

Report No. 8317-IND

# Indonesia Trade Policy Report

March 22, 1991

Country Department V  
Asia Region

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CURRENCY EQUIVALENTS

Before November 15, 1978      US\$1.00 = Rp. 415

Annual Average 1979-89

1979	US\$1.00 = Rp. 623
1980	US\$1.00 = Rp. 627
1981	US\$1.00 = Rp. 632
1982	US\$1.00 = Rp. 661
1983	US\$1.00 = Rp. 909
1984	US\$1.00 = Rp. 1,026 <sup>/a</sup>
1985	US\$1.00 = Rp. 1,111
1986	US\$1.00 = Rp. 1,283 <sup>/b</sup>
1987	US\$1.00 = Rp. 1,644
1988	US\$1.00 = Rp. 1,681
1989	US\$1.00 = Rp. 1,770

December 1, 1990      US\$1.00 = Rp. 1,884

FISCAL YEAR

Government	-	April 1 to March 31
Bank Indonesia	-	April 1 to March 31
State Banks	-	January 1 to December 31

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<sup>/a</sup> On March 30, 1983 the Rupiah was devalued from US\$1.00 = Rp. 703 to US\$1.00 = Rp. 970.

<sup>/b</sup> On September 12, 1986 the Rupiah was devalued from US\$1.00 = Rp. 1,134 to US\$1.00 = Rp. 1,644.

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## SUMMARY AND CONCLUSIONS

### Trade Policy Reform and Economic Adjustment

(i) Indonesia's trade policy strategy has changed significantly during the 1980s. At the start of the decade the trade regime was inward-oriented, promoting investment by both the public and private sector in highly protected activities geared towards supplying the domestic market. Initially the primary instrument of protection was a high and disparate tariff structure. From 1982, the steady weakening in the prices of Indonesia's commodity exports (particularly oil) and the adverse effects of the world recession, resulted in slower economic growth. While the Government responded appropriately at the macroeconomic level, by promptly implementing a stabilization program designed to reestablish financial stability (1982-85), the trade regime became more inward-oriented. Faced with slower growth in domestic activity and many manufacturing plants carrying excess capacity, tariff protection was supplemented by a proliferation of non-tariff barriers (NTBs) in the form of restrictive licenses. Although the Government did implement a comprehensive reform of the tariff structure in early 1985, the beneficial effects of this reform were significantly reduced by the introduction of many specific duties and the increased use of NTBs. By the end of 1985, more than 1,700 tariff positions were subject to import licensing accounting for over 40% of both import value and traded domestic production. In addition, export restrictions in the form of bans, taxes and quotas became more commonplace - particularly for unprocessed agricultural commodities. Thus, while short-term macroeconomic stability was restored by 1985, other medium-term structural problems in the economy had not been adequately addressed.

(ii) The collapse in oil prices in early 1986, and the forecast of continued slow domestic growth, encouraged GOI to reassess this strategy. The rapid decline in oil-related tax revenue and export earnings further curtailed the Government's capacity to finance planned levels of public expenditure and underlined the danger of fostering a 'high cost' domestic manufacturing sector that was uncompetitive on the world market. In response, the Government implemented a series of "deregulation packages" aimed at increasing private sector activity and stimulating non-oil exports. A key component of these packages has been several trade reform measures designed to improve the international competitiveness of the economy and reduce the overall bias against trade.<sup>1/</sup> The primary focus of the trade reforms has been to move away from a trade regime based upon non-tariff barriers towards a less distorted regime based on import tariffs and to provide exporters with access to imported inputs at world prices. Prior to the May 1990 reforms, about half of the restrictive import licenses had been removed, lowering the NTB coverage of total domestic production from 41% in 1986 to 29% by end 1988. Also, in 1987 the need to obtain an export license was abolished which opened trade to all holders of a business license, except those goods under special export regulations. These measures occurred within the context of a second macroeconomic stabilization program (1986-88), designed to reduce the external and internal deficits which had occurred in the wake of the further decline in oil prices and the adverse effects of currency movements on debt payments.

