departments. Such establishments, because they are usually unlicensed, will be excluded from this discussion.

<sup>/2</sup> Strictly speaking, two separate DSPs have been issued. One for foreign investment (PMA) and one for domestic (PMDN). The discussion is facilitated by treating them as one. Despite the two-year time interval between the first and the 1980 DSP list, it is now expected to be issued every year.

the associated tax and investment allowances are dependent on several conditions specified for each subsector. These conditions, among others, include: maximum allowable production; minimum economic capacity; location; participation of the weaker economic group as partners or cooperatives; use of raw materials; and proportion of output exported. The mission was informed by BKPM officials that some of these conditions could be adjusted for investors under certain circumstances.

4.06 The new DSP also explicitly recognizes the Government's concern to provide opportunities to the weaker economic group. An explicit condition that this group must be involved in the production process is specified in numerous subsectors; in some cases, the subsectors are specifically reserved only for this group. Previous DSPs were not quite so explicit and, thus, facilitated the avoidance of the provisions requiring the involvement of the weaker economic group.

4.07 Furthermore, the previous (1978) DSP was divided, for both foreign (PMA) and the domestic (PMDN) investment, into four investment categories that ranged from open with incentives to completely closed. The decision to close a particular subsector was based on the BKPM's estimates of domestic supply and demand. Partly in response to the argument that demand and supply for each product cannot be fine-tuned, this classification of investment categories has now been abandoned; activities not included in the 1980 DSP list are, however, not necessarily closed; they may be open but without incentives, closed or not yet classified as either. Furthermore, subsectors are now eligible for either tax holidays or investment incentives; the magnitude of these incentives depends upon the priority accorded to the subsector. The DSP, however, does not state which of the two types of incentives is more attractive and, taken together, the pattern of incentives is not suggestive of clear priorities in terms of industrial sectors.

4.08 Firms that do not register with the BKPM, and, therefore, do not seek tax and investment incentives, may simply register with the provincial Department of Industry; these "non-facility firms," which include the majority of small- and medium-sized firms and an unknown proportion of large firms, fall into the BRO sector. The BRO law, thus, provides the legal foundations for much of the production and capacity licensing.<sup>/1</sup> Under this law, a license is required for new investment as well as for the expansion of existing firms.

4.09 Until 1957, when Government Regulation No. 1, 1957 was introduced, licensing procedures were based on the BRO alone. This new legislation provided the Minister of Industry with additional powers to determine licensing procedures, and, subsequent to 1957, the licensing system was revised several times. The Foreign and Domestic Investment Laws, passed in 1967 and 1968, established new licensing procedures and resulted in the demarcation of BKPM-approved firms from those in the BRO sector. In recent

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<sup>/1</sup> The BRO and associated legislation is mainly applicable to the non-BKPM private sector. Recent developments indicate that the provisions of the BRO will form the basis for significant changes in policy in the next few years. Annex 3, therefore, looks at the Law, and the provisions that flow from it, in some detail.

years, the BRO and the amended legislation has permitted the regulation of an increasing number of sectors. Now, most light industries which are not categorized by the Ministry of Industry as "small" and which choose not to register with the BKPM are required to obtain a license for new investment and capacity expansion under the BRO and subsequent amending laws.

4.10 In addition to the licenses required either through the BKPM or through the Ministry of Industry (for the BRO sector), firms must obtain a range of other licenses such as trading licenses for internal and external trade, an environment license, a health license and a labor safety license. If firms engage in more substantial activities, then the number of licenses required rapidly increases. For example, firms operating motor vehicles to conduct their business need licenses to do so. It was noted that one cement manufacturer and associated distributing agencies required at least a total of 24 licenses to conduct business. These included, inter alia, licenses for construction, location, communication, export and import, interisland trading, central and regional trading, route clearance, distribution and motor vehicles. The manufacturer required 13 licenses, the transporter 5 and the distributor 6. The validity of these licenses ranged from 3 months (Road Transport Dispensation) to 30 years (Industrial License)./1

4.11 There are several controls on trade in particular sectors. A range of licenses is required to conduct internal trade. These licenses are issued by the Ministry of Trade and are required for the purchase of inputs which are closely regulated in many industries (e.g., the kretek cigarette industry), and the sale of output where the distribution of the product is controlled, as in the cement industry. Furthermore, foreign (PMA) firms are forbidden to enter into any distribution and marketing activity except for inter-industry sales; they must enter into agreement with domestic firms and, where possible, with economically weak firms. External trade is rigidly controlled and several licenses are required for import and export activities; e.g. for imports of second-hand machinery. Prior to September 1979, there was a total ban on such capital goods, but after that time, 36 selected items specified by BTN number could be imported subject to various conditions./2

4.12 In principle, all firms must also obtain environment and health licenses which are available from the local municipal authorities. These licenses are issued after several different agencies (e.g., water, fire and

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/1 The mission was able to compile only a partial list of these 24 licenses. See Annex 3, Table 3, for the issuing authority and the validity of each license.

/2 See Annex 3, Table 4 for details.

health) are satisfied with conditions at the site. However, once the licenses have been issued, regular inspections of the factories are not made. In many cases, the official requirements specified in these licenses are only honored in the breach. The same is true of labor legislation which regulates working hours and factory working conditions.

4.13 Often, additional regulations are specified by local or regional governments which require manufacturers to obtain permits of various kinds. The numbers of regulations of this sort are numerous and difficult to compile. Examples of such regulations include decrees to control industrial waste products (introduced in Jakarta in mid-1977) and establishing standard measurements to be used in the garment industry in the Jakarta area (introduced in February 1980). Many other regulations of this sort have been issued for the Jakarta area alone, and the total number issued throughout Indonesia is quite substantial. The manner in which these various regulations are implemented is discussed in paras. 4.22-4.28. But first, the official justification for the different licenses, the necessary procedures to obtain them and the allocation criteria are discussed below.

#### The Objectives of Industrial Controls

4.14 An overriding concern of the Government is the "orderly" development of the industrial sector so that private decisions made by businessmen may be made consistent with the social interests of the nation. Within this framework, the major objectives of the licensing system may be broadly divided into economic and social/political objectives. Table 4.1 lists 13 important licenses which must generally be obtained and the main justifications for each.<sup>/1</sup> Many of the objectives listed are similar to those advanced in other developing countries that have used licensing systems; some of these are discussed below.

4.15 The economic objectives include: (a) the allocation of scarce resources to conform to predetermined priorities and plans; this justification arises from the perceived inability of the market mechanism to allocate these resources in a socially optimal manner; (b) the prevention of excess idle capacity; (c) the prevention of market structures from becoming monopolized; simultaneously government officials also wish to maximize the benefits to be achieved from economies of scale that are important in some industries; (d) the encouragement of regional development, especially in the Other Islands; the licensing system, through the DSP, is used to impose restriction on entry into certain industries in some areas, particularly in Java, so that employment opportunities are created in the rural and semi-urban parts of the country; (e) increasing the domestic value-added content of exports; for example, licenses are used to encourage the domestic processing of logs; (f) the encouragement of the use of modern technology; the import controls on

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<sup>/1</sup> As mentioned earlier, the total number of licenses and permits in existence is considerably more.

Table 4.1: MAIN LICENSING CONTROLS AND THEIR OBJECTIVES

Aspect of industrial activity controlled	Main Objectives
Product to be produced (entry banned in some sectors)	Market structure; basic industry; promotion of the weaker economic group
Capacity & production level	Market structure
Ownership arrangements	Promotion of the weaker economic group; indigenous ownership and management control
Location of plant	Regional development; market structure
Cooperation arrangements (with local firms & cooperatives)	Promotion of the weaker economic group
Internal trade (marketing, transport)	Promotion of the weaker economic group
External trade: imports	Market structure; promotion of the weaker economic group
External trade: exports	Guarantee of domestic supply; export substitution; quality control
Import of second-hand equipment	Encourage use of modern technology; avoidance of multiple types of outdated equipment
Labor (wages, working conditions)	Protection of employees
Intended market (domestic or export)	Balance of payments; employment; protection of domestic market structure
Funding arrangements	Promotion of the weaker economic group; balance of payments; indigenous ownership and management control
Foreign staffing	Promotion of the weaker economic group; employment; indigenous ownership and management control

second-hand equipment are, therefore, intended to prevent a multiplicity of different types of outdated equipment for which spare parts availability could be a problem; and (g) quality control.

4.16 In addition, the Government also has many social and political objectives which it wishes to attain through the licensing system. Among others, they include: (a) the development of basic industries; capital-intensive sectors such as petrochemicals, steel and fertilizers are regarded as key sectors, and their control by the Government is considered to be essential for purposes of national prestige; private sector participation is either forbidden or permitted only under very close government supervision;<sup>/1</sup> (b) the promotion of the weak economic entrepreneurs; this is an important objective of the Government and a number of licenses are justified on this ground; (c) indigenous ownership and management control; several controls are instituted to protect Indonesia from dependence on foreign sources of supply; and (d) the guarantee of domestic supply; this is related to the previous objective; a number of export controls were imposed in the wake of the devaluation to ensure that domestic supplies would be sufficient.

#### The Procedures to Obtain Licenses

4.17 The procedures to obtain specific licenses (Tables 4.2)<sup>/2</sup> are clearly enunciated by the BKPM and in the BRO provisions. Under the current system, most of these licenses can be obtained from the BKPM (which has now become a "one-stop" agency) and the official processing time for each license ranges from one to ten weeks. Regional licenses which are also required, can be obtained from provincial government offices; officially, they should be available within ten weeks. Finally, once the projects are implemented, investors are required to report their progress annually to the BKPM.<sup>/3</sup> In practice, this reporting system does not work well because many investors provide little information or do not report at all. Furthermore, any subsequent changes to the projects, except extremely minor ones, must be approved by the BKPM prior to their implementation.

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<sup>/1</sup> In many countries, such as India, this objective is often referred to as the control of the "commanding heights" of the economy. Recently, the Government has adopted a policy of encouraging private foreign investment into these capital-intensive sectors. There have also been some signs that the Government may permit increased domestic private sector involvement in these industries.

<sup>/2</sup> The procedures for obtaining licenses, their function and time and conditions of issue are discussed in Annex 3.

<sup>/3</sup> In the pre-production phases, investors must report on their progress every six months.

4.18 The procedures are relatively simpler for firms that register under the BRO provisions. Most firms under this set of provisions are regulated by the Directorates General of Miscellaneous Industry or of Small Industry in the Ministry of Industry. Firms falling under the Directorate General of Small Industry are merely required to register with the local Department of Industry; this does not involve the granting of a license, and agreement to the operations of these firms is automatic and the procedures simple.

4.19 Currently, there is a move to centralize procedures for all BRO firms in the Ministry of Industry as part of a wider effort to set up an Investment Priority List for firms in the BRO sector. The main purpose is to prevent excess capacity in such firms through Government estimations of supply and demand, and may well be the most significant extension of the licensing system in recent years. In addition to the investment licenses, all firms in the BRO sector (excluding small firms which are often ignored by the authorities) must obtain several additional licenses (para. 4.10). Unlike the BKPM "one-stop" system, these firms must obtain their licenses from the different local municipal authorities such as those of Trade, Labor, Health and Finance.

#### The Criteria for Allocating Licenses

4.20 Given the wide array of licenses, the criteria for their allocation vary. It is, however, possible to isolate three main criteria which apply to most types of licenses. The first is the eligibility of the applicant given the existing market situation; this criterion applies to investment licenses issued through the BKPM or under the BRO provisions, land permits and import and export licenses. The conditions of eligibility are clearly stated and, thus, few applications are made which would result in their outright refusal. For example, if a particular sector is "saturated," the BKPM will not normally issue new licenses; once this fact is announced, investors rarely apply for approval.<sup>/1</sup> Other licenses, such as environment and internal/external trading licenses are available to all qualified applicants.

4.21 Once the applicant is entitled to carry out an activity, the second criterion is whether the applicant is a member of the weaker economic group, or in the case of a foreign investor, if the applicant has appropriate indigenous Indonesian affiliations. It is government policy that the economically weak entrepreneurs are to be favored and this is explicitly stated in the conditions of issue of several licenses in the 1980 DSP. The third criterion is that licenses are allocated on a first-come-first-served basis. This criterion has implications for sectors in which the Government

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<sup>/1</sup> In practice, the objective of avoiding over-capacity by forecasts of demand and supply is taken seriously at the national and the regional level. For example, in one province, government officials explained that all ice factories and copra plants must be licensed to avoid oversupply. For the ice factories, demand is estimated on the basis of per capita income and the income elasticity of ice; it is argued that this approach permits local Industry Department officials to regulate entry to the industry.

Table 4.2: LICENSES AND PERMITS ISSUED BY THE BKPM

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License/permit
<u>APPLICATION AND EVALUATION STAGE</u>
1. Provisional Letter of Approval
2. Letter of Final Approval Presidential approval is needed for foreign (PMA) projects
3. Statement of Incentives
4. Temporary Operating Permit
<u>BKPM LICENSING STAGE</u>
5a. Limited Domestic Purchase Permit. For foreign (PMA) projects only.
5b. Limited Domestic Trading Permit. For domestic (PMDN) projects only.
6. Limited Import License
7. Machinery Imports Permission
8. Raw Material Imports Permission
9. Recommendation for Letter of Credit
10. Import Clearance Statement. Combining (a) Tax Clearance Certificate and (b) Customs Clearance License.
11. Visa Recommendation Letter. For foreign personnel.
12. Work Permit and Decree. For foreign personnel.
13. Permanent Operating License
14. Final Statement on Tax Facilities
15. Limited Export License
<u>REGIONAL LICENSING STAGE</u>
16. Location Approval License
17. Right-to-Use Land
18. Building Permit
19. Environment License. (Under the Disturbance Act of 1926.)
20. Land Certificate

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Source: Annex 3, Appendix 1, Table 2

wishes to control excess capacity, but it has no bearing on say, distribution activities. There are no established formal economic criteria to allocate licenses; the BKPM, however, is moving in that direction.

#### The Regulatory System in Operation

4.22 The licensing system discussed above does not appear to be very different from those in other developing countries or in the developed mixed economies. But the actual operation of the system is, in fact, quite complicated, cumbersome and time consuming. These characteristics derive, not only from the numerous licenses required per se, but also from the detailed documentation that is a strict precondition. For example, many firms complained about the complex and inflexible procedures associated with the machinery and equipment master list for importing equipment. This list requires very detailed information on every piece of equipment. Consequently, the number of completed pages in this form can vary from 25 to over 100.

4.23 After submission of this master list to the BKPM, the time involved in its processing and until the machinery finally arrives at the port can be quite long; in some cases, it exceeds 18 months. Since considerable time elapses between the BKPM's approval and the actual importation of items, firms often make adjustments to these items. Most modifications to an approved project require further BKPM approval; the mission has documented 15 modifications for which reapproval from the BKPM is required. Examples of such changes requiring approval are: change in the company name, in the management structure, in the approved machinery and equipment master list, in the use of funds and in the date of trial or commercial production as well as obvious changes such as changes in products produced, capacity, technology and location. Such changes usually occur for reasons of unavailability, of unexpected price changes, or simply new and better information. The time required to get new BKPM approval for the substitution of one item for another can be as long as one year. In some cases, investors import the new items, pay the duties and then attempt to have them reimbursed. But it has been claimed that, under these circumstances, there is little incentive for the BKPM to approve the replacement; many investors have found this to be a costly procedure and, thus, attempt to settle the duty exoneration prior to customs clearance.

4.24 The process of BKPM clarification of regulations and issues also tends to be slow; BKPM rulings on simple matters often require six months. Furthermore, it is widely reported that these rulings are not always clear and it is not unusual for them to be overruled by the specific ministries concerned.<sup>/1</sup> Despite the availability of standard forms, the procedures remain complex because with each modification several additional documents in multiple copies must be submitted. Similarly, in the BRO sector, where the procedures are relatively straightforward, it is in the preparation of the documents required by the Ministry of Industry that difficulties

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<sup>/1</sup> The BKPM is also heavily dependent on other government agencies and departments for its staff.

arise./<sup>1</sup> More often than not, these documents are either not easily available or are very difficult to prepare. An example of the former is that tax receipts may not have been issued; documents difficult to prepare include a list of all equipment used, with meticulous details of make, place, year of manufacture, and capacity. The sheer volume of paper work involved is, therefore, extremely large.

4.25 The import procedures cause considerable difficulty, but so does the precondition of obtaining an import license from the BKPM or the Ministry of Trade and Cooperatives; this in itself requires considerable documentation. Once this license is obtained, there still remains the difficult process of moving goods through the ports. Despite the reforms instituted by the Government to facilitate the process, problems still exist. The mission was provided with a list of the numerous steps required to import goods through the ports; some of these may, of course, be justified whereas others may be of questionable value./<sup>2</sup> Approvals must be obtained at many stages and the absence of one signature can halt this process. Moreover, the officials are often short of staff and overworked. Importers regard the system as being extremely cumbersome and many stated that the process could be (or had to be) circumvented through illegal payments; these were accepted as the costs of doing business. Many importers have begun using import-export expeditors to deal with the customs. The fees paid to these expeditors is dependent on the volume and the nature of the item to be processed through customs.

4.26 Manufacturing firms must also have regular contact with tax officials in order to obtain letters or permits for say, methods of inventory valuation or to obtain tax relief. The tax laws are vague and it is difficult to obtain clarification from tax officials; this has led to several complaints from businessmen and accountants. Again, the characteristics of taxation regulations necessitates, in the opinion of many businessmen, illegal payments; these are made when taxes are negotiated with the assessors. The Government has recognized many of these problems and has made significant efforts to improve the situation (para. 4.41). However, according to senior officials, a major stumbling block to effective reforms is the current salary structure of civil servants empowered to assess taxes. Officials, however, also face considerable difficulties in the assessment of taxes; they include the fact that taxpayers often keep multiple books in order to avoid paying the appropriate taxes and the numerous problems inherent in the taxation process such as those associated with the definitions of particular terms. The March 1979 reforms (para. 4.40) were undertaken to improve the business climate and the extent of compliance with these new regulations by domestic and foreign firms has been high; however, the shortage of certified public accountants in Indonesia remains a constraint to the implementation of tax regulations. The universities in Indonesia are, however, attempting to increase the supply of accountants and there are special training facilities for accountants within the Ministry of Finance.

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<sup>1</sup> Annex 3 gives specific examples.

<sup>2</sup> See Annex 3, Appendix 1, Table 5. This table provides a simplified list of the steps required to be undertaken.

4.27 In recognition of the many complaints received from businessmen about tax procedures, the Government informed the mission that effective communication between the taxpayers and assessors often stemmed from the fact that taxpayers tended to formulate their problems in very general rather than specific terms; this, according to the officials, made tax rulings very difficult. They, however, emphasized that senior tax officials are more than prepared to clarify tax regulations, particularly if confusions arise at the lower levels of the bureaucracy.

4.28 Enterprises also experience considerable difficulties in obtaining the mandatory Environment License. In some cases, the firms operate on temporary licenses which are repeatedly extended. In others, the licenses have taken several years to obtain and the firms are thus often conducting their operations illegally and can risk fines up to Rp 650,000 (about \$1,000). For instance, one businessman in West Java had applied for this license in 1965; he had reapplied in 1967, 1970 and in 1973 without receiving an official reply. As of end 1978, his license had not been issued. Another large investor informed the mission that he had operated for seven years without being aware of the requirement of the Environment License. He had finally applied for one in early 1977 and after submitting numerous documents, he had still not received his license as of February 1980. In addition to obtaining this license, firms must also comply with provincial regulations on pollution; these regulations are often published long after they come into effect. For example, the one on industrial waste products in Jakarta was issued in mid-1977 and published in mid-1978 in a private newsletter. This makes it difficult for firms to comply with regulations, yet they are liable to be closed down for noncompliance. Businessmen have encountered similar difficulties with most other licenses.<sup>/1</sup> As a result, considerable uncertainty is generated among domestic and foreign investors.

4.29 The regulatory environment, as it now exists, has gradually developed over a number of years. The stage has now been reached where the licensing system is an extraordinarily legalistic and complicated bureaucratic maze. A major problem is that the laws and regulations are often couched in broad terms, and often, in ways that are ambiguous or are unsuited for the current industrial structure. Consequently, several regulations require more clarifying regulations and, therefore, it is common for even minor officials to interpret regulations. Furthermore, the system is designed so that some licenses are dependent on other licenses, which, in turn, depend on yet others. Thus, officials often tend to cut through the delays by granting exemptions or making additional policy pronouncements. For example, a senior local official, on discovering that a factory had been partly constructed without a Letter of Final Approval, first ordered the construction to cease, and, after discussions with the factory owner, reversed that decision on the understanding that if this license were not granted, construction would have to be stopped. While this permits some flexibility, it also generates considerable uncertainty, as confirmed by many businessmen, and adds to the scope of personal discretion available to officials. Many businessmen discussed with the mission their difficulty in

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<sup>/1</sup> Annex 3 provides specifics and detailed examples of problems caused by many of these regulations.

keeping abreast of the regulations. Interviews with officials in Jakarta and the regional offices indicate that they have a similar problem; thus, regulations are implemented in an ad hoc manner with officials doing their best to keep up with changing requirements. Furthermore, the extensive and detailed documentation required precludes officials from making appropriate checks and careful decisions; in practice, only a cursory check is made, thus, frustrating many of the objectives of the Government.

#### The Economic Implications

4.30 The previous section highlighted some of the difficulties associated with obtaining a license or complying with the regulations. We now turn to the effectiveness of using administrative controls in attaining their stated objectives. The question addressed in this section is: has the licensing system been successful in attaining the objectives of the Government or has it, in fact, unintentionally enhanced the state of affairs it was initially designed to discourage?/1

4.31 Industrial licenses designed to control excess capacity by the fine-tuning of supply and demand do not appear to have succeeded. Indications are that excess capacity exists in many industries./2 It does so for a number of reasons including macroeconomic conditions, fluctuations in demand and the existence of incentives such as protection, low interest rates and tax holidays./3 Whatever the reason, the licenses, through barriers to entry, protect firms that would otherwise fail. Given the first-come-first-served allocation system, the earliest firms to enter an industry may not be the most socially efficient. The benefits to such firms of government-erected barriers is demonstrated by the support given by existing firms to such licenses. The support exists because firms that have undertaken the fixed costs of mastering the complexities of the licensing system have a significant edge over potential entrants and are able to earn profits sufficient to cover the costs associated with the effort required to obtain these licenses. For example, in April 1980, the chairman of a major manufacturer's association called on the Government to take more care in issuing licenses, saying that 60% of capacity in the particular sector was unused. He warned that the indications were that a "sharp competitive situation" was emerging, and that "unhealthy competition" might result./4 Such barriers, and the first-come-first-served criterion, discriminate against smaller firms that do not have the resources to master the complexities of the system. This is particularly true for the firms

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/1 The implications of the licensing system on credit availability are discussed in Chapter 5.

/2 The mean value of capacity utilization in the manufacturing sector (6,758 firms) in 1974/75 was 28.18%. That in the private sector was 33.21% (in foreign firms) and 27.18% (in domestic firms); that of public manufacturing firms was 36.36%. See Chapter 2.

/3 This last is a case of government intervention (licensing) to counteract the effects of other government policies.

/4 See Business News, No. 3440, April 25, 1980.

owned by the weaker segments of society that need assistance and should not be discriminated against by the erection of such barriers. The BKPM is, however, aware that existing firms are not disinterested parties and that they have much to gain by the presence of such barriers to entry; the agency is, therefore, planning to undertake a major supply and demand survey in 1980 to determine the true state of affairs and this information will be used to allocate licenses. It is, however, not clear that this is the best approach or whether it will solve the problem (para. 4.40).

4.32 The available evidence indicates that, in general, market structures have not been monopolized by private firms. There are indications, however, that in some sectors only a few firms contribute to over 70% of the value-added.<sup>/1</sup> It, therefore, appears that the licensing system may have been partially successful in preventing monopoly control in some sectors. To the extent that licenses have been effective in preventing monopolies through the restriction of capacity expansion, they may have been too "successful"; there is evidence of fragmentation of firms in Indonesia. For example, in the food manufacturing sector there were (as of 1974/75) 1218 private domestic firms - i.e., 84% of all firms in that sector - producing 42% of total output and contributing to 30% of total value-added. This same phenomenon manifests itself in the machinery, cement and the paper and paper products sectors. This implies that the licensing system may be restricting firms' sizes to less than the optimal level.

4.33 It also appears that the objective of regional development, using the licensing system, has not been achieved. Despite the various incentives provided by the BKPM to locate outside Java, there has been little regional dispersion of industry to the Other Islands; in fact, 84.8% of the private sector manufacturing firms were located in Java as of 1974/75.<sup>/2</sup> This is because an industrial license acts as a one-edged sword; it can proscribe entry into Java but, by itself, cannot stimulate investment in the Other Islands. The geographical centralization of firms arises from their access to government officials in Jakarta, proximity to the major financial institutions and related, input producing industries, superior transportation and communication facilities and access to ports. Paradoxically, the day-to-day contacts with various Government agencies necessitated by the regulatory system also acts as a powerful disincentive to regional dispersion.

4.34 Quantitative import controls appear to be partially successful in restricting imports. Their use may be justified when indirect measures are too slow or under special circumstances, but such occasions are likely

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<sup>/1</sup> For example, quasi-monopolistic market structures appear to exist in the glass and glass products, and the nonferrous metals sectors. As of 1974/75, four firms contributed to 70.5% of the total value-added in the glass and glass products sector. In the nonferrous metals sector, 5 firms contributed to 80.5% of the total value-added.

<sup>/2</sup> The regional dispersion of private domestic firms is as follows: West Java: 23.0%; Central Java: 22.8%; East Java: 24.2%; Jakarta: 12.6%; Yogyakarta: 2.2%; Sumatra: 8.1%; Kalimantan: 2.3%; Sulawesi: 2.4%; Nusatenggara: 2.1%; and Maluku Irian: 0.3%.

to be infrequent and in most cases, their imposition can lead to high economic and social costs; this is particularly true if the initial justifications for their imposition have been overtaken by events, thus, invalidating their prolonged use. Economic problems caused by continued use of import controls, include increases in: (a) the incentive to smuggle; (b) delays in clearing imported goods; (c) the costs of holding larger amounts of inventories; (d) the costs of imports through illegal payments at the port and the foregone interest of holding goods there; and (e) uncertainty. All these contribute to increasing the cost of the final product produced domestically and often result in the loss of export orders./<sup>1</sup>

4.35 Export controls appear to have been effective in guaranteeing domestic supply at what the Government considers to be reasonable prices, but they also impose high social costs in order to generate short-run benefits. The erratic intervention in international markets increases uncertainty for exporters as well as for international consumers with resulting damage to Indonesia's reputation as a dependable supplier. For example, the recent decline in domestic supplies caused by the devaluation, which necessitated many export quotas, could have been viewed as a short-run phenomenon which could be ameliorated by increased imports; long-run supplies could then be ensured through the rapid expansion of new capacity. Clearly, there are short-run benefits from using export controls, particularly in special circumstances such as adjustment periods following a devaluation, but their continued use is of doubtful value. Furthermore, the cost of the short-run relief must be measured in terms of new export capacity not created by this distortion of incentives, and by the uncertainty about long-run export policy generated by "switching" signals to entrepreneurs; export quotas may, in fact, negate the beneficial impact of the devaluation.

4.36 There is some evidence that the controls on the use of second-hand equipment have been effective in preventing investors from using such machinery. But these controls limit the range of capital goods available to entrepreneurs; they also encourage the use of new machines, which may be socially inappropriate and inefficient for Indonesia, through the incentives offered by the BKPM. Moreover, some smaller firms that cannot afford new machinery and, consequently, do not qualify for the BKPM's investment incentives are forced to pay a price for second-hand machinery that is inflated by the market distortion imposed by these controls. This phenomenon is very noticeable in the case of textile machinery. As a result of this policy, the choice facing such firms is either to purchase sophisticated new machinery or to pay a domestically inflated price for more appropriate second-hand equipment. The door is essentially closed to cheaper, more appropriate, labor-intensive technologies; this in turn, has negative implications for employment generation and inflation.

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/<sup>1</sup> A detailed discussion associated with the problems of quantitative controls in several countries is given in J. Bhagwati (1978). Anatomy and Consequences of Exchange Control Regimes, published for the National Bureau of Economic Research by Ballinger Publishing Company, Cambridge, Mass.

4.37 It can, therefore, be concluded that some licenses are ineffective and some partially effective in achieving their goals. All, however, impose a high social cost that Indonesia can ill-afford to carry and, unfortunately, many of these costs are borne by the economically weak firms and entrepreneurs for whom part of the system was originally designed to support, but unintentionally does the opposite. These costs, for example, include biases in favor of large firms and against the smaller enterprises; the necessity of an enormous bureaucracy to administer the system; the resulting diversion of skilled manpower into essentially nonproductive activities; long delays; the uncertainty engendered by the system; foregone employment; and illegal payments. All of these militate against the productive growth of manufacturing output. Many businessmen indicated to the mission that were it not for the regulatory environment, the costs of producing manufactured goods in Indonesia would be the lowest in South-East Asia.

4.38 These costs, however, are not unique to Indonesia; in fact, problems in countries that have used licenses to promote industrialization are strikingly similar. These problems have been identified in countries as diverse as those of Brazil, India, Egypt, Spain, and Mexico. In all cases, the licensing system has given rise to a variety of economic costs and to very few of the expected benefits. This realization led to the relaxation of the system in Spain (in 1963) and to its elimination in Taiwan (in 1954). Some countries have made attempts at fine-tuning the system, but without much success.<sup>/1</sup> In the Indonesian context, given the quantitative dimensions of the regulatory system, the economic costs may be particularly significant. The recent decline in the real growth rate of the manufacturing sector (para. 2.10) is indicative of the need to increase the supply response of private firms. Otherwise, the foregone benefits of this regulatory system will continue to be reflected in the high cost of the output and a resulting loss in international competitiveness. Clearly enunciated and effectively enforced regulations are obviously essential if the industrial environment is to attract investors. Vague and conflicting regulations can generate considerable uncertainty; there is, therefore, an urgent need to create a regulatory environment designed to lower uncertainty and inspire investor confidence.

#### Government Policies to Remedy the Situation

4.39 The Government is aware of the difficulties inherent in the present regulatory environment and has made many efforts to reform the system. The BKPM has been reorganized several times to improve its efficiency, most recently in 1978 and 1979 and, from the investor's point of view, the situation is much better than three years ago. Some of these changes have included making the BKPM a "one-stop" agency; most of the licenses may now

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<sup>/1</sup> The experience of developing countries using direct industrial controls is discussed in detail in A.M. Choksi (1979) "State Intervention in the Industrialization of Developing Countries: Selected Issues", World Bank Staff Working Paper No. 341, The World Bank, Washington, D.C. Also see Annex 3.

be obtained from the BKPM rather than the various Ministries. Nevertheless, complaints about the functioning of this one-stop system still persist.<sup>/1</sup> Another important change is the attempt to introduce rational economic criteria in evaluating projects. The BKPM has also engaged a team of foreign advisors to assist in improving the efficiency and effectiveness of its operations.

4.40 Many of the changes undertaken at the BKPM have been aimed at streamlining the complex procedures and improving the supervisory machinery; although these changes have been relatively successful, they have not simplified the process. As the detailed specifications in the 1980 DSP indicate, the will to intervene at the very micro level is quite evident. The new detailed survey to be undertaken by the BKPM to estimate excess idle capacity (para. 4.31) also requires vast amounts of accurate information and a strong administrative apparatus. It is also likely that the "snapshot" view of the capacity situation will probably be rapidly outdated.

4.41 The Government is also aware of the discontent regarding the operation of the corporate tax laws. In March 1979, a series of reforms were introduced designed to improve the administration of these laws, of which the most important is the move towards encouraging the use of public accountants in drawing up annual corporate tax returns. This change is a very positive step and merits considerable encouragement; it should reduce the scope for negotiations between the taxpayer and government officials by introducing an element of certainty into the assessment process.

4.42 Procedures for clearing customs have also improved very markedly during the 1970s. The Government has instituted various reform measures on several occasions which appear to have had some positive effects. These reforms, again, have been more in the nature of streamlining rather than simplification: the current procedures still remain cumbersome and time-consuming, as evidenced by the numerous steps required to clear goods (para. 4.25).

4.43 Attempts have also been made within the Ministry of Industry to improve licensing procedures. In August 1979, a special team was appointed by the Minister to investigate the problems of the licensing process; this team is expected to make detailed recommendations for improvements. The Ministry is also under instructions from the Minister to simplify forms and procedures wherever possible. Primarily because of the problems mentioned earlier, there is a consensus developing in this Ministry for legislation that will provide a legal basis for the official administration of the industrial sector.

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<sup>/1</sup> As recently as the end of March 1980, the Minister of State for Administration Reform, Dr. Sumarlin, said that there were still cases of businessmen being sent around by officials from office to office in a "ping-pong" fashion, and that he hoped that the aim of having the BKPM function as a true "one-stop" bureau could be achieved; see Kompas, 1 April 1980.

4.44 The Government clearly has the ability to simplify regulatory procedures if it is committed to so doing, as demonstrated by the substitution of the cumbersome duty drawback scheme by the recently introduced export certificate system (para. 3.10). Steps are, in fact, also being taken to improve the regulatory environment in various branches of the Government, but much remains to be done; specific long-run and short-run suggestions are made in Chapters 7 and 8, respectively. They focus on the legal system, the taxation process, investment and other licenses, and the investment priority list.

## 5. THE EFFECTS OF FINANCIAL POLICIES ON INDUSTRIAL DEVELOPMENT

### Introduction

5.01 The importance of increasing manufacturing output, of lowering the costs of production and preventing the erosion of Indonesia's international competitiveness have been emphasized in the last two chapters. Financial policies also affect the behaviour and the supply response of firms. Moreover, these policies complement other industrial policies such as those relating to the incentive structure, trade regime, regulatory environment, and foreign investment. This chapter, therefore, focuses on analyzing the implications of the financial policies formulated in Indonesia and their effects on industrial growth.

### The Structure of the Financial Market

5.02 The Indonesian financial sector is still in the early stages of development. The sector comprises a commercial banking system which is dominated by five state-owned commercial banks and regulated by the central bank, Bank Indonesia. In addition, there are 79 private national commercial banks; 10 foreign and 1 joint-venture bank; 49 representative offices of overseas foreign banks; 26 regional development banks; 1 state-owned development bank; 1 state-owned savings bank; 4 private savings banks; 3 development finance companies; 8 investment finance companies; 66 insurance companies; 33 pension funds; a credit insurance company; and an inchoate capital market with four issues listed on the Jakarta stock exchange. Furthermore, there are several village, paddy and market banks scattered throughout Indonesia.<sup>/1</sup> Despite the apparent diversity of institutions, those owned by the Government dominate the financial sector. The latest (March 1979) balance sheets indicate that Bank Indonesia and the deposit money banks (i.e., the commercial and development banks) account for over 96% of the gross assets of all financial institutions, while, the five state commercial banks account for almost 80% of the assets of all deposit money banks.

5.03 The state banks are also the major suppliers of credit to the manufacturing sector; as of November 1979, their share (including that of BAPINDO, the state-owned development bank) in total outstanding credit was about 85%, compared to about 9% for foreign banks and about 6% for private domestic banks. The share of the Regional Development Bcnks, the three development finance companies (IDFC, PDFCI and P.T. Bahana) and of the other institutions mentioned earlier is almost negligible.

5.04 The asset structure is characterized by a dearth of long-term credit; short-term credits (of maturity less than one year), as of November 1979, were estimated to be about 77% of all credit to the manufacturing sector; this includes credit, denominated in both rupiah and foreign currency channelled through the banking system, for production, exports and imports.

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<sup>/1</sup> Annex 4 discusses the financial major institutions, including the stock, money, and bond markets, in some detail. Since most sectors of the economy are financed through the same institutions and under the same policy regime, this annex also has relevance to the non-manufacturing sectors of the economy.

Though no formal distinction is made between the economically weak and strong borrowers in the terms and conditions of these credits, priority is given to the economically weaker segments of society, particularly to those involved in exports. The paucity of long-term instruments has led to the roll-over of short-term credits; some estimates suggest that between 70% and 90% of all short-term credits are rolled over. Consequently, these credits have become an important source of financing investments.

5.05 Various programs have been instituted which provide long-term credit to the manufacturing sector; e.g. the KIB program for medium and large enterprises, and the KIK/KMKP program for small enterprises. Long-term manufacturing credit, which includes that denominated in rupiah and foreign currency, accounts for about 23% of all credit to the manufacturing sector (as of November 30, 1979). Of this credit, 60% is allocated to two large government-sponsored, capital-intensive projects, Krakatau Steel (46%) and PERUMTEL (14%); 29% to medium and large enterprises (KIB); 6% to the small enterprises (KIK/KMKP); and 5% to the development finance companies, IDFC and PDFCI./1

5.06 The KIB program, instituted in April 1969, provides term credits of up to 15 years, at 10.5% to 13.5% rate of interest depending on the size of the loan. Currently, this program is restricted to the economically weak borrowers, but prior to 1974, the economically strong borrowers also had access to KIB funds. KIB is a major source of institutional capital for financing industrial investments, yet its share in total credit outstanding to the manufacturing sector is low, about 6.5% as of November 1979. Moreover, over the period 1975 to 1979, the share of credit allocated to manufacturing firms from the KIB program has been declining, from 44% to 35%. At the same time, the share of public sector manufacturing loans has been rising steadily; it now accounts for about 54% of all KIB manufacturing loans and the private sector share has correspondingly declined. Furthermore, in absolute nominal terms, KIB loans to the private manufacturing sector have declined from Rp 55.3 billion in 1975 to Rp 51.5 billion in June 1978, while KIB loans to the public manufacturing sector have increased over the same period from Rp 23 billion to Rp 61.5 billion./2 This, in part, reflects, on the one hand, the difficulties state banks continue to face in finding suitable economically weak entrepreneurs, and on the other, institutional constraints in evaluating potential borrowers.

5.07 The KIK/KMKP program, instituted in December 1973, provides investment credits for small-scale enterprises. The KIK program provides credits of up to 10 years, at 10.5% rate of interest, for financing fixed investment. The KMKP program provides credits of up to three years, at 12%

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/1 Krakatau Steel and PERUMTEL are examples of the Pertamina projects that the Government had to take over as a result of the Pertamina crisis.

/2 See Annex 4, Table 10 for KIB investment credits by public and private sector.

rate of interest, for financing permanent working capital./1 The maximum credit size under either program is Rp 10 million for initial loans and Rp 15 million for repeat loans. Both programs are restricted to the economically weak borrowers. The KIK/KMKP program is the major source of institutional finance for small-scale enterprises in all economic sectors; the share of manufacturing KIK/KMKP credits as a proportion of total KIK/KMKP credits has, however, been declining in recent years and, at the end of 1979, it was only 12% for KIK and 13.5% for KMKP. KIK/KMKP outstanding manufacturing credits have also been declining as a proportion of total manufacturing credit in Indonesia, and only represented 1.4% of all outstanding credit to the manufacturing sector as of November 30, 1979./2

5.08 Finance for industry from foreign sources can be divided into foreign official borrowings and foreign private borrowings. As of the end of 1978, total outstanding foreign official borrowing for the manufacturing sector was \$1.49 billion, of which 23.3% was from multilateral sources and 76.7% from bilateral public and private sources. Data on foreign private borrowings, however, is virtually non-existent./3 No restrictions are placed on the size of overseas borrowing by private companies based in Indonesia nor are inflows and outflows of funds subject to foreign exchange controls.

5.09 In March 1980, the borrowing rate for one year foreign money for a large firm with good overseas connections and good overseas collateral was at most 5% over SIBOR./4 Small, economically strong firms meeting the above criteria, were, however, paying 15-20% over SIBOR, while small, economically weak and strong firms with no overseas connections or collateral have found it extremely difficult to borrow from such overseas sources. Offshore collateral is important as it is illegal for Indonesian land to be owned by foreign-owned institutions and because it is extremely difficult for foreign-based banks to recover bad debts through the Indonesian legal system. As a consequence, small but economically strong firms have often had to rely either on borrowing from private Indonesian banks or on reborrowing funds from large economically strong firms which have previously

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/1 Defined as working capital permanently employed in an enterprise working at close to full capacity.

/2 Annex 4 provides a detailed assessment of the KIB and the KIK/KMKP programs.

/3 One estimate (Berne Union) of total foreign currency private sector debt outstanding for all sectors, including suppliers' credit, is about \$5.5 billion. There is, however, no information available on short-term credits from abroad. There is a requirement that they be reported to Bank Indonesia, but it is not enforced; information on long-term credits is not well-documented.

/4 The Singapore Interbank Offering Rate (SIBOR) was around 15% in March 1980.

borrowed these funds from overseas institutions. Consequently, some of these larger firms act as banks and are one of the more important sources of funds for the domestic informal financial market./1 Several sources have indicated that such borrowing is expensive and almost always under six months duration, forcing the smaller firms into only undertaking very short duration projects. Moreover, these funds carry no guarantees of roll-over and the foreign exchange risk is usually borne by the ultimate borrower. In addition, the fact that Indonesian banks are not permitted to guarantee private foreign bank credits imposes an effective constraint on the use of suppliers' credits from abroad.

5.10 In contrast, large, foreign-owned or joint-venture firms, are currently able to borrow funds at 1% to 5% over SIBOR for maturities of up to seven years. No foreign funding difficulties have been experienced by these firms, but rupiah borrowings have recently been in short supply as a result of credit ceilings imposed on domestically based banks. Demand for rupiah denominated credit has been high from both foreign and domestic economically strong firms ever since the devaluation of November 1978; this brought about a 50% increase in outstanding foreign currency debt obligations and raised fears of further devaluations. The recent high interest rates in international markets have since further increased the demand for rupiah funds.

5.11 The above discussion indicates that the financial policy environment is characterized by a number of factors such as, the predominance of state banks in the financial sector; the narrow range of financial assets; the importance of short-term assets in the total asset structure; the dearth of long-term financial assets and the embryonic state of the equity market. Furthermore, by international standards, Indonesia may also be considered to be "under-banked;" its ratio of bank branches to 10,000 population is 0.07./2 The country's liquid assets to GNP ratio (20%) provides further evidence that in comparison to other nations Indonesia's financial development is not very advanced./3 These factors furnish the background against which financial policy is formulated in Indonesia.

#### The Characteristics and Objectives of Financial Policy Formulation

5.12 The formulation of recent financial policy in Indonesia can be divided into two phases: the first covers the period beginning with the New Order regime in 1966 up to 1974; the second is the post-1974 period.

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/1 Information on the informal financial market is extremely scarce.

/2 The ratio of bank branches to 10,000 population for other countries in 1978 were: India: 0.44; Korea: 0.23; and Philippines: 0.22. In Indonesia, by including the village units of Bank Rakyat Indonesia, but excluding the non-deposit money banks, alters this ratio to 0.3; if all rural banks are also included, this ratio increases to 0.75.

/3 For other countries, the ratios of liquid assets to GNP in 1978 were: India: 43%; Korea: 36% and Taiwan: 76%.