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<sup>1/</sup> Since this report was prepared before the May 1990 reforms, the analysis presented here does not reflect the implications of these new

(iii) The Changing Pattern of Incentives. The rapid and sustained deterioration in Indonesia's terms of trade from 1986, coupled with "high-cost" local industries, necessitated domestic relative prices to adjust in two ways. First, the price of tradables needed to rise relative to the price of non-tradables - both to encourage domestic resources to switch into the production of tradable goods and to reduce the domestic demand for tradable goods. Second, the price of exportables needed to rise relative to the price of importables - to further encourage resources to move into the production of non-oil exports and to increase the pressure on import substitution activities to become more competitive.

(iv) Several measures or proxies for the pattern of incentives prevalent in Indonesia since 1985 indicate that the Government's adjustment program is having the desired effect. First, the 31% nominal devaluation of the exchange rate has been supported by appropriate monetary and fiscal policies designed to contain inflationary pressures and thereby maintain the gains in international competitiveness. The resulting change in the real exchange rate has lowered real wages in Indonesia relative to competitive countries and raised the domestic price of tradables relative to non-tradables. Second, the cumulative impact of the trade reform packages announced since October 1986 has resulted in the removal of 839 items from license control, accounting for 48% of all items and 52% of the total import value previously restricted. More importantly, the share of total domestic production protected by NTBs has declined by about a third, with most of the reduction being concentrated in the manufacturing sector where nominal and effective rates of protection are highest. The removal of NTBs has reestablished a direct link between domestic and world prices, and created a trade regime which will allow the level and variance in protection to be lowered over time (i.e., by adjusting the nominal tariff). The substitution of tariffs for NTBs has resulted in a decline in the price of imports relative to exports and provided domestic users of imported materials more certainty in terms of delivery times and quality.

(v) A third change in the pattern of incentives occurred in 1985 as a result of the aforementioned across-the-board reduction in tariff rates. The tariff ceiling was lowered from 225% to 60% (with a few exceptions) and the number of tariff rates were reduced from 25 to 11. This led to a decline in the average weighted import tariff from 22% to 13% by import value or from 29% to 19% by domestic production value. Since 1985, the tariff schedule has been subject to a number of ad hoc changes primarily associated with the deregulation packages. The overall effect of these changes has been a gradual decline in the variance of tariff rates (from 108 to 84) with little impact on the overall average tariff rate. The one major recent improvement in the tariff structure was the reduction in the number of items with specific duties from 498 to 19 items. This occurred when GOI converted to the new Harmonized System (HS) of classifying traded goods. However, the positive effects of this reform have been offset by the recent proliferations of import tariff

surcharges and split-tariff positions.<sup>1/</sup> These have been used as a mechanism to target assistance to particular producers or goods.

(vi) Fourth, export incentives have been improved by the creation of the duty exemption and drawback scheme (BAPEKSTA) in May 1986, and the provision of subsidized export credit/insurance since 1982. The BAPEKSTA facility has worked extremely well, expanding rapidly to cover about 24% of total manufactured non-oil exports by 1988. The scheme has provided many of the fast growing 'emerging' sectors with imported inputs at world prices, such as food products, footwear, rubber and wood products, and textiles and garments. Aside from price considerations, firm level interviews confirmed that BAPEKSTA is important because it ensures access to good quality and uniform inputs and because it increases competitive pressures on potential domestic input suppliers. The provision of subsidized short-term export financing, pre-shipment export finance guarantees (PEFG), and export credit insurance/guarantees (ECI/G), were announced in January 1982. There has been a very rapid increase in official export financing and (the obligatory) PEFG, reflecting the recent surge in non-oil exports. Subsidized export loans have grown faster than other broad measures of credit, with most loans going to the manufacturing and trade sectors. Since Indonesia's accession to the GATT Code on Subsidies and Countervailing Duties in February 1985, interest rates have been increased from 9% (primary goods) and 6% (non-primary goods) to 14% and 14.5% respectively. While current rates are positive in real terms, they are substantially below prevailing commercial rates.