The New Order regime, at its birth, encountered an environment characterized by economic stagnation, financial repression and instability. The policies instituted by this regime dramatically reduced the inflation (from 650% p.a. in 1967 to 9% in 1973), restored economic stability, and significantly alleviated the distortions in the financial markets. This remarkable success was the result of a reform in the exchange rate system which established the full convertibility of the rupiah, a balanced budget policy, high interest rates, and a return to a more market-oriented economy.

5.13 After 1974, monetary policies were characterized by a more administratively determined system designed to control credit expansion. The recourse to direct controls in 1974 was motivated, in part, by the stabilization objective; viz., to counteract the strong inflationary pressures that emerged after the oil and commodity price escalation, credit expansion and, in part, by the difficulty of using the rediscount mechanism as an additional instrument of policy because it was being used to achieve the Government's equity objectives. Because the budget did not sterilize a large part of the resource increase, aggregate demand built up rapidly to a level such that conventional indirect monetary measures proved inadequate to control the resulting inflation. Consequently, the regulated interest rate structure was only partially effective in controlling liquidity. Thus, credit ceilings were the only viable option open to the Government to control liquidity growth. But even after the inflation rate had been reduced from a high of 33% p.a. in 1974 to 7% p.a. in 1978, these policies remained in force. During this period, financial policy also became an instrument to promote social and equity objectives; viz., the encouragement of the economically weak entrepreneurial class. Consequently, a number of additional regulations were introduced which restricted access to many forms of credit, such as the KIB program, to the weaker economic investors only. Additional regulations were subsequently instituted as the Government attempted to reconcile its stabilization and equity objectives. These regulations, *inter alia*, related to foreign investment and the flow of foreign equity; fiscal incentives as they applied to corporate retained earnings; the structure of interest rates; the ownership of enterprises; the operations of different groups of banks; the merger of private domestic banks; and the creation of a stock market./1

5.14 Apart from the macroeconomic goals, financial policies were also undertaken to play a promotional role in the development of the industrial sector through the strengthening of the financial market and the maintenance of incentives to encourage the "financialization" of savings. More specifically, four important objectives of financial policies may be isolated: (a) the use of increased resources for overall development while maintaining price stability; (b) the allocation of credit to priority sectors including industry; (c) the promotion of the weak economic entrepreneurs; and (d) the creation of an institutional environment to increase the range of

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/1 These regulations are discussed in detail in Annex 4.

financial services. The first objective is a macroeconomic one and has obvious benefits to all sectors of the economy. The other three, however, have immediate relevance for industry, and constitute the interface between industrial and credit policies. The third objective also has special implications for resource allocation in the industrial sector; it raises the issue of the use and effectiveness of credit regulations as instruments of social policy designed to achieve social/political goals. The next sections analyze the various instruments used to achieve these objectives and the resultant impact on the industrial sector.

### The Instruments of Policy

5.15 The main instruments used by the Government to regulate monetary expansion are the budget, credit ceilings and reserve requirements. Of these three, the first is the most important one since it deals with the problem at the source which, currently, is the budget. The domestic expenditure budget has been the critical factor in determining liquidity growth. Even though fiscal restraint has been practised in the overall budget, the surplus generated was not adequate to contain liquidity growth.<sup>/1</sup> The most ineffective instrument, under current circumstances, is the reserve ratio requirement because it has essentially been nullified by the use of credit ceilings to control credit expansion. The growth - by over 600% between 1972 and 1979 - and size of the budget has meant increased public sector involvement in industry. Although there was a legal commitment to an overall balanced budget, the resultant inflationary impact of the (rupiah) budget was not fully neutralized; the pursuit of price stability thus prompted the Government to use overall credit ceilings and other monetary policies which were successful in containing inflation. These policies have, however, resulted in a larger allocation of credit funds to the public sector than to the private sector. For example, of the 35% increase in credit allowed for the fiscal year 1978/79, 52.7% was allocated to the public sector industries and 20.2% to the private ones.<sup>/2</sup> In addition, the nature of the Government's

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<sup>/1</sup> An overall balanced budget is not necessarily neutral in the monetary sense, and it is the domestic expenditure budget that is important for domestic stabilization policy; a deficit here, ceteris paribus, increase domestic liquidity. See Annex 4 for a detailed discussion.

<sup>/2</sup> For the economy as a whole, over the period 1973-75, commercial bank credit to the private sector declined by 6% in real terms, while that for the public sector increased by 49%. For details see Indonesia: Long-Run Development and Short-Run Adjustment, The World Bank, Report No. 2788-IND, February 20, 1980. Furthermore, in the first quarter of 1980, liquidity expanded at an annual rate of 42%; the total expansion amounted to Rp 800 billion of which only Rp 15 billion or 1.9% was made available to the private sector.

policies towards the foreign private sector may be seen in many additional regulations, for instance, in limiting private sector credit by restricting working capital credit to joint ventures at the April 15, 1979 level, eliminating the setting-off of interbank borrowings against bank ceiling requirements, and restrictions on private foreign bank borrowings from their own parent organizations abroad.

5.16 The allocation of resources to priority sectors and economic groups has been attempted through the use of a number of selective credit instruments. They include a mandated interest rate structure, and rediscount rates and proportions rediscounted. The differential nature of the last two instruments characterize special credit schemes such as the KIB and the KIK/KMKP program, export credits and Kredit Kelayakan. Until 1977/78, the Government also had ceilings for program and non-program credit. These ceilings were applied flexibly in the sense that requests for additional credit were favorably considered. The mission was informed by the Government that such ceilings or ceilings at the subsectoral level are no longer effective or applied.

5.17 Specific financial instruments are also used to direct credit to different segments of society, to firms of differing sizes and to firms involved in specific activities, such as exports. The KIB and KIK/KMKP programs are examples of schemes designed to support the weaker segments of the society; they also differentiate credit by size of firm. Additional financial policies to support the weaker segments of society manifest themselves in the restriction of all investment credit and of equity participation by BAPINDO, P.T. Bahana and the Regional Development Banks to the economically weak enterprises only. The Kredit Kelayakan scheme is directed to those members of society who do not possess adequate collateral to secure credit. This scheme is based solely on the feasibility of the project and is of very recent origin. As shown in Table 5.1, the lending rates, the rediscount rates and rediscount proportions characterize each scheme or activity. The effective returns to state banks, therefore, vary significantly; they indicate the large incentives offered to state banks to undertake various lending activities. The mandatory nature of the interest rates, however, applies only to state banks; private domestic and foreign banks' interest rates are not regulated. Furthermore, while the five state banks have full access to the rediscount window of Bank Indonesia, domestic private banks have only limited access and foreign banks have none.

5.18 To extend the range of financial services provided to the industrial sector, institutional instruments in the form of development banks such as BAPINDO, IDFC, PDFCI and the Regional Development Banks have also been created. Bank Indonesia has taken an activist promotional role in the establishment of these institutions. The special charter of Bank Negara

Indonesia, 1946 makes it an important source of credit to the industrial sector. The sources of investment credit, however, are limited. The main sources of investment credit are the state commercial banks and BAPINDO; BAPINDO, by its charter, is expected to be a major source of long-term credit in the future.

#### Implications for the Industrial Sector

5.19 At the macroeconomic level, monetary policies have been designed to attain the important objective of the Government to control domestic inflationary pressures. But the extremely large allocations of credit to the large state-owned, capital-intensive projects (para. 5.05) has important implications for employment generation and domestic price stabilization. This follows from the fact that the size, factor proportions, energy-intensity, skill-intensity, and the nature of industrial products in the public sector differs from that in the private sector;<sup>/1</sup> this, in turn, affects the entire structure of the industrial sector. The distribution and allocation of credit is, therefore, one of the factors that determines the growth of labor-intensive, energy-conserving industries in the private sector and which, in turn, has an impact on employment generation, industrial output and the price level. However, the relatively low allocation of credit to the private sector, according to the Government, has been due to the lack of financially viable projects put forward by domestic private entrepreneurs.

5.20 Over the period 1975 to 1979, the regulation of interest rates, combined with the prevailing inflation rates, has led to negative or low positive real interest rates for deposits and loans (Table 5.2). In fact, since 1975, the real rates for short-term deposits have been negative and the real rates for long-term deposits have been marginally positive.<sup>/2</sup> Investment funds may, therefore, have been diverted away from the banking sector partly towards the rejuvenated stock market; the current interest rate policy, however, does not promote, the "financialization" of savings and the investment process. There is some evidence indicating these effects, viz., the low growth of time deposits in 1978 (2.4%), and in 1979 (0.2%). Similarly, the growth of savings deposits and certificates of deposits have also been low;<sup>/3</sup> this growth has, however, increased in the post-1979 period. Private savings through the banking system could, therefore, have contributed more to the investment process.

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<sup>/1</sup> As Table 2.2 shows, public sector activities in the industrial sector are more capital-, energy- and skill-intensive than those in the private sector.

<sup>/2</sup> The large negative rates for 1979, shown in Table 5.2, reflect the price effects of the devaluation and are not a significant cause for concern if inflation is brought under control.

<sup>/3</sup> See Tables A-42, A-43 and A-44 in Annex 4, Appendix 9.

Table 5.1: STATE BANK LENDING TO THE MANUFACTURING SECTOR (APRIL 1980)  
(in percent)

	Lending rate	Redis- count rate	Redis- count propor- tion	Effective return on state banks' own funds <u>/a</u>
<u>Short-term Credits</u>				
Production & distribution of exports	12.0	4	75	36.0
Manufacturing & production activities	13.5	6	70	31.0
Import & distribution of supervised goods	13.5	6	70	31.0
Other imports	18.0	6	40	26.0
Other	21.0	6	25	26.0
<u>Investment Credits</u>				
Medium and Large Investment Credit (KIB)				
Credits up to Rp 75 million	10.5	3	80	40.5
Rp 75 to Rp 200 million	12.0	4	75	36.0
Rp 200 to Rp 300 million	13.5	4	70	35.7
More than Rp 300 million	13.5	4	65	31.1
Small Investment Credit (KIK)	10.5	3	80	40.5
Permanent Working Capital Credits (KMKP)	12.0	4	75	36.0

/a The effective lending rate or return on state banks' own funds is given by R below. It is not the lending rate of say, 10.5% for KIK; this lending rate would be the return or the revenue received by state banks in the absence of the rediscount window. The rediscount mechanism necessitates an adjustment to the pure lending rate to determine the effective lending rate or return on the state banks' own funds. This is given by:

$$R = \frac{r_1 - r_d \times p \times 0.01}{100 - p}$$

where  $r_1$  = the lending rate;  $r_d$  = the rediscount rate; and  $p$  = the rediscount proportion. The assumption being made here is that the percentage of loans actually discounted by the state banks is equal to that allowed by Bank Indonesia regulations. The net effective rate of return would be the difference between R and the weighted average cost to the state banks of borrowing their own proportion, (100-p), defaults and interest paid on deposits.

Source: Bank Indonesia (excluding the last column).

5.21 To maintain the viability of the state banks which, in part, is affected by the mandated interest rate structure, Bank Indonesia has become an important provider of resources to these institutions; as of March 31, 1979, over 20% of all state bank resources were provided through Bank Indonesia's rediscount window. The state banks, therefore, have little incentive to mobilize resources and this is reinforced by the protection afforded to these banks by regulations circumscribing the activities of non-state banks. Development banks, such as BAPINDO, also have little incentive to issue bonds unless they are substantially subsidized; this situation arises from the fixing of the onlending rates of such financial institutions. This, in turn, further impedes the mobilization of resources for industry and the development of efficient financial intermediation.

Table 5.2: THE STRUCTURE OF INTEREST RATES, 1975-79  
(percent)

	Nominal deposit rates /a	Nominal lending rates /b	Rate of inflation /c	Real deposit rates	Real lending rate
1975	12-18	15.0	12.5	-0.5 to 5.5	2.5
1976	12-18	15.0	14.5	-2.5 to 3.5	0.5
1977	12-18	15.0	12.6	-0.6 to 5.4	2.4
1978	9-15	15.0	8.6	0.4 to 6.4	4.9
1979	9-15	15.0	37.7	-28.7 to -22.7	-24.2

/a This range is from 12-month to 24-month deposits.

/b Applies to representative rates for manufacturing industries equivalent to Category III credits. Lending rates for Category I and II credits are even lower, varying between 9-12%.

/c GDP deflator 1973 = 100; the GDP deflator is used because the demand for credit derives from consumption as well as investment demand.

Source: Annex 4, Table 19.

5.22 The subsidization of lending rates in the manufacturing sector and the selective access to funds has also resulted, in some cases, in the creation of premia between these rates and open market rates. In other cases, credit arbitrage takes place in that loans obtained from state banks are deposited in private commercial banks on which the borrower, now turned depositor, earns between 6 to 9 percentage points. Furthermore, these

subsidized rates also tend to distort the choices of technology in industries in favor of the relatively more capital-intensive techniques resulting in a detrimental effect on employment creation.<sup>/1</sup> It appears therefore, that the use of the interest rate as a viable policy instrument for resource allocation, economic efficiency and inflation control has been effectively abandoned. In effect, credit ceilings, in combination with Bank Indonesia's rediscount facilities, are the major instruments used in the control of the money supply and in the allocation of capital.<sup>/2</sup>

5.23 The use of overall credit ceilings to contain liquidity can be justified as a short-term instrument; their introduction in 1974, after the oil price rise, provided legitimacy to their use. Their continued use over the long-run, however, may lead to significant economic and social costs. In combination with fixed interest rates, these ceilings appear to have led to an allocation of credit based on the preferences of the banks for "prime" customers, and have been used to reinforce the preference of the Government for large-scale, capital-intensive projects. Such an administratively determined allocation of capital not only distorts the credit market, but also leads to a suboptimal allocation of capital by preventing the allocation of credit according to its true opportunity cost; this, in turn, has negative implications for employment creation and thwarts the Government's equity objectives. This mandated allocation process operates on a first-come first-served basis; its counterpart is the "market saturation" concept utilized in allocating investment licenses. The approach discriminates against and limits the access of late entrants to specific industries, regardless of the financial and social viability of the projects. For example, in May 1978, credit ceilings were imposed on transport activities which inhibited the growth of any transport-intensive industries.<sup>/3</sup> Such an approach leads to rigidities, causes intersectoral bottlenecks, and dampens industrial growth. Given that industrial licenses are also used to restrict capacity in specific sectors,<sup>/4</sup> use of the credit mechanism duplicates the effort and adds to the administrative burden of the Government.

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<sup>/1</sup> Paradoxically, the KIK/KMKP program subsidizes the use of capital, rather than labor, in an effort to increase employment by channelling cheap credit to the labor-intensive industries in the small-scale sector.

<sup>/2</sup> One major qualification to the above relates to the current credit schemes for essential activities such as the BIMAS program. It is recognized that significant difficulties may arise in the extremely critical area of food policy if interest rates are not subsidized. Consequently, state banks should continue to serve as agents for mass subsidized credit schemes such as the BIMAS program. Regarding such essential programs, the Government has considered and rejected the possibility of direct budget subsidies.

<sup>/3</sup> New, higher ceilings were later introduced.

<sup>/4</sup> The economic implications of licenses have been discussed in Chapter 4.

5.24 Credit ceilings and other financial regulations are also not effective allocators of credit; as in the case of the licensing system, many regulations are often circumvented by investors. For example, the fungible nature of funds permits borrowers to approach banks for funds for "high priority" activities and to utilize their own funds for those activities designated as "low priority." Priority borrowers, whether designated by sector or economic group, also act as financial intermediaries and create a secondary credit market; they are, therefore, able to channel credit to the "low priority" sectors or groups. Moreover, the incentives for the creation of such secondary markets arise specifically from the Government's classification of "high" and "low" priority activities; the interest rate for the "high" priority categories is sufficiently low that the premium generated by the secondary market rates exceeds the transactions cost of obtaining such credit./1

5.25 Specifically, in some cases, firms finance their inventories using credits earmarked for distribution (internal trade) activities which, in turn, are restricted to the weaker economic groups. In other cases, firms classify themselves as weak economic firms only in order to gain access to investment credit, yet the economically strong entrepreneurs retain effective control. Furthermore, earmarked KIB funds have, on occasion, been used to purchase more land than required for the project; the excess land has been subsequently sold at a profit. In the case of KIK/KMKP funds, firms are known to split their businesses into many different companies in order to be able to borrow a multiple of the working capital allocated for companies belonging to the economically weak groups. While, in some quarters, these examples may elicit a response of "better" controls, investors will continue to find avenues to circumvent them if it is in their interest to do so. Such mandated regulations are, thus, not effective instruments for allocating a scarce resource such as credit.

5.26 The multitude of regulations determining various aspects of the financial system has, on occasion, also led to an overlap and to some conflicts with investment policies. For example, the difficulties associated with obtaining licenses has an impact on the accessibility to credit. For example, many firms experience difficulties in obtaining land titles; this, in turn, restricts their levels of borrowings as they are unable, without the license, to use land as a collateral. Certain Government licensing regulations also affect the size of the financing requirements of firms; thus, the restrictions imposed on the imports of second-hand equipment increase substantially the amount of credit required by investors who, by regulation, must buy new machinery, except in very limited instances.

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/1 The mission was provided with numerous examples of such incidents.

5.27 Industrial and financial policies also interact in the area of foreign equity participation. While the joint-venture firms are offered licenses and facilities (i.e., tax incentives) by the BKPM, they are denied investment credit and precluded from access to working capital credits above the April 1979 ceilings. Given the poor substitutability between equity and working capital, this credit limitation has deterred rather than encouraged greater foreign equity participation. Another interaction, that between foreign trade policies and credit policies, manifests itself at the macroeconomic plane; the devaluation was specifically undertaken to increase the profitability and, thus, the output of the traded goods sector, yet the broad array of credit controls and regulations, in many ways, tends to negate these objectives.

5.28 As mentioned earlier, the credit mechanism is also used as an instrument of social policy by reducing the cost and increasing the availability of credit to economically weak firms. While the support and encouragement of this weaker economic group is an important objective, the choice of instruments entails some conflicts between economic and social goals and, thus, to some economic costs. As the Government views it, the benefits of attaining such an objective manifest themselves in the form of long-run social, political and economic stability. By enunciating some of the economic costs associated with the policy instruments, the Government may be in a better and more informed position in considering these costs and weighing the benefits.

5.29 In particular, state banks face considerable difficulties in finding bankable economically weak entrepreneurs to whom they have adequate incentive to lend; it is, therefore, important to develop the latter's capability. State banks also lack the staff required to evaluate and support such firms. Furthermore, loans to the economically weak firms, in general, entail high costs per rupiah to banks because of the relatively small size of the loans, the high search costs for creditworthiness of such investors and the high arrears and default rate. Moreover, because state banks cannot charge different lending rates depending upon the risks, they do not have adequate incentives to seek out borrowers from the weaker segments of society. Thus, the mandated interest rate structure and the rediscount mechanism provide inadequate incentives to lend to such firms.<sup>/1</sup> Moreover, in many cases, the waiting time for loan processing is long; sometimes it takes as long as two to three months and the costs associated with the red tape to have loans authorized are quite high. Thus, the effective cost of money to economically weak entrepreneurs may even approximate market rates; but it is the inefficiencies in intermediation that form a large part of this cost.

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<sup>/1</sup> According to many state bank officials, the process of obtaining rediscount funds from Bank Indonesia is, in itself, quite time-consuming and acts as a disincentive. See Annex 4 for details.

5.30 Credit rationing policies designed to enhance the development of the weaker economic group, therefore, may not be completely successful in achieving their desired objective and may also entail economic costs; this arises, in part, from the denial of investment credit to the economically strong entrepreneurs who would be in a position to generate increased income-earning opportunities and employment and provide on-the-job training for the weaker economic group. It should, however, be pointed out that credit schemes restricted to the weaker economic group have accounted for a small percentage of total manufacturing credit. But, it should also be noted that with the development of long-term credit instruments, if the existing regulations are not altered, the associated economic and social costs will rise. At the moment, however, there are Government policies that deliberately exist to mitigate some of the economic costs. They include the rollover of working capital credit and the absence of foreign exchange controls. Both policies ease the existing constraints on investment credit for firms belonging to the economically strong group; yet both entail higher transactions costs. Moreover, the access to off-shore capital markets is restricted to those who are either "well-connected" or are able to provide the required collateral. In addition, the absence of a well-developed legal framework for the recovery of debt across international boundaries further constrains the extent of off-shore borrowing.<sup>/1</sup> Thus, it is the small, non-indigenous firms that are most affected by the policies discussed earlier. Nevertheless, these policies do serve as useful safety valves and ameliorate some of the economic costs.

5.31 The existing set of financial policies also has implications for the institutional development of the banking system. Given the early developmental stage of the financial sector in Indonesia, the strengthening of financial institutions and the development of a healthy credit market is of paramount importance not only for the industrial sector alone, but also for all sectors of the economy. As noted, state banks are overwhelmingly dominant as suppliers of credit to the manufacturing sector and are expected by the Government to play an active promotional role. They are, therefore, subsidized and protected in many ways. For example, they have access to Bank Indonesia's rediscount window, some of their deposit rates are subsidized, and many restrictions are placed on the activities of private banks. Thus, the rediscount rates which subsidize various state bank credit schemes imply that the effective lending rates or returns on state banks'

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<sup>/1</sup> Furthermore, the cost of these foreign funds, in March 1980, was higher than that of domestic loans; about 20% as compared to 13.5% per year. It should, however, be noted that this higher cost reflects more accurately the opportunity cost of capital than do the subsidized domestic rates. In an open economy with perfect capital mobility, foreign interest rates set an upper limit on domestic rates. The difference reflects the relative factor costs of intermediation and the foreign exchange risk.

own funds are quite high; they range from 26% p.a. to 40.5% p.a. (Table 5.1).<sup>/1</sup>

5.32 As a result of the various forms of protection, the state banks tend to be relatively inefficient in their lending and resource mobilization operations. This manifests itself in poor appraisals, lengthy loan processing time caused by extensive cross-checking, and high arrears; the proportion of the state banks' portfolio in arrears in 1976 was estimated to be much higher than that for private domestic banks and for foreign banks. There is evidence, however, that the efficiency of the state banks has been improving over time. The situation is, nevertheless, compounded by the multiple objectives imposed on state banks by the Government; they are not only expected to provide all normal commercial banking, trade financing and foreign exchange facilities, but are also expected to function as development banks through the provision of investment loans, to finance large government-sponsored projects, to aid in the development of small indigenous enterprises through the provision of services to these enterprises in rural areas, and to support all sectors of the economy through the numerous (19) categories of short-term credit. Moreover, the state banks are unable to obtain adequate staff and facilities which further restricts any improvement in their efficiency. One estimate indicates that the profitability of state banks, defined as the return on capital employed, is close to zero percent.<sup>/2</sup>

5.33 In the last few years, Bank Indonesia, recognizing these problems, has undertaken major efforts to improve the efficiency of the state banking system. For example, Bank Indonesia has established and continues to assist the Institute for the Development of Banking (LPPI) which trains bank officials and employees, and currently Bank Indonesia is formulating a nationwide upgrading program - including training and consultancy services - to strengthen the Regional Development Banks. But, despite these endeavors, it appears to be unlikely that substantial progress will be made unless the policy environment in which these banks operate begins to change.

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<sup>/1</sup> The rediscount mechanism necessitates an adjustment to the lending rate to determine the effective lending rate or return. See Annex 4 for further details.

<sup>/2</sup> This estimate refers to 1976; no later estimates are available. The figure for private domestic foreign exchange banks, which are considered to be efficient, is 12.5%, while that for private nonforeign exchange banks is 3.1%; the latter group suffers from weak management and high overheads.

5.34 Many of the policies mentioned earlier have a detrimental effect on these institutions and on financial intermediation for industry. For example, as discussed earlier, the mandated structure of interest rates inhibits resource mobilization and, thus, effective financial intermediation for industry. Moreover, administrative regulations, such as the various credit ceilings and the direction of credit to specific sectors and economic groups have contributed to the current excess liquidity position of the state banks. These same regulations, however, prevent state banks from allocating credit based on the economic viability of the project if the project does not meet particular sector or economic group requirements; yet, financially viable projects from economically weak entrepreneurs are scarce. Consequently, due to the relatively higher international interest rates compared to domestic rates, the state banks deposit some of their excess funds in off-shore markets. Some of these funds are subsequently recycled into the country at a higher cost and foreign exchange risk. While this process provides foreign and some domestic economic groups with access to funds, it also restricts the process of domestic financial intermediation; thus, off-shore institutions are developed at the expense of on-shore ones. This, in turn, hinders the development of the banking sector and restricts its size to a suboptimum level.

5.35 Since these state banks account for about 78% of total domestic financial assets, the existing inefficiencies - caused in large measure by the multitude of social and economic objectives that have shaped the design of financial policies - greatly retard the development of an efficient financial system in which banks, in the early stages, have a rather onerous role to play. Compared to other countries, Indonesia's financial sector is not very advanced. To attain the Government's objectives of price stability, employment generation, the development of the weaker economic group that need technical banking services, and efficient industrialization, it is crucial that the banking sector and the financial institutions evolve beyond their current stage; this will necessitate the creation of an appropriate policy environment.

5.36 To facilitate this process, long-run goals and policy options are suggested in Chapters 7 and 8. These are similar to those recently undertaken by the Philippines and Taiwan where the banking system was also highly regulated and constrained. These options focus on the use of appropriate instruments to control domestic inflation, the introduction of a more effective interest rate policy, the reform of the rediscount mechanism, policies to encourage banks to seek out economically weak entrepreneurs, specific schemes (credit and noncredit) designed to develop an indigenous entrepreneurial class and institutional reforms needed to bring about more effective financial intermediation.

## 6. POLICIES TOWARDS PRIVATE FOREIGN INVESTMENT

### Introduction

6.01 There is considerable debate in Indonesia about the appropriate role of private foreign investment. On the one hand, the Government's objective, as enunciated in Repelita III, has been to promote foreign investment that is consistent with Indonesia's development priorities. Consequently, various incentive programs have been offered to foreign investors over the years. On the other hand, there are many political and ideological issues that arise from Indonesia's colonial history and which have led to the perception that foreign investment constitutes a threat to Indonesia's economic independence. The purpose of this chapter is to analyze the economic implications of the Government's policies towards foreign investment in the manufacturing sector. This is an important consideration given the large amounts of foreign investments in the past and the potential for future foreign investment based on the size of the domestic market and Indonesia's labor and natural resource endowments.

### Recent Trends and Developments

6.02 Foreign investment in Indonesia is regulated by two laws passed in 1967 and 1970. These laws define foreign investments (PMA) as those with less than 100% domestic equity. The laws further state that there is no intention to nationalize any firms, revoke ownership rights or reduce investor control, except in the national interest. Nationalization would require an Act of the Legislature and the level of compensation, if not agreed to by the owners, would go to arbitration. Indonesia has also entered into double taxation agreements with source countries and adheres to the convention for the Settlement of International Investment Disputes.

6.03 From the introduction of the 1967 law until 1979, foreign investment in the manufacturing sector has amounted to \$2.2 billion, accounting for almost 65% of total foreign investment in the entire economy, except for investments in the petroleum, banking and insurance sectors.<sup>/1</sup> Foreign employment over this same period, however, accounts for less than 2% of total manufacturing employment. As in the case of domestic firms, foreign firms are concentrated in Java where more than 50% are located, followed by Sumatra (19.2%) and Kalimantan (6.9%).

6.04 Over the period 1967-78, Japan has been by far the most important source of foreign investment accounting for 35% of all approvals, followed by the US (11%) and Hong Kong (10%). If Japanese loans for large projects such as the Asahan hydroelectric aluminum smelter project are included, Japan's influence is even larger. There are some indications, however, that the rate of new Japanese investments has been slowing down. Other developed countries such as Canada, UK, Netherlands, Germany and Belgium each account for between 1% to 5% of total approvals.<sup>/2</sup>

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<sup>/1</sup> Unless where explicitly stated, "foreign investment" will refer to actual or realized investments as opposed to approved investments.

<sup>/2</sup> See Annex 5 Table 13 for details.

6.05 The share of foreign investments from developing countries is relatively small. For example, India has 11 projects amounting to a total investment of \$76 million, or about 1% of total foreign investment approvals. The corresponding figures for the Philippines are 20, \$311 million and 4% and for South Korea, 18, \$81 million and 1%. Projects of foreign investors are generally capital-intensive, particularly those from the developed countries. The projects of investors from developing countries differ in that they tend to be smaller, more labor-intensive, and in industries with little product differentiation and slow technological change. These investments are in industries in which the developing countries with their small markets and inexpensive labor have developed a comparative advantage; Indonesia now benefits from these technologies.<sup>/1</sup> Export-oriented manufacturing firms from developing countries are, however, not drawn to Indonesia for several reasons discussed earlier such as long delays in the BKPM approval processes, the absence of proper export processing zones and various other restrictions placed on foreign investment. However, Indonesia could benefit significantly from this type of foreign investor. The export-processing zone at Tanjung Priok is an example of the type of institutional support to exports that could provide attraction to foreign investors, particularly from developing countries.

6.06 The sectoral distribution of foreign investment implementations and approvals in Indonesia, from 1967-79, is given in Table 6.1. Foreign investments in manufacturing amounted to \$2.2 billion during this period, with the textile sector accounting for the largest share of manufacturing investments (36%), followed by metal products (18%), and chemical and rubber products (15%). Over this same period, actual foreign investment in all sectors amounted to about \$3.4 billion while approvals amounted to about \$7.7 billion. Thus, actual investments were only around 44% of the approved investments. This low figure reflects, in part, the difficulties involved in monitoring investment flows and delays in projects implementation. The implementation rate in mining and quarrying (27%) and basic metals (24%) appears to be especially low, while that in textiles (66%) and metal products (78%) is quite high.

6.07. In the post-1974 period, the Government's "open-door" policies towards foreign investment became increasingly restrictive. The impact of this is reflected in the data on foreign investment implementations. Foreign investments peaked in 1974 at a level of \$1.4 billion while, in the 1975-79 period, they declined by 26% in real terms compared to the 1970-74 period (Figure 6.1).<sup>/2</sup> This phenomenon is also observed in the data on approvals.

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<sup>/1</sup> For a detailed discussion, see L. T. Wells, Jr. and V. Warren (1979), "Developing Country Investors in Indonesia," B.I.E.S. 15, 1 pp. 69-84.

<sup>/2</sup> The nominal figures were deflated by the Price Index of Machinery and Equipment published by the UN. If the Unit Value Index for Machinery Exports from Developed to Developing Countries is used to deflate the nominal figures, the drop in real investment would be 36%. Over the same two periods discussed above, nominal investments increased by only 3%.

Table 6.1: FOREIGN INVESTMENT IMPLEMENTATION AND APPROVALS BY SECTOR,  
1967-79/a EXCLUDING INVESTMENT IN PETROLEUM AND BANKING  
(in millions of US\$)

Sector	Total number of projects	Total realized investment	% Realized investment	Approvals	% Approvals	Implementation rate <u>/b</u>
Agriculture	58	64.8	1.8	171	2.2	0.38
Forestry	78	299.4	8.7	607	7.8	0.49
Fishery	23	85.1	2.5	127	1.6	0.67
Mining and quarrying	11	385.6	11.2	1,453	18.7	0.27
Manufacturing	466	2,216.8	64.4	4,730	61.0	0.47
Food	53	164.2	4.7	310	4.0	0.53
Textiles and leather	70	790.2	22.9	1,205	15.5	0.66
Wood and wood products	12	22.5	0.6	51	0.6	0.44
Paper and paper products	14	40.3	1.1	117	1.5	0.34
Chemical and rubber	131	340.6	9.8	825	10.6	0.41
Basic metals	29	271.7	7.8	1,150	14.8	0.24
Nonmetallic minerals	23	177.7	5.1	552	7.1	0.32
Metal products	127	397.7	11.5	509	6.6	0.78
Other	7	12.2	0.3	13	0.1	0.94
Construction	63	38.9	1.1	77	1.0	0.51
Trade and hotels	14	106.2	3.0	183	2.4	0.58
Wholesale trade	3	10.8	0.3	12	0.2	0.90
Hotels	11	95.4	2.7	171	2.2	0.56
Transport and communication	20	37.0	1.1	97	1.2	0.38
Transport	19	12.8	0.3	47	0.6	0.27
Communication	1	24.2	0.7	50	0.6	0.48
Real estate and business services	51	108.3	6.1	307 <u>/c</u>	3.9	0.35
Other	-	117.6	-	-	-	
<u>Total</u>	<u>784</u>	<u>3,441.0</u>	<u>100.0</u>	<u>7,752</u>	<u>100.0</u>	<u>0.44</u>

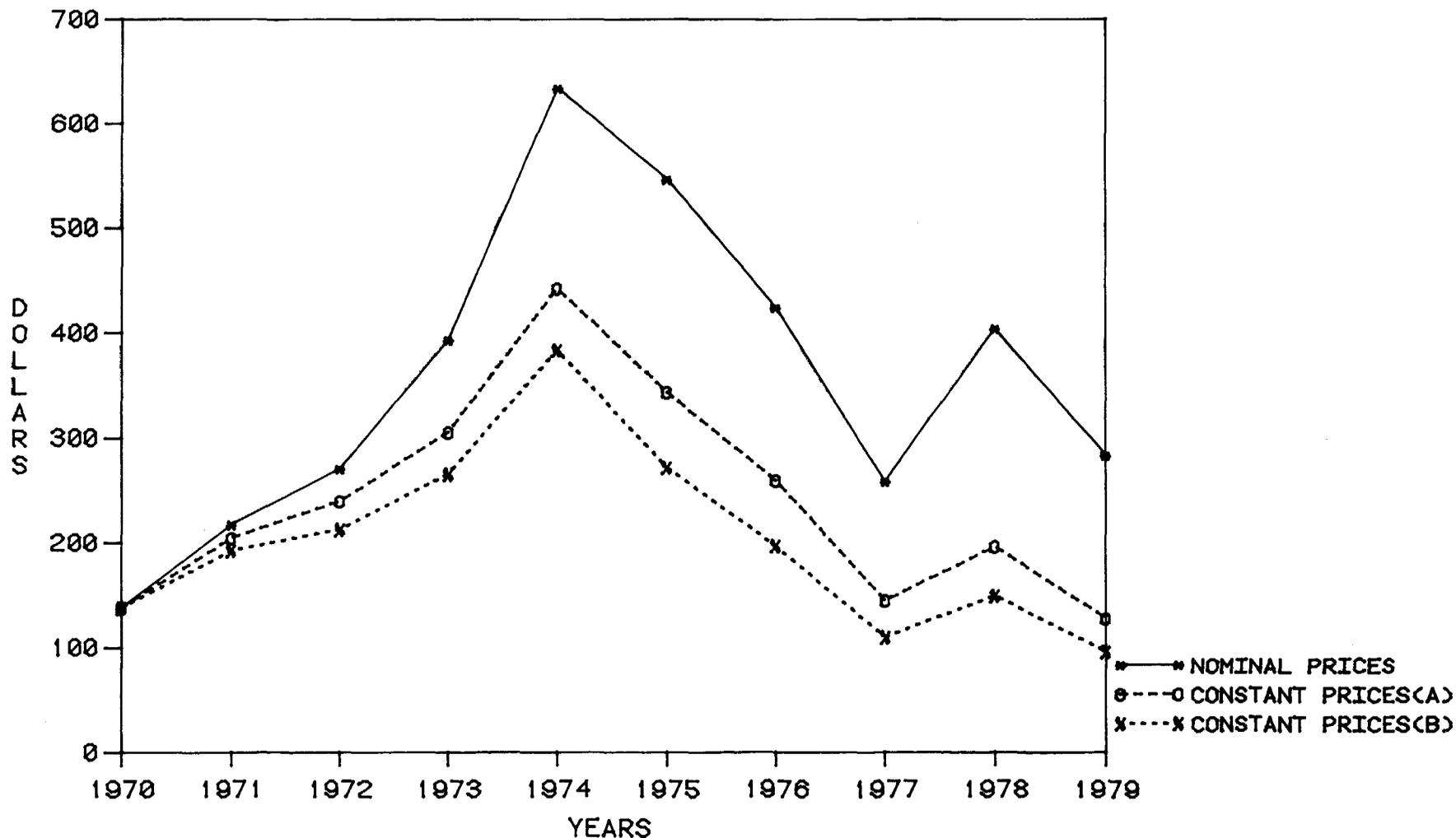
/a Implementation is the recorded disbursement on projects approved based upon cash inflows, customs data on imported capital equipment, and the conversion of foreign claims under the DICS scheme. Data cover first three months of 1979 only.

/b The implementation rate is the ratio of realized investments to approvals.

/c Refers to social and personal services and other.

Source: Bank of Indonesia.

FIGURE 6.1: NOMINAL AND CONSTANT PRICE (1970) SERIES FOR FOREIGN INVESTMENT IMPLEMENTATION (1967-79)  
(IN MILLIONS OF US\$)



NOTES: CONSTANT PRICE SERIES (A): NOMINAL PRICES DEFLATED BY THE PRICE INDEX OF MACHINERY AND EQUIPMENT

CONSTANT PRICE SERIES (B): NOMINAL PRICES DEFLATED BY THE UNIT VALUE

INDEX OF MACHINERY EXPORTS FROM DEVELOPED TO DEVELOPING COUNTRIES

SOURCE: ANNEX 5, TABLE 5

Excluding the Asahan hydroelectric aluminum smelter project which accounted for \$1 billion of approvals in 1975 - increasing to \$1.7 billion in 1977 - firms that obtained approval in the 1975-79 period accounted for only about 16% of the total investment approved (\$5.6 billion) in the entire post-1967 period. Thus, almost 84% of all investments approved from 1967 to 1979, were approved in the pre-1974 period.

6.08 It is also important to note that the size of one single project, the Asahan smelter, distorts the investment data significantly. This project alone accounts for 23% of total approvals (1967-79); the exclusion of this project shows that total approved investments dropped from about \$4 billion in 1970-74 to less than \$0.9 billion in 1975-79. Furthermore, this decline in approvals is evident for new projects of all sizes (Table 6.2). The large (78%) decline in approvals in the post-1974 period provides some evidence of the closing of the Government's "open door" policies.

6.09 Another manifestation of these more restrictive policies is that in the post-1974 period, existing firms rather than new firms have been undertaking new investments. In the 1975-79 period, approvals for expansions of existing projects, excluding Asahan, exceeded those for new projects by 47% in real terms. On the other hand, in the 1970-74 period, investment approvals for new projects were almost five times greater than those for the expansion of existing ones. These figures are not surprising since it is the existing firms rather than the new ones that are best able to operate under the increasingly restrictive environment because they have already undertaken the fixed costs associated with the initial establishment of the firms. Moreover, taking the inflation of the 1970s into account, total investment approvals declined by 26% in the 1975-79 period compared to the 1970-74 period if Asahan is included, and by 61% if it is excluded (Table 6.2). Thus, there is strong evidence indicating that the policies initiated in the mid-1970s have had a significant negative impact on new private foreign investment in Indonesia./1

#### The Impact of Recent Policy Initiatives

6.10 The mid-1970s divides the policy framework under the Soeharto Government into two distinct periods. As mentioned earlier, from 1967 to about 1974, "open door" policies were adopted towards foreign investment; these involved the provision of liberal regulations, favorable incentives and various guarantees. These policies were significantly qualified in the latter half of the 1970s which increasingly constrained the operations of foreign entrepreneurs. The most important of these included increased controls on investments by sector and location, the exclusion of foreign investments in certain sectors, required rapid increases in local participation in ownership,

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/1 There is some cursory evidence of recent increases in private investment. But while that in the late 1960s and early 1970s was primarily due to private foreign capital, the current increase appears to be due to domestic capital.

Table 6.2: FOREIGN INVESTMENT IMPLEMENTATIONS AND APPROVALS

	1967-69	1970-74	1975-79
<u>Foreign Investment Implementation (\$ million)</u>			
Market Price	-	1,655	1,707
Constant price (Series A) <u>/a</u>	-	1,332	978
Constant price (Series B) <u>/b</u>	-	1,194	753
<u>Foreign Investment Approvals (\$ million)</u>			
Total investment <u>/c</u>	752 (100%)	3,924 (100%)	875 (100%)/ <u>d</u>
Foreign equity	280 (37%)	949 (23%)	200 (23%)/ <u>d</u>
Indonesian equity	31 (11%)	505 (13%)	121 (14%)/ <u>d</u>
Foreign loans	278 (37%)	2,193 (56%)	551 (63%)/ <u>d</u>
Debt/equity ratio	0.77	1.51	1.71
<u>Approvals by Size of Firm (\$ million)</u>			
Less than \$10 million			
Number	97	410	124
Value	234	1,233	407
\$10-\$40 million			
Number	17	62	17
Value	311	919	304
More than \$40 million			
Number	4	18	4 (3) <u>/d</u>
Value	205	1,772	1,881 (164)/ <u>d</u>
All investments			
Number	118	379	145 (144)/ <u>d</u>
Value	752	3,924	2,592 (875)/ <u>d</u>
<u>Approvals for Projects (constant 1970 \$ million)</u>			
Total approvals	396	2,177	1,605 (856)/ <u>d</u>
New projects	393	1,822	863 (345)/ <u>d</u>
Approvals for expansions of existing projects	3	449	738 (504)/ <u>d</u>

/a Deflated by the Price Index of Machinery and Equipment.

/b Deflated by the Unit Value Index for Machinery Exports from Developed to Developing Countries.

/d Figures in brackets exclude the Asahan hydroelectric aluminum complex.

/c Total investment does not equal to Foreign and Indonesian Equity plus Foreign loans as some investments are financed from retained earnings and because of data omissions in some applications.

Source: Annex 5, Tables 5, 7, 8, and 9.

more rapid promotion of Indonesians into managerial positions, prohibitions on foreign firms in engaging in distribution activities, and various credit restrictions placed on foreign firms./1

6.11 Since 1974, investment applications from foreign firms to the BKPM have been subject to the requirement that the initial Indonesian share be at least 20% to be increased to 51% within 10 years from the start of operations. It appears that this time period will not be applied to firms that obtained their investment licenses before February 1974. There is, however, some ambiguity about this policy. At present, the policy consists of statements made by political leaders, guidelines issued by the BKPM and Presidential Decrees which may be interpreted as statements of policy rather than binding legislation. Moreover, there is also some uncertainty about the coverage, timing and penalties for the violation of these guidelines.

6.12 In practice, foreign firms have interpreted this ruling to mean that the initial share of Indonesian equity needs to be from 10-20% at the start of the project and increasing to 30-60% at the end of ten years; but the "start" of a project has varied from one project to another. In some cases, the BKPM had stipulated that the ten-year period should start from the moment it has approved the investment application, while in other cases, from the moment the capital goods have cleared customs, and still in others, from the moment commercial production has started. Furthermore, foreign firms remain unclear as to whether this regulation applies to the total amount of foreign equity or only to the expansion of an existing project. This policy has also added to the risks associated with plantation investments in agro-industrial projects where the first year of positive cash flow takes place usually between six and ten years from the start of the project. This policy has, therefore, deterred new investments in these areas.