(vii) Finally, the costs of processing goods through Indonesian ports (exports and imports) and maritime transport have been significantly reduced by recent policy reforms. During the 1980s the port clearance and transport sector became highly regulated with controls on tariffs, licenses on routes and a range of other permits. This caused serious delays, restricted new private investment in the sector and raised the costs of international trade. An important step towards addressing these problems was taken in 1985 when the Government replaced the public customs service with a private sector organization (SGS),<sup>2/</sup> restructured port operations and partially deregulated international shipping. This resulted in cargo clearance and ship turnaround times falling dramatically, freight rates declining, and an improvement in the quality and reliability of service to shippers and consignees. The Government moved further in 1988, when it introduced a sweeping range of reforms designed to deregulate international and national shipping. An initial assessment of this latter reform would indicate that Indonesia now has a more open and unregulated shipping industry than most other maritime nations. As a result, over 40 new shipping companies have been licensed, with a corresponding increase in price competition.

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<sup>1/</sup> A split-tariff position is the subdivision of a standard nine digit Harmonized System product description, into finer product descriptions. It is used to provide different import tariff rates or import license protection for similar products - depending primarily on whether the specific product is produced domestically or not.

<sup>2/</sup> Societie Generale de Surveillance S.A., a Swiss based private company.

(viii) The Effects of Policy Reform. At the macroeconomic level, the economy has responded strongly to the government's balanced adjustment program. Since 1982, both the current account and budget deficit have been contained at manageable levels, inflation has been reduced and economic growth has been maintained. Indeed, there is mounting evidence that the economy has been growing at a faster pace than previously estimated, particularly since 1986. This strong performance has enable GOI to substantially reduce the incidence of poverty at the same time as undertaking the necessary measures to adjust the economy to the large external shocks experienced throughout the 1980s.<sup>3/</sup>

(ix) During the initial stabilization phase (1982-85) the current account deficit was quickly brought down through a combination of appropriate macroeconomic measures (i.e., adjusting the exchange rate, reordering public expenditure priorities, reducing expenditure levels) combined with a less appropriate tightening of import controls (i.e., a proliferation of NTBs). In the second stabilization phase (1986-88) most of the adjustment in the external account derived from the rapid growth in non-oil exports, which increased from US\$6.7 billion in 1986/87 to an estimated US\$12.1 billion in 1988/89. In contrast to the first stabilization period, imports also grew by 5.8% p.a. between 1986/87 and 1988/89 - reflecting the relaxation of trade restrictions.

(x) As noted in the latest Economic Report on Indonesia, the Government's fiscal and monetary management has been at the center of Indonesia's success in reducing internal imbalances and containing inflation. A major tax reform, expenditure restraint, and tight monetary policy have reduced the budget deficit to a manageable level and contained inflation below 10% since 1985. This in turn has preserved the competitive advantaged provided by the change in nominal exchange rate.

(xi) The trend in both private sector investment and macroeconomic efficiency indicators differ markedly between the two stabilization periods. In the initial adjustment phase, private investment declined due to higher real interest rates and lower aggregate domestic demand. Since 1986, private investment has recovered, responding to the improved incentive and regulatory framework created by the post-1985 reforms and the resulting higher level of economic activity. Much of this new investment has been directed towards export activities. Indicators of macroeconomic efficiency mirror this pattern, with both the average rate of return on investment and total factor productivity improving markedly in the period 1986-88 relative to 1982-85. The acceleration in economic activity is also reflected in the recent surge in private investment approvals issued by the Investment Authority (BKPM). Domestic investment approvals rose by 134% in 1987 and 45% in 1988, and foreign investment approvals rose in US dollar terms by 76% in 1987 and a remarkable 300% in 1988 to US\$4.4 billion. While this increase in private sector activity is an extremely encouraging sign it should be noted that realization of these investments is lagging behind approvals. This is partly due to the remaining complexities and weaknesses of the domestic regulatory

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<sup>3/</sup> For an assessment of the incidence of poverty during the 1980s, see, "Indonesia - Poverty Assessment and Strategy Report", World Bank report - Green Cover.

framework. It is also not clear that all this new investment is being channelled into areas where Indonesia has a clear comparative advantage due partly to remaining distortions in the trade regime. Both of these create world argue for an acceleration of the pace of reform to hasten the realization of planned investment and to ensure that new productive capacity is created in areas where Indonesia can compete on world markets.

(xii) The trend in imports reflects the changes in incentives outlined above. From 1983-86 imports declined by 12.5% p.a. in constant prices, as a result of the devaluation, the general slowdown in economic activity and the increased use of import licensing restrictions. Since 1986, the recovery of private investment and partial deregulation of imports has been accompanied by a 6.6% and 4.6% p.a. real growth in capital and intermediary goods imports respectively. It is noteworthy that most of the trade deregulation to date has focussed on lowering the price of capital and intermediate goods and improving the access of exporters to imported inputs. By contrast the continued decline of consumer goods imports since 1986 (-3.9% p.a. 1986-1988), reflects both the decline in real purchasing power due to the oil shock and the fact that this is the area in which there has been the least deregulation.

(xiii) The most striking feature of Indonesia's successful economic adjustment has been the growth of non-oil exports, which increased from US\$3.9 billion in 1982/93 to US\$12.1 billion in 1988/89. This growth has more than offset the decline in oil and LNG export earnings, resulting in the share of non-oil exports in total exports rising from 21% in 1982/93 to 61% in 1988/89. This strong performance has been primarily based on the rapid expansion in manufactured exports. While textiles and plywood provided most of the gains in the first stabilization period, the wide range of products classified under 'other' manufactured goods has taken the lead since 1986. For example, dollar export earnings from plastics, ceramics, glass, basic metal products, footwear, furniture, paper and rubber products, have all grown by more than 80% per annum since 1985. Two recent econometric studies indicate that the strong growth in non-oil exports during the second adjustment period cannot be fully explained by the change in the real exchange rate, and that improvements in the trade and domestic regulatory framework have contributed to this performance. These reforms have led to an increase in capacity utilization in export oriented industries coupled with, as noted above, a surge in private domestic and foreign investment. It is also important to note that despite this strong export performance, Indonesia still accounts for a small share of most world markets. Although manufactures have been the most rapidly growing component, Indonesia's share in world exports of manufactures is estimated at 0.4% in 1987 (compared with 0.1% in 1980).

(xiv) Finally, another important finding is that deregulation has coincided with a strong surge in manufacturing employment. Preliminary data on the growth and composition of the manufacturing sector, indicate that not only has the rate of growth in value added increased (from 15.0% p.a. during the period 1982-85 to 18.3% p.a. during 1986-88), but that the growth in employment accelerated from 5.1% p.a. to 9.1% p.a. over the same periods. The strong growth in employment reflects a switch in resources during the second stabilization period, both between and within sectors, towards those relatively labor intensive activities in which Indonesia is internationally competitive.

## The Current Trade Regime

(xv) Despite the progress noted above, Indonesia's trade regime still hampers the efficient allocation and use of resources as well as taxing domestic consumers. Due primarily to the effects of the import regime, the pattern of trade incentives continues to provide high protection to manufacturing relative to agriculture and favors production for the domestic market over exports. And, although the aforementioned export assistance measures reduce the overall anti-export bias of the trade regime, their effect is partial, leaving many potential economic activities and the losses incurred by consumers untouched.

(xvi) With respect to the import regime, two policy instruments dominate:- the Restricted Goods List and the import tariff structure. The Restricted Goods List, limits the right to import listed commodities to holders of a particular type of license, thereby creating a non-tariff barrier (NTB) to trade. There are about 900 items on the Restricted Goods List, accounting for about 21% of total import value and, more importantly, 29% of total domestic production. Aside from import bans, there are basically four types of import license under which restricted goods can be classified.<sup>4/</sup> The degree to which these different license categories restrict trade (i.e., the height of the NTB) varies significantly.

(xvii) The least restrictive import license category is the IP license (105 items). This is available to those domestic producers who use IP items as inputs into their production process. The IP category covers a range of mechanical and electrical goods in their completely knocked-down condition (CKD Kits), as well as some textiles and steel items. The overall intention of the IP license is to encourage domestic production of the listed item (e.g., fabric or diesel engines) at the same time as allowing some downstream users (e.g., garment or motorcar producers) access to imported inputs. Aside from raising the cost of restricted items to domestic consumers, the IP license increases uncertainty for downstream users due to the administrative discretion involved in determining both access to the IP license and the inputs producers will be allowed to import.