6.13 Presumably, these ambiguities will be clarified in the future through actual practice or new legislation. For the moment, the Government has approached its objective in a flexible manner through negotiation or encouragement rather than forced compliance. One approach used by the Government to increase Indonesian equity in foreign firms is to provide extremely attractive incentives in terms of reduced taxation through lower rates, and special tax credits in the form of special depreciation allowances on revalued assets to foreign firms going public on the recently revitalized Jakarta stock exchange. In some cases, these incentives are so attractive

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/1 See Annex 5 for a detailed discussion of the specifics associated with these policies. This annex also discusses the Government's policies towards the natural resource-based industries; these industries are not the focus of this report. Annex 3 discusses foreign investment controls through the DSP list in detail, and Annex 4 discusses the credit restrictions placed on foreign entrepreneurs.

that the present value of the tax savings can exceed the value of the equity transferred to the public./1

6.14 Another major area of restrictions results from increased control on new investment. Certain fields have been closed to foreign investment from the start of the "open door" policies; these fields include munitions manufactures, harbors, telecommunications and electric power. Subsequent decrees prohibited new investment or continued operations in specific activities such as the cessation of forestry concessions to foreign firms in 1974. In December 1977, restrictions were placed on foreign firms in the area of marketing and distribution; no new foreign investments were permitted and existing foreign firms had to sell out their interests in these activities. Restrictions were also placed on various aspects of about 40 light industries such as paint, cigarettes, and tire manufacture. Eventually, these restrictions became sufficiently numerous to warrant a systematic procedure which was introduced in February 1978 with the publication of the first DSP List. As mentioned in Chapter 4, the recent 1980 DSP List demonstrates an increased desire to restrict foreign investment so as to favor domestic, and in particular, the economically weak firms. This trend towards increased controls on foreign investment also manifests itself in regulations on the use of foreign skilled labor and management. Schedules for phasing out the use of foreigners in particular categories of jobs have been introduced for the forestry sector and for the oil and gas sectors. It is widely believed by foreign investors that such restrictions will soon apply to other sectors of the economy.

6.15 These restrictions, however, are not costless to the Indonesian economy. For example, the restrictions on distribution and marketing have led to the creation of relatively high cost Indonesian distribution firms resulting in higher retail prices. Moreover, the absence of foreign distribution firms has prevented Indonesians from developing the required marketing skills which can best be obtained by on-the-job training under experienced management. Apart from the inflow of capital, equipment and engineering designs, foreign investment provides essential knowledge in the areas of logistics, financial control, specific designs tailored to customers' requirements, and before- and after-sales services; it is in these areas that domestic firms and entrepreneurs have difficulties and which result in low efficiency and productivity.

6.16 Ownership restrictions have also, on many occasions, been counter-productive. These restrictions can be, and have been, avoided by using local firms or individuals as fronts. Equity sharing restrictions have been satisfied by allowing local partners to purchase shares on the basis of a loan from the foreign partners; all shareholders' rights are held by the

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/1 See Annex 5, Chapter 5 for details. These incentives are also provided to domestic firms.

foreign partner until the indefinite term loan is repaid. Another mechanism is for the foreign partner to surrender equity, but to maintain full control via long-term management contracts. These policies frequently end up as a way of generating rents for local partners in return for their ability to satisfy ownership regulations; any impact on developing entrepreneurial abilities is, therefore, likely to be minimal. Consequently, enterprising Indonesians concentrate on developing their connections and maximizing their returns as front men rather than on investing and acquiring the business expertise required for efficient production and distribution of products. This tends to prolong the control of established foreign firms that are not faced with effective competition from new foreign investment.

6.17 Furthermore, foreign firms that are concerned about protecting production or management secrets are reluctant to invest in areas where their control of this knowledge is threatened by regulations which force loss of ownership with controlling shares to be transferred to local firms or individuals. Such restrictions have limited foreign investment in the very competitive export-oriented fields that are important for the Indonesian economy. This recognition has led to some discussion in the Government on the need to relax these restrictions for export-oriented firms. This may facilitate the establishment of such firms, but they are likely to face difficulties in exporting their products. As noted (Chapters 3 and 4) administrative problems are pervasive in the customs department. Consequently, heavy costs are imposed on foreign (and domestic) firms because raw materials, spare parts and exports can be tied up for weeks until complex clearance procedures requiring several signatures are worked out. Because of the associated invisible costs, many foreign firms have expressed a strong preference for using neighboring countries as their base for regional exports.

6.18 The restrictions placed on the operations of foreign firms and joint ventures in the domestic market for investment credit (para. 5.29) partly reflect a belief that the net returns to Indonesia increase significantly with the transfer of investment resources from abroad or are significantly reduced if such projects compete for domestic credit. An inflow of debt or equity capital to Indonesia, however, generally involves a commitment on part of foreign firms for a future transfer in the opposite direction. Moreover, there is little reason to believe that Indonesia would incur exceptional losses through transactions undertaken by foreign enterprises in the domestic financial markets. In countries with severe constraints on potential domestic savings, both financial and technological transfers may be required and, in many cases, can be expected to occur simultaneously. However, in a country such as Indonesia where the central problem is not the availability of resources, but its efficient use, there is little justification for imposing credit restrictions that inhibit the flow of foreign investment. Removal of these restrictions would also work to eliminate the transfer of investment resources abroad which are then, in effect, brought back through off-shore borrowing with increased costs of financial intermediation; as discussed in Chapter 5, this cyclical transfer of resources has restricted the development of domestic financial institutions.

6.19 The perception of many foreign firms is that arbitrary decision-making and uncertainty with respect to taxation is also a serious obstacle to good business practices and has a significant detrimental effect on foreign investment. It is claimed by these firms that currently, there is a large backlog in tax collection; for instance tax liabilities settled in early 1980 by foreign firms were predominantly for the 1974-75 period. Tax assessments are reported to be frequently adjusted upwards, a problem felt to be especially common for joint ventures. These problems have, however, abated after the introduction of the March 1979 reforms and the situation appears to be improving significantly. There is, however, no effective way of having tax disputes settled through the court system - all appeals must be made through the tax collecting agencies. Rebates on prepayments for corporate income tax, collected through the MPO tax on various transactions, frequently exceed corporate tax obligations; these are often refunded with a four- or five-year delay.

6.20 The costs associated with the BKPM investment procedures have already been discussed in Chapter 5. Many new foreign investors, not familiar with the process, find the difficulties insurmountable and watch the development of more elaborate regulations with concern. Many foreign managers claimed that the BKPM does not function effectively as a promotion agency; they claim that, in fact, it has managed to stifle new investments. Thus, despite the very generous tax incentives offered to foreign firms to invest in Indonesia, it appears that the benefits of these incentives do not exceed the costs associated with the restrictions. Furthermore, there is little evidence that tax incentives have had a significant impact on the level of foreign investment. In many countries, investors have often chosen to bypass applying for these incentives where they have that option. For example, in Thailand, it is estimated that over two thirds of foreign investment is carried out without going through the Board of Investment which offers special incentives similar to the BKPM. This small impact of these incentives is due to the limited value of various tax breaks or holidays in the early years of operation, or because firms can take tax credits in source countries for tax payments in Indonesia, or because the various costs of obtaining incentives are high relative to the benefits provided. On the basis of extensive discussion with foreign investors in Indonesia, it appears that special incentive systems remain a relatively minor factor in their investment decisions. On the other hand, it is the numerous controls and restrictions placed on foreign investment, combined with the weakness in the tax system and in the legal and commercial infrastructure that have led to the observed decline in foreign investment since the mid-1970s (para. 6.07), and to the expansion of existing firms rather than of new foreign firms in Indonesia (para. 6.09). Measures for stimulating new foreign investment in the manufacturing sector are discussed in Chapters 7 and 8.

## 7. A FRAMEWORK FOR LONG-TERM INDUSTRIAL DEVELOPMENT

### Introduction

7.01 The previous chapters provided an analysis of various policy measures that the Government has adopted to encourage industrialization and influence the pattern of industrial investment. These measures, although often uncoordinated, have, in the recent past, focused around a philosophy of state intervention and around a trade strategy that has emphasized import-substitution over export promotion. As noted in Chapter 3, any benefits that were to be achieved in the early phase of such a trade strategy appear to have peaked and, given the increasing economic costs of such a strategy, its continuation is only likely to slow down industrial expansion and employment creation.

7.02 To ensure rapid, efficient industrial growth and increased employment and income earning opportunities which will contribute to the Government's objective of achieving equity, the Government may wish to consider the adoption of a strategy that would create an economic climate in which Indonesian entrepreneurs are able to exploit the investment opportunities that arise. Clearly, the Government has limited administrative resources. To the extent that it undertakes natural-resource based capital-intensive projects, it is important that they be selected and implemented carefully. But Indonesia also has comparative advantage in labor-intensive industries that can best be undertaken by the private sector. The expansion of such industries will enhance employment, output, exports and contribute to equity. The appropriate long-term industrial strategy for Indonesia is, therefore, one based on capital-intensive (or "basic industry") projects as well as labor-intensive ones. This necessitates an appropriate policy environment which facilitates the expansion of the industrial sector. This, in turn, involves the establishment of a regulatory environment that permeates certainty and inspires confidence in foreign and domestic investors; the institution of financial reforms that lay the basis for a faster development of the financial intermediation process; and the formulation of a trade strategy that facilitates the transition from an import-substitution biased economy towards a more outward-looking one until, eventually, a neutral trade regime is established. Since these policies affect all investment decisions, they are interlinked. Thus, changes in one direction alone (i.e. licenses) without simultaneous movement along other fronts (e.g. protection) could set up unanticipated and even undesirable distortions. Political reality may, however, mandate sequential changes. An overall policy restructuring would not only ensure that the inefficient use of resources is minimized, but would also contribute to creating a dynamic and internationally competitive economy. The purpose of this chapter, therefore, is to provide the broad framework which forms the basis of, and provides the general

directions for long-term industrial development in Indonesia./<sup>1</sup> The specifics of the policy adjustments associated with such a strategy are discussed in the next chapter. These proposals for reform are made in the spirit that they present an alternative approach which would accomplish the Government's objectives of growth and equity at a lower economic and social cost to Indonesia.

#### Improving the Investment Climate

7.03 A major long-run objective of the Government should be to provide an economic environment that permits a rapid industrial expansion in line with Indonesia's actual and medium-term comparative advantage. Using comparative advantage as a criterion of efficiency will not only ensure that costly industrial efforts will be minimized, but that efficient resource allocation will also take place. Since Indonesia is relatively well-endowed with natural resources and with unskilled and low-skilled labor, it is important to change the focus of trade and industrial policies from the present directly interventionist and protectionist policies to ones that are more promotional. This implies that although there would still be assistance to industry, industrial growth would be encouraged through indirect intervention which deflects the pull of market forces in the interest of public policy. The resulting structure of the industrial sector that will emerge will involve a mix of capital-intensive sectors based on Indonesia's natural resource endowments and in which the Government, at least in the short- and medium-term, will be involved (such as petrochemical, fertilizer and LNG projects) and labor-intensive sectors based on Indonesia's cheap labor (such as wood-processing, sawmilling, and certain classes of textile products) in which the private sector would be the primary moving force.

7.04 The Government, therefore, needs to emphasize the creation of an overall economic climate that is relatively stable and free from uncertainty and from the numerous existing impediments to industrial development and employment creation. Indonesia's remarkably free exchange regime is an excellent example of the general direction in which the Government could move in order to create a stable economic climate. This regime, on the one hand, and the restrictive regulatory environment for other economic transactions on the other, stand in sharp contrast to one another. An open economic climate is probably more important in encouraging healthy industrialization than any single policy tool on its own; minor policy adjustments will have only limited value if the overall climate is restrictive. But it must also be recognized that the process of achieving such an environment will be a slow one; it may take many years to accomplish the desired change. This implies that the transition process in the areas of regulatory, trade, finance and foreign investment policies must take place gradually. Such an

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<sup>1</sup> For the purposes of this report, the medium-term will be defined to mean five to ten years and the long-term as any time period exceeding ten years.

approach will preclude undesirable shocks to the existing industrial structure which, in the short-run, must be taken as given. But over time, under the influence of appropriate policies, the structure will slowly evolve towards one that will contribute to the development of industrial growth of both capital- and labor-intensive industries and to increased income earning opportunities, employment and thus to the Government's objectives of growth and equity.

#### Reshaping the Regulatory Environment

7.05 Clearly, the most important change that would contribute to an improvement in the economic environment would be a sweeping overhaul and simplification of the complex licensing and regulatory system and of the customs procedures at the ports. This is not to imply that "better" controls need to be devised, but that "fewer" controls should be the long-run goal. As shown in Chapter 4, direct controls are not a deus ex machina which eliminate the allocative consequences of market failure and attain the objectives of the Government. The importance of deregulation, therefore, cannot be over-estimated since the economic costs of the present system far exceed the benefits. As a general rule, Indonesia would be best served by using broad tools that achieve limited goals, rather than detailed tools which are essentially ineffective in achieving ambitious objectives. This emphasizes the need for clearly enunciated and effectively enforced regulations that will lower uncertainty and inspire investor confidence. Similarly, the use of licenses to achieve noneconomic objectives requires a careful consideration of their economic costs and anticipated benefits.

7.06 This suggests an eventual three-way classification of the industrial sector for investment licenses: (a) a group considered to be of "high priority" by the Government; (b) a "main" group; and (c) a cottage and small-scale industry group. The first group would consist of domestic firms involved in specified large-scale, capital-intensive industries such as cement, steel, petrochemicals and fertilizers which are subject to large economies of scale and long gestation lags and which, for economic reasons or otherwise, the Government would wish to supervise closely. This group could be subject to investment licenses, but the criteria for allocating these licenses should be clearly specified and be based on a careful cost-benefit analysis which determines the project's optimal scale, location, timing and choice of technology. Moreover, there appear to be no economic reasons for the BKPM to provide special tax or investment incentives to this group over and above those received by manufacturers in other subsectors.

7.07 The second group would consist of all firms currently classified under the BRO legislation as well as domestic firms currently registered with the BKPM. These firms would no longer be subject to investment licenses. Furthermore, the fiscal incentives provided by the BKPM to this group should not vary between industries, but should be uniform depending on the degree of

assistance that is to be judged appropriate for the entire manufacturing sector in the medium-run. Thus, the sector and firm-specific tax and investment incentives currently offered by the BKPM should be replaced by general concessions available to all investors. In the long-run, these fiscal incentives should also be eliminated. These firms would then be subject only to annual registration with the local Department of Industry and be required to provide the information that is in the public interest. The cottage and small-scale industries, in the third group, currently face only registration requirements which are largely voluntary and widely ignored. No special changes, in the medium- or the long-run, are recommended for this group. They would, however, be affected by the general recommendations made below.

7.08 In the long-run, unless there are very strong economic justifications for not doing so, the above distinction between these groups for investment licensing purposes should be eliminated. Investors would then be subject to annual registration licenses only; these would be issued automatically and would obligate the investor to provide information that would be useful to the public such as location, production, employment and planned expansion.

7.09 To facilitate officials seeking industry information and investors planning new investments and seeking market information, the basic information to be provided by all firms should be kept in an open public register. This should be maintained at the national, provincial and regency levels throughout Indonesia.

7.10 The general principle underlying the other licenses in Indonesia should, over the long-run, be changed to rely on the enforcement of current or new legislation with strong punitive measures, rather than the existing detailed licensing procedures which are extremely costly and largely ineffective. This involves a major policy change and an acceptance of a new approach to the problems of licenses such as the Domestic Purchasing License and the Labor Safety License. It is, however, important to note that, in general, the passage of new legislation or regulations is not a costless act. Consequently, the expected benefits and costs of such legislation must be carefully evaluated. For some other licenses, such as those required for transport, communication, internal and external trade, no legal mechanisms are necessary; these licenses only raise the social costs of production and should be eliminated.

7.11 Two major long-range tasks that also need to be given high priority by the Government are the reform of the tax regulations and the legal infrastructure. The Corporate Law system based on an Act introduced in 1847 requires considerable revision on several issues such as the limited liability of owners, issuance of shares and voting rights. The legal system which supports industrial policy also needs improving; some laws and regulations overlap, whereas there are inconsistencies between others. The ambiguities associated with the entire taxation process also needs substantial clarification.

### Restructuring Trade Policy

7.12 The positive impact of changes in the regulatory environment is likely to be diminished without simultaneous policy changes in the foreign trade sector. A major focus of the Government should, therefore, be on the long-term goal of creating a more open international economic environment and on a more decentralized approach to industrial development. To this end, the current trade policy which focuses on high protection rates and import-substitution should give way to one that emphasizes lower protection and exports. As mentioned in Chapter 3, the exportable manufacturing sectors in Indonesia are much more labor-intensive and substantially less capital- and skill-intensive than the import-competing sectors. Thus, the employment costs to Indonesia of following an import-substituting, capital-intensive strategy are severe, and it is unlikely that the present strategy will attain the objectives of Repelita III and create many new jobs. The recent review of the Government to reduce nominal protection on final and intermediate goods and raw materials are steps in the correct direction. However, depending upon the proportions by which nominal tariffs are lowered on the various stages of production, an improper adjustment of the tariffs on intermediate goods and raw materials may have the unintentional effect of increasing effective protection on the final stages of production for some goods.

7.13 A related consideration is that the present domestic market in Indonesia is small in terms of purchasing power and is further restricted by the current high costs of manufacturing. The domestic market alone is unlikely in the near future to be able to support a high growth rate in the manufacturing sector. Indonesia must, therefore, become more outward-looking than it is at present. This, however, does not imply that the domestic market is not a source for industrial growth; it is, but it will require time to develop. Moreover, in addition to the need for policies of rural industrialization, policies in other sectors, such as agriculture, transport and related infrastructure, are essential to increase the agricultural surplus and the purchasing power of the domestic market and to facilitate the domestic and international distribution of goods.

7.14 The suggested change in the orientation of trade policy, however, does not imply an export-biased policy. The ideal, long-run policy would be one that is neutral to the domestic and foreign markets and one that is based on the principle of comparative advantage as a criterion of efficient industrialization. But given the existing bias towards the domestic market, a more outward-looking trade policy is now required. In addition, the benefits accruing to developing countries from exports are also significant

and have been well-documented./<sup>1</sup> The introduction of the export certificate scheme in 1978 has gone a long way towards contributing to a more outward-looking economy. The desire of the Government to increase the coverage of goods eligible for export rebates will contribute even further to reducing the current trade policy bias. Moreover, such changes in policy will result in the establishment of efficient import-substituting industries that will also be able to compete with imports in the domestic market as the domestic demand increases over time. But it is important to emphasize that efficient import-substitution does not necessitate an import-substitution biased trade policy. In fact, the long-term neutral trade policy suggested above will not only exploit Indonesia's comparative advantage and boost exports, but will also establish efficient import-substituting industries.

7.15 Economies that have successfully transformed their import-substitution biased policies towards more neutral policy regimes include Korea, Singapore and Taiwan. The resulting change in export performance has been quite significant. In Korea, the share of exports in manufacturing output rose from 14% in 1966 to 41% in 1973. Over the same period, in Singapore, where the level of protection was lower, the share rose from 20% to 43% and, in Taiwan, from 19% to 50%. Because of their policies, these economies have also been able to withstand the shocks generated by the international trading environment of the 1970s (para. 7.20). On the other hand, India, Chile, Turkey and the Philippines are examples of countries that have pursued import-substitution biased policies for very long periods. All have used import restrictions at various times and all have had poor export growth. For example, India's share of exports in manufactured output fell from 9.4% in 1966 to 8.6% in 1973, many of India's import-substituting industries are economically inefficient, and the continued discrimination against primary exports by Chile and India also resulted in their relatively slow expansion./<sup>2</sup>

7.16 As shown in Chapter 3, Indonesia has potential comparative advantage in many labor-intensive sectors such as textiles and wood products. The country currently appears to be in a position to progress along the "scale" of comparative advantage to replace the exports of other countries, such as Korea and Taiwan as they move to "higher level" (more capital- and skill-intensive)

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<sup>1</sup> Increased export incentives will ease excess capacity currently prevalent in many industries and partly generated by the import-substitution strategy; they will also reduce the need to hold excess inventories, eliminate critical bottlenecks, provide learning opportunities and aid in attaining high quality standards. See, for example, A.O. Krueger (1978) Liberalization Attempts and Consequences. National Bureau of Economic Research, New York; and B. Balassa (1978) "Exports and Economic Growth: Further Evidence." Journal of Development Economics, 5:181-189.

<sup>2</sup> For details, see B. Balassa et al (forthcoming). Development Strategies in Semi-industrial Countries. The World Bank, Washington, D.C.

exports./1 But a caveat is necessary here. In many industries, labor productivity and capacity utilization still appear to be low. In addition, there is a shortage of skilled managers, engineers and technicians. These factors, therefore, may negate Indonesia's presumptive comparative advantage in some of these industries.

7.17 Nevertheless, the promotion of labor-intensive, manufactured export is explicitly endorsed in Repelita III. To that end, the Government should capitalize on the recent devaluation; such a devaluation, in many countries, has usually been the first step in the transition to a more outward-looking trade orientation and also in letting the official price of foreign exchange take an increasing role in the domestic allocation of resources. This devaluation can, therefore, be used to start the reform process in the foreign trade sector. The general principles involved would include setting clearly specified time targets for replacing the existing import quotas by tariffs, reducing the variance in effective protection rates, and eventually reducing the home market bias by lowering and thus equalizing tariffs on import-substitutes with any export incentives./2 In Indonesia's case, optimal export taxes will also be necessary for products, such as timber, in which Indonesia has quasi-monopoly power. Experience has, however, shown that there is no single "correct" sequencing of these steps./3 Some of these steps are currently being contemplated or have been undertaken by the Government. For example, some import quotas have been replaced by tariffs, while other quotas are under review, and, as mentioned before, the current plans to lower nominal tariffs may also have the effect of lowering the average rate of effective protection for the manufacturing sector. Moreover, the export certificate scheme has also contributed to reducing the import-substitution bias.

7.18 There will, of course, be some adjustment costs associated with this transition process, but these costs should not be used as a justification to postpone the transition; it would merely become more difficult and the adjustment costs would be even greater, the more prolonged and entrenched are the protectionist policies. Thus, the transition towards a more open trading environment must begin as soon as possible in Indonesia; once exporting firms face price and quality competition in the world markets, it is less likely that inefficiency will persist in the long-run. But, to minimize the adjustment costs, a gradualist approach to policy restructuring should be undertaken. The presence of various vested interests may also mandate initial changes only at the margin. It may, therefore be prudent to first increase

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/1 See B. Balassa (1979). A "Stages" Approach to Comparative Advantage" in Economic Growth and Resources, Proceedings of the 5th World Congress of the International Economic Association, September 1977, London, Macmillan.

/2 The specifics associated with these principles are discussed in detail in Chapter 8.

/3 The experience of many failed and successful attempts at transition towards a neutral trade strategy has been documented in Krueger (1978), op. cit.

exports, a policy that the Government has already undertaken, and then to liberalize imports. This implies not only providing the appropriate price incentives to exporters, but also eliminating other impediments to exports such as the administrative bottlenecks created by the various export documents required, the check-price system and quantitative export restrictions, and those created by internal and external transportation, interisland shipping and the loading procedures at ports.

7.19 Policies to expand exports are also strongly related to domestic and world inflation rates. Export incentives can evaporate if the domestic rate significantly exceeds the international rate. As shown in Chapter 3, there are some indications that domestic inflation has partially eroded the recent devaluation. Given that the objective of the 1978 devaluation was to provide increased incentives to exporters, to maintain the real value of these incentives and to prevent their deterioration due to inflation, the Government may wish to consider two alternative approaches. The first approach to compensate for changes in the relative inflation rates would be to consider a crawling or trotting peg exchange rate system. Under such a system there would be small but frequent changes in the exchange rate during inflationary periods. This would ensure the stability of the real exchange rate which has been shown to be more important than the level of this rate for expanding exports. Thus, the real incentives to exporters afforded by the exchange rate would not change due to domestic inflation. Delayed and sporadic devaluations under inflationary conditions would hamper the expansion of manufactured exports as they have in some other countries such as Argentina, Colombia and Pakistan. This appears to be a major lesson that emerges from both successful and unsuccessful attempts at liberalization. For example, the crawling peg system instituted in Brazil and Colombia led to much higher and stable exports and thus GNP growth. This system is, therefore, by far preferable to the large and infrequent parity changes that have so far characterized exchange rate policy in Indonesia. The second approach to maintain real incentives to exporters would be to index the export rebates provided to exporters. This may be a preferred, short-run solution and is discussed in para. 8.20 within the context of sequencing changes in overall trade policy.

7.20 Furthermore, despite recent actions by the Common Market,<sup>/1</sup> the fears that a successful transition to a neutral trade regime will not generate the expected benefits because of a deteriorating external environment should not deter a move towards such a trade regime. Clearly, increased international protection is undesirable from Indonesia's point of view and retaliation in the form of cancelling or not awarding major contracts to firms from quota-imposing countries is a very real possibility. But apart from such actions, the relevant question for Indonesia is: what is the

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<sup>/1</sup> The EEC recently imposed quotas on textile exports from Indonesia to the UK market for 1980: trousers and slacks (315,000 pieces); blouses (225,000 pieces); and shirts (171,000 pieces). However, on the day these quotas were imposed, the British Government, in a parliamentary report, reaffirmed its belief in an open international trading environment; hopefully, the quotas, therefore, may be only temporary.

appropriate trade strategy from Indonesia's own self interest and point of view? The answer still remains that, in the long-run, a neutral trade strategy would best serve Indonesia's interests. Reverting to a more inward-looking import-substitution biased policy will not solve the problem of international protectionism nor will it serve the Indonesian industrial sector. On the other hand, a neutral policy will lead to increased production and exports of capital- and labor-intensive goods. Developed country protectionist policies may reduce that country's demand for some Indonesian labor-intensive products, but this may be compensated for by aggressive marketing policies in nonquota imposing developed countries and other developing countries. Therefore, as undesirable as international protectionism may be, there is little that Indonesia can do to affect the policies of developed countries and, thus, the search for solutions must remain in Indonesia developing a trade strategy such as the one suggested above in order to minimize the costs imposed by developed country trade policies.

7.21 Furthermore, despite the recent world recession and international protectionist sentiments, total world trade in labor-intensive manufactures has continued to expand. During the 1980s, manufactured exports from developing countries are expected to grow at 9% to 10% a year compared to a 3% to 4% annual growth rate for fuels and other primary products.<sup>/1</sup> Admittedly, this growth in manufactured exports is less than that experienced by developing countries in 1979; it is, nevertheless, much larger than that anticipated for fuels and other primary products in the 1980s. Consequently, Indonesia should attempt to obtain as large a share of this growing market as it possibly can. Moreover, countries such as Brazil, Mexico, Japan and most recently Singapore, have continued to progress along the scale of comparative advantage as their exports have become more capital- and skill-intensive, making room for countries producing labor-intensive products. For example, through the late 1960s and early 1970s, Japan's declining share of labor-intensive products in the world markets was fully accommodated by the quantum increase in the share of Hong Kong, Korea, Taiwan and Singapore<sup>/2</sup>; these countries maintained rapid export growth in the 1970s despite setbacks in the world trade situation.

7.22 Now, with rapidly rising labor costs, the structural transformation of these countries away from labor-intensive manufactures enhances the prospects of Indonesia to emerge as the successor. The recent rapid growth of Indonesian labor-intensive exports in textiles, electronics and wood-products, discussed in Chapter 3, should be the precursor of strong export growth in other industries as well, provided appropriate policies are followed. A related benefit of these policies, as mentioned earlier, will also be an efficient allocation of resources which will lead to a more dynamic

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<sup>/1</sup> World Development Report, 1980.

<sup>/2</sup> See H. W. Arndt and Ross Garnaut (1979), "ASEAN and the Industrialization East Asia," Journal of Common Market Studies, vol. XVII, No. 3.

and flexible industrial sector, which is essential in a world of uncertain and rapidly changing trading environments. Such a flexible sector will not only permit rapid redirection of exports away from the quota-imposing countries towards those with more open trade policies, but it will also encourage the growth of efficient import-substituting industries that are essential for industrial growth. If, however, Indonesia maintains the current bias towards import-substitution policies which have, in the past, encouraged the growth of some inefficient industries, then the prophecy of poor manufactured exports will become a self-fulfilling one and the manufacturing sector will be ill-prepared to cope with the uncertainties of international trade.

### Financial Policy Reforms

7.23 As discussed in Chapter 5, the provision of credit in Indonesia has constrained industrial development. The shortage of long-term borrowing instruments, the nonallocative role of interest rates and the ineffectiveness of the financial intermediation process have greatly restricted the availability of credit to the private sector. The financial policy framework, therefore, needs to evolve into one that can be adapted to the needs of the 1980s. In many ways, the long-run reforms suggested are similar to the policies undertaken by the Government prior to 1974. The changing environment suggests the importance of controlling inflation and managing liquidity, not through the current exclusive reliance on credit ceilings except under conditions of emergency, but through the domestic expenditure budget - which, in the recent past, has been the most important source of inflation - and appropriate interest rate policies.

7.24 This, in turn would permit more effective use of interest rates in the allocation of financial resources in determining an appropriate choice of technology in the manufacturing sector and in containing liquidity growth. The use of sectoral ceilings to allocate credit should, therefore, be abandoned; their perpetuation will only introduce uncertainties and raise administrative costs. The key problem in Indonesia today is not the overall adequacy of resources, but the allocation of resources. Any reform in the interest rate structure should reflect that fact. The existing fragmentation of the financial market means that borrowers who have access to credit from the state banks must pay one rate of interest, while those who must borrow from private banks or in the international market must pay much higher rates of interest. As noted before (para. 5.09), some private borrowers, particularly new firms and small firms, have no access to external funding, while at the same time, the public sector has a large surplus. Specifically, real

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/1 See H. W. Arndt and Ross Garnaut (1979), "ASEAN and the Industrialization East Asia," Journal of Common Market Studies, vol. XVII, No. 3.

positive rates, which need not necessarily imply high nominal rates if inflation control is successful, would reduce the fragmentation of the financial market and ease the existing supply constraints by encouraging greater real savings and investment. Given Indonesia's open access to international capital markets, the level of the lending rate would then be set by expectations of inflation and exchange rate changes. However, in so far as the weaker economic group is concerned, the Government should continue to provide credit at subsidized interest rates to this group until indigenous entrepreneurship develops to the desired level.

7.25 To support real positive deposit rates, the Government should also consider the re-establishment of the rediscount mechanism as a tool of monetary policy to control the reserve money base. With adequate rates of return to financial institutions, the current use of the rediscount window to subsidize these institutions can be abandoned. Furthermore, to reduce the intermediation costs and to improve the efficiency of state banks, the degree of competition faced by these institutions needs to be increased. Such a policy is essential if the desired expansion of services and financial intermediation is to be achieved.

7.26 As noted in Chapter 5, the use of financial policies to attain social objectives may have economic costs which are higher than anticipated; these policies have not only constrained industrial growth, but also have had only limited success in achieving their goals. A realignment of policies which explicitly uses budget subsidies rather than the rediscount window to provide subsidized credit, and emphasizes business education, on-the-job training, and employment creation in the manufacturing sector provides an attractive alternative to the current exclusive focus on regulations to develop the entrepreneurial talent of the weaker economic group (paras. 8.38 to 8.41). Nevertheless, the Government may choose to pay a high cost for objectives that transcend economic considerations; the social benefits of these policies - to the extent that they are effective - only the Government can evaluate.

7.27 Institutional reforms are also essential to expedite the process of financial intermediation. But without the long-range changes in the policy environment mentioned above, administrative reforms, such as training, recruitment and streamlining procedures, will have only limited, short-run benefits. A financial policy climate that encourages the growth of the banking sector is a sine qua non for industrial growth. Moreover, improvements in the legal framework for debt collection within Indonesia and across international boundaries, reduction in the variance in administrative interpretation of regulations related to debt intermediation, and improvements in accounting practices, company law and tax regulations will further enhance the evolution of an efficient financial sector.

#### Policies Toward Private Foreign Investment

7.28 The potential for direct private foreign investment with significant benefits for the Indonesian economy is very high. The central problem for the Indonesian economy is to transform available resources into investments with

high rates of return. The most important element in achieving this objective is the need for entrepreneurial, technical, and managerial expertise. The major benefits of private direct foreign investment lie in its efficiency in the international transfer of such expertise relative to alternative processes based on licensing, consulting arrangements, or local research and development. Private foreign investment can also aid in attaining the Government's objective of creating indigenous Indonesian entrepreneurship, but the process would be more of a long-term nature rather than one that would confer immediate benefits. Private foreign investment can not only contribute to the broad objective of improving the economic position of such lower income groups through its impact on wage rates and skill development, but also to the narrow objective of developing commercial expertise and the economic power of specific indigenous groups; constant exposure to efficient and modern business techniques is one of the best training grounds for entrepreneurial skills.

7.29 Given the objective of the Government to attract foreign investment into Indonesia, the incentives for these firms to locate there, rather than in other Southeast Asian countries, must be provided. This implies that the general investment climate needs to be improved to overcome the reluctance of new foreign investors to make investments in Indonesia. Despite recent restrictions, foreign investors still believe that Indonesia with its large potential domestic market makes it an attractive place for long-term investment, but there is less unanimity as to whether it will remain so if current trends continue.

7.30 The intent of the reforms outlined earlier in this chapter is to eliminate the distortions in the economy so that a close correspondence can be achieved between private and social profitability. Many of the investment controls and restrictions placed on foreign firms are, in fact, responses to existing distortions. As these distortions are gradually eliminated, there will be little reason to favor or discriminate against specific sectors and foreign firms. Thus, these long-run reforms would also contribute significantly to improving the economic climate for and the social profitability of foreign investment.

7.31 Specifically, this implies that, over the long-run, existing investment controls for foreign firms in the manufacturing sector can be relaxed. Licenses could be maintained for firms in the capital-intensive extractive sectors of the economy, but, in the long-run, foreign firms in other sectors should not be subject to investment controls; they should, however, be expected to register with the Ministry of Industry or the BKPM. As with domestic firms, detailed, sector-specific investment incentives should also be replaced by general incentives. The elimination of special incentives should be carried out in conjunction with the elimination of restrictions as these policies currently tend to work at crosspurposes. Once price distortions, such as tariff protection, that lead to net losses to the Indonesian economy are eliminated and if the previous suggestions for long-run reform are undertaken, then there is no compelling reason to either restrict or differentiate the incentives to any type of investment in the manufacturing sector.

7.32 As part of a move towards eliminating or reducing the use of special incentives of the type administered by BKPM, the Government of Indonesia should propose an agreement within ASEAN aimed at both moderating and creating more uniformity in incentives systems for foreign investment. It is to be disadvantage of the ASEAN economies to bid up the cost of foreign investment to each other; this is one area of economic policy where mutual cooperation would be both feasible and beneficial.

7.33 Furthermore, as part of an overall policy reform, the restrictions on the use of foreign workers might be relaxed. Such a relaxation would be part of a process of achieving efficiency in production; this may lower returns to Indonesians in executive positions, but it is to the advantage of the Indonesian consumer and worker. A clear long-run policy of access to high level personnel from abroad, combined with a cooperative effort between the Government and firms to replace such workers would eliminate the high costs of uncertainty in the investment process. A few key personnel can make the difference between success or failure and any uncertainty created by Government restrictions on hiring practices of the firms will be reflected in a larger risk premium attached to the operation of foreign firms.

7.34 There is also little evidence to support economic arguments that current ownership regulations are effective in permitting Indonesians to exercise local control, to develop entrepreneurship or to increase Indonesia's share of profits. There is also little evidence demonstrating that foreign firms behave significantly different than domestic firms. In fact, there are grounds to believe that foreign firms operate closer to the legal norms with respect to tax payments and business operations in general than do domestic firms. Thus, ownership control policies that are currently generating considerable uncertainty must be carefully evaluated by the Government with clearly identified long-run economic and noneconomic objectives in mind.

#### The Role of the Government

7.35 The primary focus of this report has been on analyzing the investment climate for the private sector. No attempt has been made to analyze the issues relating to public sector industrial investment planning. Given the key role of the Government in the industrial sector, the remainder of this chapter briefly addresses this issue. The Government currently plays a dual role in the industrial sector. The first one involves the formulation of policies and incentives/disincentives to production and exports; the appropriate policies to be formulated by the Government over the long-run have already been discussed in the preceding sections and the specifics are outlined in the next chapter. The second is direct intervention in the production process through Government investments which have been predominantly, but not exclusively, in the capital-intensive sectors.

7.36 The reasons for such investments and for the resulting establishment of state enterprises are similar to those in other developing countries: there is believed to be a shortage of entrepreneurial and managerial talent

in the private sector; the capital market is not well developed, so private business firms find it difficult to raise sufficient funds for large projects; the private sector is too cautious and risk averse to undertake "appropriate" investments; the Government considers it essential to own and control the "commanding heights" or the "key sectors" of the economy so that prices and marketing channels can be directly administered for basic products in order to achieve equitable growth; and, as noted earlier, there is widespread concern that private sector involvement in important industries would strengthen the economic power of minority entrepreneurial groups. To the extent that the Government is involved in investing in the industrial sector, great care must be taken to ensure that individual projects are carefully evaluated and selected, since once they are initiated, the practical possibilities of reversing such mistakes appear to be limited in Indonesia. There is, however, little economic justification for continued public sector ownership and control of labor-intensive industries. To further the goals of Repelita III and to increase the participation of the private sector, the Government should consider selling the existing firms to the private sector through public offerings on the Jakarta stock exchange.

7.37 Regarding the capital-intensive industries, there is little question that the Government has an important role to play in the investment process and will continue to do so in the foreseeable future; as indicated in para. 2.25, over the period 1977/78, 68% of all industrial investments have been made in the public sector. Government investment in large-scale capital-intensive projects such as petrochemicals, fertilizers, LPG and other such industries in which Indonesia has a comparative advantage must be carefully undertaken. This is because, if due to an incorrect evaluation, a high cost "upstream" industry is established by the Government, to maintain its financial viability, the Government may be forced to impose import tariffs to protect this industry from more efficient imports. "Downstream" industries using the domestic high cost input will now themselves be unable to compete efficiently with imports, thus, necessitating increased tariffs on a range of such input-using industries. These measures would constitute retrogressive steps given the Government's current plans to move towards a lower overall tariff structure. Consequently, it becomes extremely important that the selection of projects in the public sector be carefully undertaken and that considerable emphasis be placed on quality project preparation and implementation; otherwise the ripple effects of an incorrect "upstream" decision could be quite far reaching.

7.38 The Government's current objectives of encouraging foreign equity participation in large projects without Government guarantees are likely to prove beneficial for the industrial sector. One hundred percent government equity in these projects may be justified if it can be demonstrated that the social profitability of the project exceeds its private profitability, and private domestic or foreign investors are unprepared to undertake the investment. This appears to be the case because, as mentioned earlier (para. 2.25), due to delays in project implementation and the external

resource position of Indonesia, the Government is considering financing some of the large petrochemical complexes entirely from domestic resources. In Chapter 3, it was shown that Indonesia had a potential comparative advantage in certain capital-intensive sectors, such as fertilizers and petroleum products, whereas others, such as iron and steel and motor vehicles, would impose large economic costs to the society. To the extent that, in the short- and medium-run, direct Government investment is deemed to be socially desirable, only the profitable sectors should be considered; no investments should be undertaken in the unprofitable ones.<sup>/1</sup> Rather, domestic demand should be met through imports which would be cheaper.

7.39 There is, however, little reason to protect new or existing state enterprises from domestic or foreign competition. The efficiency of both public and private firms can be enhanced by permitting both types of firms to operate in the same sector and by creating an environment in which both are subject to competitive pressures from each other and from imports. The Government should, therefore, permit private sector activity in any industrial subsector provided it is private capital that is at risk. This implies that the current policy of demarcating industries between the private and the public sectors should be abandoned, and, contrary to the present situation, public firms should not receive more favorable treatment than private firms. This, in turn, has important implications for and places further urgency on the reform of the licensing procedures, financial policies and the incentive system, all of which currently add significantly to the costs of operations of private firms.

7.40 Furthermore, given the scarcity of skilled manpower and managerial resources in the public sector, care must be taken to ensure that these scarce resources are not spread too thinly across too many projects. Thus, the Government should also consider utilizing, in state-owned firms, management skills from the private sector. This is not inconsistent with public equity or with meeting social objectives; it may also serve to insulate the operations of these firms from political influence.

7.41 In the long-run, as the domestic capital market develops and domestic entrepreneurial skills and abilities are in increasing supply, the Government could ensure continued efficient operation of these capital-intensive firms by selectively selling them to the domestic private sector utilizing the Jakarta stock exchange. The arguments for this divestiture arise from the finite limits to the state's managerial abilities and from the fact that this policy makes available a "revolving fund" which can be used to pioneer other efficient state ventures in monopolistic or oligopolistic markets to promote competition in specific industries, or to invest in the social sectors in which the private sector is unlikely to enter. This policy has been adopted by several countries such as Japan, UK, Singapore, Korea, Argentina and Brazil, in the belief that the efficiency of continued production would be ensured by private investors risking their own resources rather than by managers of public enterprises.

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<sup>/1</sup> Annex 2 shows the relative rankings and the social profitability of several manufacturing sectors.

## 8. AN AGENDA FOR POLICY ADJUSTMENTS

### Introduction

8.01 The previous chapter outlined a general framework for long-term industrial development in Indonesia. It provided the broad directions towards which various industrial policies should move if Indonesia is to achieve a structural transformation that would provide the basis for efficient industrial growth and the expansion of exports, productive employment and increased income-earning opportunities and equity. The industrial policies of the 1960s and the 1970s have served Indonesia well as witnessed by the high growth rate of manufacturing in 1970s. This, however, should not be viewed as the sole parameter of success. It is essential that any high growth rate be accompanied by the evolution of an efficient industrial base that can make Indonesian manufacturing internationally competitive by the end of the decade. As para. 3.14 (and Table 13 in Annex 2) indicate, there are, at the moment, several subsectors that cannot compete on the international market without substantial explicit or implicit subsidies. Therefore, to facilitate the desired evolution of the sector, reforms would have to be undertaken now and continued throughout the 1980s to ensure that the Indonesian manufacturing sector does not fall into the quagmire of a high growth rate accompanied by the creation of an inefficient industrial structure as in the case of some other developing countries such as Turkey.

8.02 The above suggests that policy reforms need to be undertaken in the near future so that their effects can be visible by the mid-1980s. Moreover, the current period is particularly opportune to begin the process given Indonesia's large foreign exchange reserves and the relatively small size of the industrial sector. In this context, Indonesia is far more fortunate than many developing countries that have either undertaken major policy reforms under crisis conditions or when a relatively large and inefficient industrial sector has been firmly established.