(xviii) The AT license (70 items) is used exclusively for engineering and transport equipment in its completely built-up (CBU) form. AT items are restricted to a few designated foreign suppliers. The Government's intention is to encourage these suppliers to make a long-term commitment to provide back-up services and/or establish assembly plants in Indonesia. Although this policy may yield some benefits in terms of standardizing spare part and maintenance needs, the absence of open competition imposes costs in terms of higher prices and limited choice. Import bans (18 items) are used to further

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<sup>4/</sup> These are IP (Importer Producer); AT (Agent Trader); IT (Importer Trader); and PI (Producer Importer). For a detailed description of these license types see Chapter 2.

control the importation of mechanical and electrical machinery. Import bans primarily cover many of the CBU items that are not listed as AT items but which can be imported in their CBU form under the aforementioned IP license.

(xix) The IT license (348 items) is used to restrict imports to the six State Trading Companies (STCs). In some instances these items are also under an informal quota imposed by the Ministry of Trade. The objective is to restrict the overall level of imports and encourage the development of STCs. The items covered include all batik fabric and clothing, agricultural tools, electronic computer equipment, salt and some fertilizer types. The determination and allocation of quotas is non-transparent, and many end users view the STCs as an unnecessary cost-raising intermediary.

(xx) The PI license (269 items) is potentially the most restrictive import license as it limits the importation of a range of items to designated sole importers, many of whom are domestic producers of the same final product. In terms of domestic production and import value the most important items under this category include: (a) selected steel, tin plate and aluminum products which are restricted to the state owned Krakatau Steel Industry and Tambang Timah; (b) a range of agricultural commodities (including rice, wheat, wheat flour, sugar, soybeans and soybean meal) which are restricted to BULOG and account for over half of Indonesia's total food import bill; and (c) a number of processed food and beverage items that are restricted to Tjipta Niaga and Karta Niaga (two of the six STCs). With the exception of rice, domestic consumers and downstream users of these PI products complain of high prices, poor quality and uncertain delivery. Finally, there are about 105 products that were listed in the 1988 Restricted Goods List but have proved difficult to classify under any specific license type. This lack of clarity is one of the negative features of allowing trade policy to be determined via multiple decrees issued by different ministries.

(xxi) Indonesia's import tariff schedule has 12 different ad valorem rates, with 99% of all items falling below the target tariff ceiling of 60%. In January 1989, Indonesia converted to the new Harmonized System (HS) of classifying traded goods. GOI used this opportunity to reduce the number of specific duties from 498 to 19, which has improved the transparency of the tariff schedule. Unfortunately, the positive effects of this reform have been more than offset by the increased prevalence of "split" tariff positions and surcharges. Although the original HS schedule did not contain any split tariff positions, a series of decrees since January 1, 1989, have reintroduced 592 splits. As a result, the number of effective tariff positions is now 9,662 compared with 9,070 in the original HS schedule. In addition, the number of items with surcharges has increased from 180 in mid-1988 to 376 at the present time. The overall result of these developments has been a slight increase in the average weighted tariff and a more significant increase in the dispersion of tariff rates since mid-1988. Split tariff positions and surcharges have been used to provide 'made to measure' assistance to particular products. In addition, they create uncertainty for those administering customs as well as importers because of the resulting difficulty of classifying goods and determining whether a surcharge applies or not. Finally, actual import tariff revenues are less than half the average statutory import rate, reflecting the wide-spread use of import tariff exemptions. Aside from the duty exemption scheme for exporters (BAPEKSTA) and

lower import tariffs under ASEAN trade agreement, there are other exemption schemes which may warrant review. These include exemptions for investments approved by BKPM, foreign aided projects, imports for the oil and gas industry and imports by particular domestic firms.