8.03 The focus of this chapter is, therefore, to provide specific recommendations necessary to move towards the long-term industrial development framework described in Chapter 7. Clearly, the suggested reforms cannot and should not be implemented overnight. Apart from the existence of vested interests, social and political considerations and the possibility of industrial dislocation suggest the adoption of a gradual approach. In order to reduce uncertainty, and to provide opportunities for existing firms to adjust to the new environment, a phased schedule of changes is outlined in this chapter. Such an approach would assure a smooth adjustment and also provide the opportunities to coordinate the different policies with one another, thus, laying the foundations for improving private sector incentives for industrial expansion. Therefore, by their very nature, these recommendations are not of the "first-best" variety; they are, rather, transitional policies designed to provide the basis for developing a much improved economic environment. Furthermore, there is no unique optimal sequencing of these policy adjustments. The recommendations made below represent best

judgments made within the Indonesian context. The recommendations made are designed to attain the Government's objectives of growth, improved income distribution and equity. Many of them can be considered without making fundamental decisions on overall policy directions. These recommendations involve a time phasing which extends over a ten-year period; the period beyond ten years is considered to be the long-run and has already been discussed./1

### Simplifying Administrative Controls

#### Establishing a Deregulation Commission

8.04 The analysis provided in Chapters 3 to 6 suggests that the most serious obstacles to increased industrial activity in the private sector are the variety of controls imposed on such activities. To begin the process of simplification, it is recommended that the Government establish a Deregulation Commission that gives serious consideration to the suggestions made below and treats them as an initial terms of reference for its task. The broad mandate of this Commission would be to undertake a major review of the system in order to disentangle the existing procedures for issuing licenses. On a periodic basis, the Commission may wish to consider preparing and publishing reports which discuss the various phases of reforms as they are undertaken. The following seven actions provide examples of what would constitute a first step towards their task; these would apply to a broad range of licenses:

- (a) all the forms in use need to be revised to eliminate superfluous questions and requirements. This is a very detailed and sensitive assignment and assistance should be sought from consultant firms proficient in management techniques;
- (b) to the extent possible, multiple copies of documents should not be required of applicants; this, however, can only be decided on a case-by-case basis;
- (c) brochures clearly explaining different licensing requirements for different firms and applications for various licenses should be available free of charge from all Government offices which issue licenses; where service charges are necessary they should be publicly posted;
- (d) applications should be approved or rejected within specified time periods and the reasons for rejections should be given;
- (e) until significant reforms take place, the evaluation of all projects for investment licensing purposes should be based on careful cost-benefit analyses performed by trained staff within the BKPM;
- (f) formal procedures should be established for businessmen to appeal against rejected applications; and

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/1 Annexes 2, 3, 4 and 5 discuss the specific recommendations in much greater detail.

- (g) all offices responsible for issuing major licenses should be required to report annually and make public the time taken to process applications.

Resolving the Ambiguity in the DSP List

8.05 The simplification of procedures also involves a reform of the DSP system for allocating investment licenses. A useful step would be to resolve the existing ambiguity in the 1980 DSP regarding those sectors that "may be open for investment, closed or not yet classified". It is suggested that these sectors be open for new investment with no conditions of approval and no special investment or taxation incentives. Only their registration should be required which would make them eligible for general fiscal incentives available to all firms.

Modifying the DSP List

8.06 This step should be followed by modifying the current DSP list; the detailed 866 subsectors in the latest lists should be reduced to about 50 (or any reasonably small number determined by the Commission). One criterion that the Commission may wish to consider in determining this set of subsectors would be to preserve in the DSP list those few subsectors that would be subject to significant economic disruptions as a result of the delicensing procedures. Another criterion would be to identify certain subsectors in which the Government may wish to give preference to the economically disadvantaged groups of society. In applying this criterion, great care must be taken to ensure that, as a result of such a preference policy, the development of the particular subsector is not retarded. But using the current DSP list and the associated licenses to achieve, in the short-run, objectives other than the support of the weaker economic group (such as regional balance, and preventing excess capacity) not only has limited success in meeting these goals, but as discussed earlier (Chapter 4) also discriminates against the economically disadvantaged groups and succeeds, albeit unintentionally, in thwarting the equity goals of the Government.

8.07 In conjunction with the above suggestion, detailed tax and investment incentives specified at the subsectoral level may be substituted with incentives that differentiate only between broad categories of industries. For example, incentives (such as tax holidays) which least distort the choice of technology may be used to encourage labor-intensive industries. There is, however, considerable evidence indicating that tax and investment incentives given by the BKPM are not a significant factor in affecting domestic or foreign investment decisions, nor do they provide adequate encouragement for domestic firms to obtain licenses through the BKPM; these incentives are relatively unimportant given the existing levels of protection. Consequently, many domestic firms have chosen to bypass the BKPM and the DSP system and forego these incentives. There is, therefore, a strong argument for reducing administrative costs by eventually moving towards a uniform set of tax and investment incentives as suggested in Chapter 7.<sup>/1</sup>

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<sup>/1</sup> Annex 5 discusses the economic principles that the BKPM should consider in providing special incentives to domestic and foreign firms.

8.08 Subsequent steps could be taken, in the short-run, to eliminate the many categories of project modification for which reapproval from the BKPM is necessary; simultaneously, the detailed documentation required with each modification can also be minimized. Moreover, the interdependence of various licenses should be abolished; procedures should be established to permit non-BKPM investors requiring licenses such as health, environment and labor, to apply simultaneously for these licenses at the regional and at the national level. This would significantly reduce the current delays in obtaining these licenses.

#### Relaxing Restrictions on Second-Hand Machinery

8.09 The Government has already taken some steps to relax the regulations precluding investors from importing second-hand machinery; these regulations should be further liberalized. Since this principle has already been accepted for a small range of equipment, the process could begin immediately - as it is particularly easy to implement - and could be done in stages until the ban is eventually eliminated. This conforms with other recommendations made regarding quantitative restrictions on trade (para. 8.19).

#### Shortening the Master Lists

8.10 In the same vein, the extensive difficulties associated with the master lists for equipment, machinery and raw materials suggest that steps could also be taken to shorten these lists. Since the detailed information required for each item of machinery and raw material cannot be effectively supervised, they serve little purpose. Such requests should, therefore, be minimized. Furthermore, specific tariff exemptions, granted by the BKPM on a firm-by-firm basis, and which encourages the use of capital relative to labor, should be replaced by an alternate tariff structure, discussed in para. 8.20, that applies to the entire manufacturing sector. Gradual movement in these directions would make the master lists eventually superfluous; they could be eliminated over the same time frame as the short-run reforms in the tariff structure are implemented; viz., within five years. Moreover all of the suggestions made above, including the aggregation of the DSP sectors, should also be accomplished within five years; this would now set the stage for the three-way classification of the industrial sector discussed in Chapter 7.

#### Controlling Environmental Pollution

8.11 Although the size of the industrial sector is still small, the impact of industrial pollution on some densely populated areas surrounding an industry has been known to be quite significant. This is particularly true of the impact of industrial pollution on water; consequently, this is of great concern to the Government. As the sector grows, the need to address industrial pollution and environmental issues in a systematic manner will become increasingly important and measures to control pollution will need to be applied more vigorously. Consequently, clear procedures and regulations are required covering the treatment of

waste and effluent through a system of effluent taxes and penalties (which may be recycled into the system to improve the ecological processes of the environment), tariff concessions on imported equipment required to control pollution, tax incentives for industries that succeed in reducing the damage to the environment, and industrial zoning and other environmental instruments that allow for substantial differences between the regions of the country. Furthermore, it is suggested that an environmental impact assessment be an integral part of project design and choice of technology. Such an assessment should specify the type and level of environmental change (e.g. pollutants) expected from the firm's production activities, and the control mechanisms necessary to keep the change within a tolerable level. This would be particularly useful if the project involved a type of pollutant not accounted for in the effluent tax, zoning or regulatory system. The objective of the above would be to ensure that due consideration is given to the proper choice and use of energy, natural resources and technology in order to minimize environmental destruction, optimize the recycling of materials and maintain the essential ecological process and life support systems. The above system of tax incentives and penalties should equate private costs with social costs and the incremental burden of the social costs should be borne by the producers and the consumers of the relevant product. Moreover, within a particular industrial zone, tolerable levels of pollution may be maintained by the automatic allocation of an environmental license specifying, for each firm, the permissible level of pollution. In addition, the Government should also permit the existence of a market that facilitates the trading of these licenses between firms. This will ensure that the maximum tolerable level of pollution is not exceeded in that particular zone. However, for small-scale industries, particularly those involving the weaker economic group, the Government should provide tax relief or even straight subsidies to control environmental pollution, particularly for those located on mini-industrial estates.

8.12 Environmental factors must also be incorporated into the large industrial projects undertaken by the Government such as power, mining and pulp and paper. For example, in the planning of all hydroelectric projects a thorough analysis of the effects of building dams on the people and the environment of the area must be undertaken. In the design of thermal plants measures to control air pollution should be included in the project design as should instrumentation to monitor pollution levels. In addition, forest industries projects should be designed to prevent over or underharvesting of trees, or damage to remaining stands. They should also provide for commensurate reforestation and should use all felled trees either for sawwood, pulp, or fuel to provide electricity and steam for the sawmills and pulp factory.

8.13 Environmental standards at the provincial level should be set by the provincial governments in consultation with the Ministry in charge of the environment. Moreover, the control and implementation of these standards should also be decentralized to the provincial governments. Furthermore, in cases of conflicts between the industry and the public at large, settlement of disputes should be attempted at the provincial level with the right of appeal to the Ministry of Environment. However, the successful implementation of an appropriate environmental policy will also

necessitate considerable training and education in the field of pollution control and environmental impact assessment. Therefore, a large program of training and education of public officials is of urgent priority. In addition, the development of laboratories for field research on environment, especially in the Environmental Study Centers at the universities throughout Indonesia should be given serious consideration.

#### Improving Customs and Port Procedures

8.14 Customs and port procedures also continue to need reform. This recommendation has been made in past World Bank reports, but much more progress needs to be made. It is suggested that the Government inquire into the reasons why previous attempts to improve procedures have not had the expected effect and that it establish a specific deadline to complete the study regarding the streamlining of these procedures for which funds were allocated in Tanjung Priok Port Project (Loan 1337-IND). The current status of this study is in some question; as a first step, this status needs to be clarified if the objective of reducing the costs to importers and exporters is to be achieved.

#### Reforming Tax Laws and the Legal Infrastructure

##### Establishing a Tax Board

8.15 The current difficult relations between company taxpayers and tax officials suggests that substantial problems continue to exist with the company tax system, particularly for smaller firms. It is, therefore, proposed that a Tax Board be established composed of Indonesian lawyers and accountants and foreign advisers experienced in taxation law and accounting practices. This group should look into a wide range of matters including a review of the Corporate Law system, simplification of the corporate tax system and incentives, clarification of ambiguities and the establishment of effective procedures for appeal. The recent decision to reactivate the Court of Appeals will improve the current situation, but proper staffing, facilities and judgements perceived to be fair by the aggrieved party will be necessary to reestablish faith in the tax system. The March 1979 reforms undertaken by the Government, in particular the use of public accountants in preparing corporate tax returns, are good examples of the type of steps required to improve the institutional environment.

##### Improving the Legal Framework

8.16 The weakness in the legal infrastructure for the industrial sector manifests itself in the numerous regulations that overlap with one another, that are inconsistent between one another and, in some cases, are out of date. Furthermore, there is no organized system for circulating and publicizing laws related to the industrial sector. A Legal Group should, therefore, be established to conduct a codification of all industrial laws and regulations. This could begin with laws and regulations enunciated by the Ministry of Industry, but could then be extended to those issued by the Ministries of Trade and Finance. The Pusat Dokumentasi Hukum (Center for

Legal Documentation) at the University of Indonesia would be a suitable organization that could be involved in this undertaking. The codification process, at a minimum, should ensure that outdated regulations are eliminated from the books, recent regulations that supersede old ones clearly identify those that are no longer legally valid, and the language of these regulations should be carefully constructed to avoid, to the extent possible, ambiguity and confusion. To provide firms with adequate security against the proliferation of contradictory decisions, a legal mechanism also needs to be established that would protect firms against prosecution for ignoring instructions from a "lower" (regional) level if they differ from those legally issued by a "higher" (Central Government) authority.

#### Distribution of Information

8.17 There is also an urgent need to establish a well-organized system of making public the numerous government laws and directives. The first steps can be taken by the Ministries of Industry and Trade and by the Directorate General of Taxation. An official publication should be issued, at least monthly, by these agencies containing the text of recent regulations, laws and decisions made at the national and provincial levels. These publications should be on sale throughout Indonesia and also be made available on a subscription basis. Furthermore, regulations and formal decisions made by the Government and affecting the industrial sector should not become effective until announced in such a publication. All related official material on industrial policy should also be distributed through Government stores and distributors throughout Indonesia. The current system of combining private and public sector initiatives by the Government's use of a reputable pribumi company, Cafi, and the Government gazette, Berite Negara, are excellent examples of how the system of publishing regulations should be undertaken (para. 4.03). To build on this system and to facilitate the distribution of these bulletins, the Government may wish to consider their large-scale purchases for national distribution.

#### Reducing the Import-Substitution Bias

##### Expanding the Export Certificate Scheme

8.18 The extent to which domestic firms become internationally competitive is of paramount importance in affecting industrial growth, employment and exports. Therefore, in conjunction with the gradual deregulation of the economy, steps should also be taken to reduce the current inward-looking bias of the trade regime. To facilitate this process, the Government can begin by improving the operation of the export certificate system. These certificates should be provided for more broadly defined groups of commodities rather than for specific items only, as at present. The Government may, therefore, consider making eligible all groups of manufactured goods, including those that are currently not being exported. Furthermore, as a rough initial guideline, the export certificate rates should be set at a level which, at a minimum, provides an average of zero effective protection for export sales for every group; this can be done for sets of commodities at the two or three-digit SITC level rather than at the current six-digit level. Any firm that chooses to export a commodity would

now be guaranteed this export certificate rate without having to provide detailed documentation on tariffs paid on inputs. Currently, there is some consideration being given by the Government to increase the coverage of goods eligible for the export certificate scheme. The Government also recognizes the increased administrative burden that will be imposed by the expanded coverage and by the detailed current six-digit level of commodity specification. It is, therefore, also considering grouping commodities into more aggregated sets and specifying these sets at less than the six-digit level.

#### Providing Increased Incentives to Exports

8.19 In order to improve the efficiency of the manufacturing sector, the current bias towards production for the domestic market may be reduced by providing positive incentives (protection) to exports. However, export certificate rates necessary to achieve these subsidy levels may raise the question of international acceptability and to the imposition of countervailing duties under GATT rules. One alternative, therefore, would be to establish a "wastage allowance" system which permits duty-free imports of input beyond that necessary for export production. Firms could use the excess inputs for domestic production or resell this amount to other firms. A second alternative would be to develop an "export-import link" system which provides exporters with a "duty-exemption" certificate which qualifies the holders for duty-free imports of any number of listed intermediate (or final) commodities. Thus, for example, for every \$100 worth of exports, the exporter would obtain a certificate worth Rp 10,000 at customs in lieu of customs duties, in addition to the export certificate rebate. In the early 1960s, under the then existing stringent exchange controlled trade regime, the Government attempted an "export-import link" system which resulted in some administrative problems. These may have been exacerbated by the exchange control regime which now no longer exists. This system may, therefore, be worth some consideration as a potential approach if the need arises. Export credit subsidies provided for working capital can also aid exporters, but subsidized export credit for investment capital should be avoided as they tend to distort the choice of technology and lead to a misallocation of resources. The provision of positive protection to exports through subsidies on energy (gas, fuel oil and electricity) distorts significantly the allocation of this scarce resource; such measures, are, therefore, not appropriate instruments for protection.

#### Reforming the Export Check-Price System

8.20 The export check-price system for commodities on the export certificate list should also not be used as a policy instrument to alter the effective rate of export rebate as is the current practice. These check-prices should reflect real f.o.b. prices and be set by customs using the same foreign sources now used to set import check-prices. These prices should continue to be adjusted at least semi-annually, as is the current practice, except in cases of unusual international price movements. Once the smooth operation of the redesigned export certificate system has been established, the export check-prices can be eliminated and the export rebates should then be provided on actual realized f.o.b. prices.

### Maintaining Real Incentives to Exporters

8.21 Furthermore, to ensure that, in the short-run, the real incentives to exporters provided by the export certificate scheme are maintained, increases or decreases in export certificate rebates should be provided, at least every quarter, to reflect changes in the domestic price level relative to international inflation. This will ensure that the effective exchange rate for manufactured exports will be indexed so as to prevent its real deterioration and, thus, dissuade further expansion of export capacity.

### Replacing Export Quotas with Export Taxes

8.22 Except for special circumstances such as adjustment periods after devaluation or for goods whose domestic price stability affects those at the lower end of the income distribution scale or when price stability is considered to be essential by the Government to ensure political stability, the continued use of export quotas is not in the long-run interest of improving industrial efficiency. Consequently, export prohibitions which are currently still in force could be replaced by a 5-10% export tax which could be phased out over five years. Such a level of protection will be sufficient to encourage the domestic processing of raw materials if Indonesia has a genuine long-run comparative advantage in these activities. Higher rates of export taxes, however, can be justified (on optimal tariff grounds) for those commodities, such as timber, in which Indonesia has monopoly or quasi-monopoly power. To facilitate the proper exploitation of this instrument and to reduce the associated administrative costs, the legislation restricting export taxes to only three levels - 5%, 10% and 20% should be replaced by a more flexible one that permits the Government to replace export quotas with appropriate export taxes. Thus, the current policy of imposing export quotas in addition to export taxes on commodities can be abandoned.

### The Development of Export Processing Zones

8.23 Throughout the transition process, the emphasis on the encouragement of exports through appropriate policy instruments mentioned above can be supplemented by strong political commitment to this goal and high level official support to expedite the needs of export-oriented manufacturing through the creation of private trading houses that facilitate international marketing and exports and through the establishment of export-oriented industrial complexes. The formation of export processing zones would be particularly beneficial to Indonesia in its early phase of an export-oriented strategy and can form part of Indonesia's overall strategy for the expansion of manufactured exports. The benefits include increased employment for the country, the additional sales of raw materials and services and the resulting increase in export value-added. The benefits to firms would arise from the low cost of available labor, the proposed infrastructure and plant facilities, and the visible assurance to domestic and foreign investors that they will be free to export and import without any institutional constraints; this "extraterritorial" status is a special characteristic of such industrial complexes. The benefits to Indonesia would arise from the progressive development of backward linkages and by the channelling of capital, management and know-how which can have significant demonstration effects on the industrial sector.

8.24 Such zones have been established in many developing countries. In the 1960s, they formed part of the industrial development programs of Korea, Singapore, Malaysia, and Taiwan. Since then, they have spread to several other countries such as Barbados, Haiti, India, Mexico, Morocco and Senegal. It is, however, important to point out that the most dramatic expansion has taken place in countries where the general economic policies have favored exports. In countries that have continued to adopt policies biased towards import-substitution, export processing zones have been merely established to by-pass the entire system. Therefore, without a genuine change in policy bias to one favoring manufactured exports, the long-run benefits derived from such zones will be lost to Indonesia. It is, therefore, suggested that the pilot project at Pulo Gadung be expedited, that the reasons why the zone at Tanjung Priok does not operate as a true export processing zone be investigated, and that potential sites be identified for future zones in Indonesia.

#### Replacing Quantitative Restrictions with Import Tariffs

8.25 Shifting the focus to imports, quantitative restrictions and total bans on imports may be needed at times when indirect measures to restrict imports are too slow. But the occasions to resort to such measures are likely to be infrequent. Furthermore, protection by quotas does not provide a criterion for the selection of activities to protect and there is no discipline provided by import competition. Quotas also tend to create monopoly situations since they eliminate import competition, and insulate the domestic economy from foreign developments. Given the urgency to improve the efficiency of the industrial sector, any use of bans and quantitative restrictions should be made very judiciously. It is, therefore, suggested that the existing quantitative restrictions and bans be phased out over five years and be replaced by tariffs. The Government is currently reviewing the list of quantitative restrictions with a view to eliminating such restrictions and replacing them by tariffs. A few months ago, the Government lifted the import quotas on checkered sarongs and replaced them with relatively low import tariffs.

#### Making Import Tariffs the Sole Source of Protection

8.26 Before the tariff structure can be properly reformed, it is important to ensure that tariffs are made the sole source of protection; a number of steps may, therefore, be taken. First, the import sales tax and the domestic sales tax could be harmonized; this implies that these two taxes should adopt the same nomenclature and rates; this "sales tax" would then apply equally to all sales of a commodity whether it originates at the factory-gate or at customs. Simultaneously, the current 1% rate of sales tax should be abolished as the associated administrative costs far exceed the revenues collected. These actions can be undertaken in the near future.

8.27 Second, discriminatory protection afforded through the import pre-payment scheme, sales tax, MPO rates, import check-prices and quantitative restrictions should also be eliminated. The import of a commodity should bear the same duty rate regardless of who the importer is, or what sector will make

use of the commodity. Protection for specific sectors should be provided via tariffs on outputs - which should preferably be ad valorem rather than specific - or through production subsidies which are superior instruments to discriminatory taxes and tariffs on inputs.

### Restructuring the Tariff Schedule

8.28 In order for the Government to move gradually towards a more uniform and lower tariff structure, the entire tariff schedule needs to be reviewed. As mentioned earlier (para. 7.12) such a review is currently underway. It is, however, suggested that a Tariff Board be established to consider such a review and the suggestions made below. At the moment, the nucleus of such a Tariff Board already exists and is made up of only Government officials. One more step needs to be undertaken to incorporate the private sector into this group and establish its permanence in overseeing the tariff situation. A primary objective of this Board would be to lower the average effective protection and its variance. In certain situations a combination of ad valorem and specific tariffs may be practical if protection is desired for a particular quality range. But as a general rule it is suggested that initially ad valorem rates not to exceed 50% be established for all final and intermediate goods whose nominal tariffs currently exceed this amount. These rates should be slowly reduced to a uniform ceiling of 20% within five years with annual targets set and announced in advance. Higher tariff rates may be justified to protect firms on infant industry grounds. But great care needs to be taken to ensure that legitimate and credible grounds have been first established to justify these higher rates. Furthermore, these industries should not be given more than a 15% margin over the 20% afforded to other sectors, and these rates should be set for a finite period not exceeding five years to permit the infant industry to mature; over this period, the incremental protection should decline to the 20% level. It is also important that this decline in protection be announced in advance to prevent expectations of continued protection; such expectations, in other countries, have often turned infant industries into senile industries. To ease the adjustment process for firms, the Government may wish to provide some industrial adjustment assistance to those firms who, with a little bit of support, could operate efficiently under the new tariff regime. The difficulty would lie in making the appropriate selection of firms because most firms, including the extremely inefficient ones, would apply for such assistance. If the administrative machinery required to undertake the selection and provide the necessary assistance proves to be too cumbersome, the Government may wish to consider lengthening the transition phase from the five years suggested above to permit firms to undertake their own adjustment programs.

8.29 The Tariff Board will also have to modify the system of uniform tariffs for the entire industrial sector in cases where the eventual result of the tariff reform is very non-uniform effective protection; given the uniformity objective, there will inevitably be a conflict between uniform nominal rates and uniform effective rates. In practice, the Board will have

to make a final judgement on the best compromise./<sup>1</sup> The restructuring of tariffs will not only encourage the growth of efficient domestic firms, but it will also dissuade "tariff-jumping" by foreign firms seeking refuge and high profits behind high tariff walls in Indonesia; once appropriate changes are made, only those foreign firms that are prepared to compete efficiently on the domestic and international markets will have the incentive to invest in Indonesia. However, the Government should develop a program, as in many other countries, to safeguard against short-term dumping policies that contravene GATT regulations. Consequently, a mechanism needs to be developed that identifies genuine cases of dumping and imposes appropriate countervailing duties.

8.30 It is, however, important that the Tariff Board avoid piece-meal reforms and temporary exemptions. This Board should also oversee the formulation of import check-prices. These should be proper estimates of c.i.f. prices and should continue to be published at least twice a year, as is the current practice, and be kept in line with international price movements. The reductions in import tariffs suggested above would also permit the eventual elimination of the import check-prices; now the incentives for importers to under-invoice their goods will be significantly reduced as will the incentives to make illegal payments that arise from the current high tariff rates and the check-price system.

#### Equalizing Tariffs and Export Rebates

8.31 The reductions and uniformity in the import tariffs structure also permits an opportunity to introduce uniformity in the export certificate scheme. Once the tariff structure is reformed as suggested above, the export certificate rates could also be made uniform across all groups of manufac-

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<sup>1</sup> This conflict arises from the fact that non-uniform nominal rates are required to yield uniform effective rates and vice-versa. Uniform nominal rates will yield uniform effective rates only if all inputs of manufactured goods are always themselves manufactures with no basic material input at any stage. But when some inputs are basic materials or exportables, then the nominal tariff for one activity becomes the input tariff for another in a multistage production process where the semi-manufactured components are inputs into further processes. It should also be noted that tariff reductions will, of course, have implications for tax revenues. It is not, however, obvious that reductions in tariff rates will necessarily lead to a loss in revenue; this would depend upon the import elasticities of demand. Furthermore, the Government's ability to raise revenue from mineral exploitation makes the use discriminatory excise and customs taxes questionable policy instruments as revenue raising devices given their negative impact on the manufacturing sector's efficiency, output and exports. Improving the incentive mechanisms will not only lead to increased manufacturing output, exports and imports, but also, ceteris paribus, to increased tax revenues from several sources.

tured goods. As a final step, which can most likely be taken in about ten years, the Government should attempt to equalize tariffs and export rebates. Since it is likely that import tariffs will exceed the export rebates at this stage, the equalization should be achieved by lowering the tariffs to reduce the domestic market bias. Since the long-term goal would be to provide an approximately neutral trade regime, the Tariff Board should continue to oversee the equalization of the export rebates and import tariffs in an attempt to achieve the above objective.

## Sequencing Adjustments in Financial Policy

### The Control of Inflation

8.32 The movement towards a more outward-looking trade policy also suggests a movement towards a more viable financial policy for the 1980s to accommodate an expanding economy and a growing industrial sector. This implies that a series of steps be undertaken to gradually transform the current system of controlling liquidity and allocating financial resources. To facilitate this transformation, a sequencing of policy adjustments, which may be undertaken over the next decade, is given below. It is, however, recognized that political and administrative constraints may indicate an alternate sequence of steps. As a start, it is suggested that the major task of controlling liquidity in the economy be assigned to the budget which should be used to sterilize the expected increase in foreign resources due to increased oil revenues; moreover, greater reliance on fiscal policy for monetary stability requires, under current circumstances, a surplus in the rupiah budget. In recent years, the Government has achieved a budget surplus, but this surplus has not been adequate to sterilize the increases in foreign resources. Once this task is properly assigned to the budget, the dismantling of administrative controls on credit can begin and measures to make interest rate policies more effective for inflation control and resource allocation purposes can be introduced.

### Elimination of Credit Ceilings

8.33 The use of the budget to control liquidity growth and an increased use of the reserve requirement ratio will aid in reducing the dependence on credit ceilings for monetary control and will permit the substitution of current policies with effective interest rate policies. Consequently, the reliance on credit ceilings can be gradually diminished and synchronized with reforms of the interest rate structure.

### Reforming the Interest Rate Structure

8.34 Indonesia is today pursuing a policy of being an open economy with an effectively fixed exchange rate. With such a policy, Indonesia must continue, as it has in the past, to keep its interest rates, suitably adjusted for expected exchange rate changes, in line with world interest

rates in order to prevent destabilizing capital flows. In the long run, that will mean paying positive real interest rates on deposits. Changes in interest rate policy needed to ensure real positive deposit and lending rates imply that nominal rates be adjusted to conform with long-run expectations of inflation. This, however, does not imply that interest rates be constantly adjusted to reflect short-term changes in the inflation rate. Under present world conditions of high inflation, slack economies, and large reservoirs of international liquidity, interest rates in world markets and correspondingly Indonesian interest rates may be below the rate of inflation. Thus, short-run negative real interest rates can exist so long as there is movement towards eventually establishing a real positive interest rate structure. As an example, a 5% real return on deposits implies that nominal rates be set at 20% for 12-month time deposits, if inflation, over the longer term, is expected to be reduced to 15% per year from 1981 onwards. For 24-month deposits, a similar adjustment must be made, but it must also include the transaction costs of redepositing for another 12 months. If expectations of inflation are on the rise, the Government may wish to consider "twisting" the deposit rate structure which rewards deposits longer than 12 months with higher interest rates. This will aid with inflation control and permit banks to transform their portfolio of assets towards longer term ones than at present.

8.35 The establishment of real positive deposit rates necessitates real positive lending rates. A competitive banking industry would permit a decontrol of the deposit rate and the lending rate would then be established by a competitive margin that accounts for the costs of intermediation. Given that such a competitive structure will emerge only after some time and after a variety of institutional reforms have been implemented, the real lending rate will have to be set. But banks should be given the authority to charge differential loan rates corresponding to the risk associated with different borrowers.<sup>/1</sup> It should be recognized, however, that given Indonesia's access to the international capital markets, the real domestic lending rate cannot deviate significantly from real international rates; the extent of this deviation would be determined by the relative costs of intermediation, relative inflation rates, expected changes in exchange rates and the different risks associated with lending to prime borrowers in other countries relative to those in Indonesia where the legal framework and the provision of collateral are less advanced.

8.36 Such a reform of the interest rate structure need not be at the expense of the weaker economic group. To meet the objectives of the Government to increase equity in the country, the weaker economic group should continue to have access to subsidized interest rates and credit programs (paras. 8.39 to 8.42). There is, however, little economic argument to provide subsidized credit to those who do not need it, such as the economically strong group of entrepreneurs, and who currently obtain short-term credit at subsidized rates. Such groups and joint ventures

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<sup>/1</sup> In the short-run, subsidized lending for essential areas such as the BIMAS program should, however, continue.

should be encouraged to pay market rates for investment and for short-term credit (para. 8.42). Over the long run, such a policy will benefit the financial intermediation process in Indonesia, as opposed to the current situation where such groups borrow, at market rates, Indonesian funds deposited offshore by the state banks and then invest these funds in Indonesia.

8.37 The elimination of subsidies on short-term credit for the economically strong segments of society and joint ventures will reduce their demand for such credit, a significant amount of which is currently being rolled over and used for investment purposes (para. 5.04). On the other hand, because of existing restrictions on long-term credit, increased access to such credit at market or international rates will result in an increased demand from such groups for long-term credit from the domestic banking system; this will, at most, result in a commensurate decline in demand for such credit from offshore capital markets. In an open exchange economy such as Indonesia's, there is little reason to believe that, as a result of the policy recommendations made, there will be a net increase in total (i.e. domestic plus offshore) demand for long-term credit from the economically strong group. In fact, in the short-run, until the domestic banking system develops, given the current high costs of intermediation and the inefficiency of the state banks, the shift in demand, from offshore banks to domestic banks, for long-term credit at international rates may not be significant. Given the above, the ratio of firms owned by the economically strong and weak groups is not likely to change significantly, particularly since the economically weak groups will continue to have access to domestic credit at subsidized rates. Furthermore, the recommendations made above, along with those made in the areas of foreign trade, licensing and foreign investment policies will lead to increased employment and income earning opportunities of the weaker segments of society, thus improving income distribution and contributing to the equity goals of the Government.

#### The Role of the Rediscount Rate

8.38 Once real positive deposit and lending rates have been implemented, attention can be focused onto the proper role of the rediscount mechanism. The current policy of providing subsidies to commercial banks through the rediscount system would no longer be necessary as the interest rate structure would provide adequate returns to these institutions. Subsidies to commercial banks to encourage them to undertake loans to the weaker segments of society should be continued, but this should be done through the budget (para. 8.40) or through a special development fund (para. 8.41) rather than through the rediscount mechanism. The current policy of using the rediscount rate as a mechanism of transferring subsidies to the commercial banks robs the Indonesian economy of a major tool of monetary control. Rediscount rates could, therefore, be raised to reflect the cost of credit which, in turn, would influence the growth of liquidity. This implies proper control over the reserve money base, particularly since, at this stage, credit ceilings would no longer be in use. Differential rediscount rates may also be considered to influence resource allocation among sectors; but this is clearly a second-best policy to letting resource allocation be determined by the profitability of each sector as perceived by the borrower. In either case, the entire structure of rediscount rates needs to be raised from its present levels to ensure control over liquidity expansion.

### Supporting the Economically Weak Entrepreneurs

8.39 The rediscount mechanism is currently also used to subsidize specific borrowers. In keeping with the thrust of the previous recommendations, and to further the Government's objectives to promote equity among the different economic segments of society, it is suggested that such subsidies be granted directly from the budget rather than through the rediscount window. Thus, long- and short-term credit to the economically weak firms should be continued at subsidized rates; they should, however, be financed by direct subsidies to all banks, not only to state banks. Attractive returns to loans made to economically weak investors through this mechanism would encourage state as well as private domestic and foreign banks to seek out such enterprises and provide them with expertise and advice regarding financial management and exports. This approach would also provide incentives to develop skills required for retail banking; these, at the moment, are inadequate.

8.40 These subsidies, however, would probably create an excess demand for funds. This makes it important for the Government to earmark a fixed quantum amount in the budget, on an annual basis, to be allocated for the development of the economically weak entrepreneurial class. The Government, should also continue the present arrangements regarding the KIK/KMKP credits targetted to the small entrepreneurs. Despite certain weaknesses in these schemes, the amounts involved are small, and with time, the benefits can be expected to exceed the costs. But it may be desirable to encourage all banks to provide these credits - not only state banks - by assuring them adequate margins through the budget subsidy. An alternative approach to the budget subsidy would be for Bank Indonesia to establish a special development fund for the weaker economic group and subsidized credit to this group may then be financed from this fund. As a distinctly second-best approach, the rediscount system may be used to transfer subsidies, but this should be restricted only to investment and short-term credit designed to aid the economically weak groups of society. Neither equity nor allocative efficiency objectives are served by the use of the rediscount mechanism to encourage lending to specific sectors or activities as is the current policy. The Government may also wish to permit institutional equity funds to be treated as surrogate capital with the intention that these shares could be later sold to individual economically weak investors. The state commercial and development banks can play an effective role in this process and should be encouraged and strengthened to do so.

8.41 More effective support for small entrepreneurs may be provided by coordinating the above credit schemes with other programs such as the development of mini-industrial estates, cottage industry projects and the development of industrial extension services throughout the country. The possibilities here include assistance to weak entrepreneurs in completing application forms and in obtaining licenses, advise on the appropriate choice of technology, establishment of district industry centers where assistance from Bank officials and extension officers can be provided, and the creation of provincial committees on which bank extension agencies and local government officials would be represented. The Government may also wish to

consider providing tax incentives to private foreign and domestic firms to employ and provide training to the weaker economic groups. This will provide increased exposure to efficient and modern business techniques. A graduated tax incentive system could also be considered in order to encourage private domestic and foreign firms to increase their share of management and ownership of firms by the economically weak groups. Tax incentives of the above kind are superior to current incentives provided through the credit system because, as noted in Chapter 5, the latter distort significantly the allocation of credit with undesirable consequences for the industrial sector. Additional policies that may be undertaken simultaneously to promote economically weak enterprises include Government support for on-the-job training, special training facilities and business schools.

8.42 Once adequate credit at subsidized rates is made available to the economically disadvantaged groups of society, the Government may be able to begin to relax the restriction on extending investment credits to the rest of the society including the joint-venture firms. Restricting investment credit to the weaker economic groups, as is the current policy, does not ensure their participation in the industrial sector; it merely precludes access to long-term funds by the economically advantaged segments of society. In this way, such restrictions like investment licenses, act as one-edged swords; they preclude access, but do not ensure participation of the weaker groups. Since investment credit is made available at subsidized rates to the economically disadvantaged segments, access to investment credit at international or market rates can be made available to all who seek it (paras. 8.37 and 8.38). At these non-subsidized positive real rates, such restrictions will not be necessary. If the Government, however, feels that significant social and political costs are associated with the removals of these restrictions, then, as an interim measure, it may wish to consider a positive (rather than the current zero) ceiling level that will restrict the demand for credit to a level lower than that determined by the real rates of interest.

#### Improving the Efficiency of State Banks

8.43 The sequencing of the above reforms in a phased manner will ensure a smooth adjustment as the substitution from an administratively determined allocation system to a price determined system takes place. These reforms can be implemented over a ten-year period so that they can begin to provide the foundations of an efficient financial intermediation system. This process will be enhanced if the protection afforded to state banks is gradually reduced with all relevant policy changes announced well in advance to permit these banks to make adjustments. Such reforms would have to address the various regulations that shelter state banks, such as those that exempt interest earnings from deposits held with state banks from taxes, restrict state enterprises to holding deposits only with state banks, restrict the opening of branches by nonstate banks, impose borrowing ceiling on private domestic and foreign banks, include interbank call money as liabilities against which reserve requirements have to be held, geographically restrict the lending operations of foreign banks, and those that place

limitations on private banks to undertake foreign exchange business. All these restrictions could be gradually dismantled in a phased manner and as rapidly as is politically feasible.

8.44 At the same time, support could be provided to the state banks through various means. For example, the long-term lending capability of these banks could be developed and state bank officials could be trained through technical assistance from large foreign banks; this has worked extremely well in the case of one national private bank and a major international bank. This example is well worth emulating by state commercial banks. Major international banks can bring to bear their experience in the areas of retail banking, investment analysis, portfolio selection and information handling capabilities. This will constitute an important transfer of technology to the commercial banking system in Indonesia. In addition, the restrictions on the expansion of the fixed assets of state banks could be removed, bad debts should be written off on a once-and-for-all basis and systems procedures could be introduced to speed up the loan processing schedule. Furthermore, with regard to the KIB program, decisions should be decentralized from Bank Indonesia to the state banks and within the state banking system; this will permit greater access to the KIB rediscount facilities. These actions should, over time, increase the efficiency of the state banking system and permit these banks to compete on the basis of increased service capability.

#### Enhancing Financial Intermediation

8.45 To further enhance the intermediation process, the development banks should be permitted to open branches in different parts of Indonesia, and the focus of the Regional Development Banks should be shifted from their present concentration on commercial banking activities towards specialization in development banking. This would enable these banks to play a larger role in the financing of small and medium economically weak enterprises in the rural areas. Thus, the training of loan officers in appraisal and supervision techniques, and the streamlining of their operating procedures and internal administration are of very high priority.

8.46 Other institutional policy measures that the Government may wish to consider would be the creation of a deposit insurance scheme for domestic private and foreign bank deposits; the liberalization of the regulations on the issuance of bank guarantees to foreign lenders for suppliers' credit; the encouragement of the development of long-term savings instruments and bonds through minimizing issuance criteria; the provision of tax incentives (or the removal of disincentives) to the provision of institutional equity capital; and the encouragement and/or the creation of leasing companies and of NBFIs to set up secondary brokerage services. All the institutional reforms suggested here could be undertaken simultaneously with reforms in the policy environment mentioned earlier; the interdependence of the institutional and policy reforms is such that one without the other will severely hinder the development of an efficient financial sector.

## Stimulating Private Foreign Investment

### Providing Optional Incentives for Foreign Firms

8.47 The reforms in the regulatory environment, trade and financial policies would have an effect on stimulating both domestic and foreign investment. But, there are also specific actions which would stimulate foreign investment that can be undertaken. As a first step towards the long-run goal of a system of general incentives suggested in Chapter 7, special incentives that are currently offered to foreign firms could be made optional. This would permit foreign firms with an option already available to domestic firms; viz., that of going through the BRO process and of bypassing the incentives and the restrictions administered by the BKPM. While all foreign investment applications should continue to be processed by the BKPM, this should be done routinely as a way of assisting foreign firms in quickly satisfying various registration requirements, hopefully in a matter of days or weeks, while allowing these firms the option of bypassing an evaluation process tied to the provision of special incentives that would reasonably be expected to take several months. The result of the current procedures has been that many of the benefits to the foreign firms are presently being whittled away by time delays and other costs imposed on them. This policy would, therefore, also provide some mechanism for eliminating incentives that are not only very costly to Indonesia, but which are also of relatively minor importance for foreign firms.

8.48 The main reason for providing any special tax incentives to foreign (or domestic) firms would be to take account of distortions brought about by say, trade restrictions. Thus, special incentives would still be made available for sectors subject to unfavorable discrimination, such as the export sectors, where the effective rate of protection is less than zero; this group of activities does not currently account for a large proportion of industrial investment in Indonesia and would become progressively smaller as the policy reforms outlined earlier are carried out.

8.49 In those cases in which the BKPM extends special incentives to investors, it should be required to calculate the projected costs of these incentives and to provide subsequent reports to the Government on actual costs once projects are undertaken. Under the present system, costs of special incentives are reflected in foregone tax income and this is effectively hidden in a complex system of tax exemptions and rebates; estimates of the costs of these incentives are currently not available at the BKPM. Furthermore, these special incentives should take the form of direct subsidies paid in the form of specific tax credits that could be used by the firm in settling corporate tax payments or tax payments for any imports subject to duty.

### Improving the Quality of Labor and the Transfer of Technology

8.50 To enhance the quality of labor and to facilitate the transfer of technology, the Government should also undertake joint efforts with foreign firms to develop educational and training programs. Many other countries have been able to achieve substantial benefits from public sector activity to stimulate labor training in the industrial sector. Public sector financial support for vocational and business-oriented educational institutions could be augmented by schemes to share costs with foreign firms in programs aimed at providing training and assistance in the transfer of technology. This might take the form of a fellowship program for business studies, financing programs in which industrial or business experts are brought to Indonesia, and financial support for well-defined training programs carried out by foreign firms. A section concerned with training and technology transfer should also be established within the BKPM which should solicit the desired aid from foreign firms.

### The Use of Foreign Workers

8.51 Furthermore, there is a shortage of sufficiently well-trained or experienced Indonesians to fill middle and higher management levels. This is most acutely felt in the marketing, accounting, engineering and personnel management areas. This, in turn, hinders the rapid promotion of Indonesians into managerial positions. Consequently, restrictions on the use of foreign personnel should not be increased from their present levels. As part of an overall policy reform, restrictions in several areas should, in fact, be relaxed and there are several ways in which these could be achieved in the short-run. For example, specific skills that are in short supply in Indonesia, and the supply of which is not expected to increase significantly in the near future may be made exempt from the current restrictions. In addition, the current process of obtaining entry documents entails costs and time delays. The Government could provide multiple entry visas at the same time as the work permits are issued to foreign nationals. Furthermore, if Government efforts to decrease the use of foreign nationals are found to be insufficient, then rather than placing restrictions which entail significant administrative costs, the Government should impose an annual fee for working permits; this fee can be varied, depending on labor market conditions, in order to increase or decrease the incentives to use foreign workers.

### Policies Towards Lower Skilled Workers

8.52 Current policies with respect to lower skilled workers also need to be reconsidered. The restrictions on dismissing workers employed for more than three months discourage an efficient selection of low skilled workers for training and promotion to higher positions; this policy encourages foreign and domestic firms to rely instead on casual workers. The interests of such workers are better protected if a severance fee - say, a half-months severance payment for every six months of employment - tied to the length of employment is instituted.

8.53       The reforms suggested here, combined with specific actions designed to improve the investment climate in Indonesia will stimulate the growth of both foreign as well as domestic investment in sectors in which Indonesia has a long-run comparative advantage; this approach, would therefore, form the basis for increased production, exports and employment in the manufacturing sector in Indonesia.