(xxii) Indonesia's export regime is comprised of two types of policy intervention. First, there are several export policies designed to regulate, in most cases restrict, the export of designated commodities. These are export bans, quotas, taxes, quality controls and approved exporter arrangements. The government's objectives in regulating exports include: taking advantage of Indonesia's perceived market power; encouraging domestic processing; ensuring adequate domestic supply; and responding to externally imposed quotas. Second, there are a number of measures designed to directly assist exporters. The most important of these are the import duty exemption and drawback scheme (BAPEKSTA) and the subsidized export credit program. The objectives of these measures are to offset the anti-export bias created by the import regime and to protect exporters from the resulting 'high cost economy'.

(xxiii) In contrast to the progress made in deregulating import regulations, domestically imposed export regulations have increased. The product coverage of export bans was broadened in 1988 and the prevalence of approved exporter arrangements appears to be spreading. It is estimated that 50% of total non-oil export trade is affected by some form of regulation, with most of these regulations concerning agricultural or forestry products. While the Government's desire to increase domestic processing is understandable, care needs to be taken in deciding on the appropriate policy instruments through which to achieve this objective. In general, the regulation of exports is appropriate on economic grounds only under very specific (and rather uncommon) conditions. Experience in other countries which have imposed export restrictions, provides strong evidence that the dynamic effects are often negative. In addition, aside from whether a product should be regulated, a second but no less important issue, concerns how a product is regulated. The current range of bans, approved exporter arrangements, implicit quotas, etc., are not likely to achieve the government's objectives. For some products, current holders of quotas play an important role in determining future quota allocations and domestic suppliers are enforced to sell through designated exporters. This creates significant barriers to new more efficient entrants and can result in a level of domestic market power which is detrimental to efficiency and equity considerations.

(xxiv) There has also been a significant increase in export assistance measures. Almost a quarter of total non-oil exports use the BAPEKSTA facility to access part of their imported input needs, while the share of non-oil exports supported by export financing is estimated at about two-thirds. BAPEKSTA provides two facilities through which exporters can access imported inputs free of both import duty/VAT and license restrictions, i.e., the exemption scheme and the duty drawback scheme. The exemption scheme has worked extremely well, with major users including many of the new emerging export industries such as footwear, food products, rubber products, etc. Interviews with large and medium scale firms confirm the importance of the scheme and the high regard the private sector has for BAPEKSTA's administrative efficiency. However, small-scale firms benefit less from the exemption facility because they are unable to order in large enough

quantities, they are reluctant to disturb relations with large domestic suppliers, and BAPEKSTA application procedures are beyond their administrative capacity. The duty drawback facility has been less successful, primarily because final exporters find it difficult to get domestic suppliers of imported inputs to document import costs and duties paid.

(xxv) Although the existing export financing, PEFG and ECI/G schemes have supported the growth of Indonesia's non-oil exports, they have had a limited impact on broadening the export base or assisting indirect exporters. The report identifies a number of shortcomings with the current schemes including: (i) the preferential interest rates charged to the exporter have encouraged misuse of the export loan, whereby funds have been diverted by the borrower for purposes other than exports; (ii) rationing of credit has restricted its use principally to large, established exporters; (iii) the low intermediation margins on export loans as compared to other commercial loans have discouraged commercial banks from extending loans to small and new exporters; (iv) the pre-shipment export finance guarantee system which was expected to assure the access of small and new firms to export loans has been unable to provide banks with a substitute for collateral; (v) indirect exporters, crucial to promote backward integration, do not have easy and automatic access to official export financing as well as duty free imports; and (vi) relative to the number of exporters, the export credit insurance/guarantee scheme has been utilized by a very limited number of products and exporters.

(xxvi) The current pattern of incentives produced by Indonesia's trade regime have been estimated in terms of both nominal and effective rates of protection (NRPs and ERPs). The results show that there continues to be a strong anti-export bias, as indicated by comparing the aggregate ERP for all import-competing goods (44%) against that for all export-competing goods (-2%). This bias in favor of import-competing activities applies between sectors and within broad industrial groups. For example, within primary industries (agriculture, forestry and mining) export competing activities - such as logging, rattan, rubber, coffee and semi-processed vegetable oils - have low ERPs and are subject to bans, quotas and taxes; whereas import-competing sectors - such as milk, soybeans and sugar - have high ERPs and receive direct or indirect subsidies. In secondary industries (manufacturing and processed agriculture commodities) the same pattern of incentives is found, although the picture is more complex due to Government's efforts to stimulate non-oil manufactured exports at the same time as continuing to protect existing import substitution activities.

(xxvii) There is a strong connection between the share of domestic production protected by NTBs and relative ERPs. In manufacturing, four of the five most highly protected activities in terms of NTB coverage also rank highest in terms of ERPs. Finally the current trade regime produces a wide variance of protection within the manufacturing and agricultural sectors. For example, even though the ERP for the basic iron and steel industry is relatively low, the index of dispersion is 120 compared to an average of 42 for the manufacturing sector. Much of this variance in rates of protection results from the use of split-tariff positions and import surcharges to provide additional protection to specific products.

Effects of Trade Regime on Selected Manufacturing Activities

(xxviii) The effects that the trade regime has on manufacturing activities has been examined by focusing on four industries (steel, paper, textiles and footwear). These industries have been selected to represent the spectrum of manufacturing activities in terms of their trade orientation, i.e. ranging from primarily inward-oriented (steel) to outward-oriented (footwear). As many of the effects of the trade regime are the same for different manufacturing activities, it is hoped that the lessons provided by these industry studies will have broader relevance across the whole manufacturing sector.

(xxix) All of the selected industries have maintained positive growth rates since the early 1980's, with the expansion in value added being strongest in the outward-oriented industries since 1986. As the outward-oriented industries are more labour intensive than the inward-oriented industries, there has been a corresponding acceleration in the rate of growth in employment. There is also evidence of a move towards more labour intensive products within industries. Each of the industries attained higher export growth in the period 1986-88, compared with 1983-86. Even those industries that are classified as being inward-oriented (e.g., steel, and to a lesser extent paper) demonstrated that there are certain products within these industries which can compete on the international market. Finally, in three out of four of the industries (i.e., textiles, paper and steel) imports also increased over the period 1986-88.

(xxx) The major trade policy issues that arise from these industry studies differ according to the trade orientation of the industry. For those industries, or parts of an industry, that are primarily geared towards import-substitution, the most important trade policy issues are: the remaining incidence of NTBs, high tariff protection on 'upstream' inputs, and the increased use of split-tariff positions and surcharges. While the sequential approach to trade reform has suited the Indonesian context, it has allowed some manufacturing activities to maintain their highly protected status. Some non-competitive activities remain under NTBs (e.g., cold rolled steel products) or have been partially deregulated (e.g., moved to the less restrictive IP license) but accorded high import tariffs. In these cases, tariff positions have often been split to target the remaining NTBs or surcharges to particular products or producers. This has resulted in a fragmentation of the trade regime and a loss in transparency. It has also significantly increased the dispersion of protection within an industry and reduced competitive pressures to restructure. Downstream users of these commodities that produce for the domestic market, such as galvanized steel sheet producers or tin can users, are particularly disadvantaged as they cannot use the BAPEKSTA facility to obtain imported inputs.

(xxxi) Broadening the reform program to encompass those activities that rely primarily on supplying a highly protected domestic market will be difficult - particularly where there is considerable existing capital stock. Nevertheless, the hidden costs of not tackling these anomalies are high both in terms of slowing the further efficient development of the manufacturing sector and reducing the tax on Indonesian consumers. In addition, there are

strong indications that import-substitution industries do have the capacity to restructure when faced with increased competition. The recent expansion in steel exports and reports from downstream steel users of a more 'businesslike' attitude from large domestic steel suppliers support this hypothesis. Where restructuring is not possible, alternative steps will need to be taken to deal with the financial implications of further trade reform.

(xviii) For those industries that are outward-oriented the most important trade policy issues are: high tariffs (and a few NTBs) on their imported inputs and the dependence on BAPEKSTA that this creates, the increasing use of export bans and taxes on upstream unprocessed domestic inputs, and the continued high import tariffs on their outputs. Some of Indonesia's fastest growing export industries receive levels of protection on their domestic sales well above the manufacturing sector average. This reflects the continued prevalence of relatively high import tariffs (and in some cases NTBs) on imported inputs and, as a consequence, even higher tariffs on outputs. In some instances, these high levels of effective protection also reflect export bans and taxes on upstream domestic inputs (e.g., leather for footwear or rattan for furniture). Medium to large-scale exporters have been able to circumvent tariffs and NTBs on imported inputs by using the BAPEKSTA facility. Nevertheless, BAPEKSTA has been less successful in assisting small-scale and indirect exporters, and it cannot assist producers for the domestic market. In addition, high tariffs on the output of some export industries (e.g., textiles and footwear) has reduced the competitive pressure on high cost producers for the local market. This has penalized the Indonesian consumer who cannot buy goods at the export price. There seems little doubt that these industries can effectively compete on world markets. The more efficient domestic firms appear eager to establish foreign joint ventures to gain access to technical expertise and foreign markets. The reduction of high import tariffs (with surcharge removal a priority) on outputs, combined with the removal of remaining NTBs and lower tariffs on inputs would encourage further efficiency gains. These reforms are necessary to change the current situation whereby international competitiveness (and competitive pressures on domestic firms) is heavily dependent on the continued efficiency of BAPEKSTA.

#### Effects of The Trade Regime On Selected Agricultural Activities

(xxiii) International trade in Indonesia's agricultural products is more highly regulated than trade in industrial products. While the share of domestic production protected from import competition through NTBs is similar in both sectors (about 40%), agriculture differs from manufacturing in that most agricultural exports are also regulated. However, despite the prevalence of trade restrictions, the aggregate level of protection provided to agriculture is lower than that for manufacturing.<sup>5/</sup> Put another way, agricultural prices depart less, on average, from free trade prices than those in manufacturing. This primarily reflects two important characteristics of the trade regime as it pertains to agriculture. First, although international

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<sup>5/</sup> The average effective rate of protection for agriculture is 21% compared to 73% for manufacturing. It should be noted, however, that this bias has been partially offset by large direct public investment in agricultural infrastructure.

trade in rice is highly restricted, domestic rice prices have generally been maintained close to world prices. Given the weight of rice in total agricultural production (about 65%), this lowers the production-weighted estimate of protection. Second, some of the important trade interventions in agriculture result in a tax on domestic producers rather than providing assistance (e.g., crude palm oil, wood, leather, rattan, and rubber). This is rarely the case in manufacturing.

(xxxiv) While the aggregate level of protection for agriculture is low relative to manufacturing, there is an almost equally wide dispersion around this average. Thus, while many agricultural products sell at close to world prices, others trade well above import/export parity (e.g., sugar, wheat, refined edible oils and soybean meal). The overall conclusion of this report is that substantial economic gains would result from relaxing and simplifying the current restrictions on the international trade of agricultural commodities. More specifically, the removal of NTBs and lowering of import tariffs on agricultural commodities would improve the allocation of agricultural resources, increase competitive pressures on traders and producers, and benefit domestic consumers. This should be accompanied by a review of the current coverage of export regulations. Where appropriate, export restrictions should be removed. In those rare instances when export restrictions are in the economy's best medium-term interest, the primary issue is to design the policy intervention so as to minimize the negative effects on producers. In regulating exports, it is also important not to reduce domestic competition by creating domestic barriers to entry into either trading or producing agricultural commodities. While an export tax is preferable to other forms of export regulation, where a quota is used it is important to use a transparent and efficient quota allocation mechanism.

(xxxv) The report also examines the effect that the current trade regime has on the production of some processed food products. This is an area where Indonesia is thought to have a potential comparative advantage and the government is keen to encourage further growth. The analysis shows that the current trade regime provides high levels of protection on both important inputs (e.g., tin plate, sugar and tetrapak) and outputs (processed meat, fruit and vegetables). As a consequence, it is primarily the larger firms that can compete on world markets because they are capable of using the import duty exemption and export credit facilities to access inputs at world prices. Smaller-scale and indirect exporters are disadvantaged by the current trade regime because they have much more difficulty avoiding the high cost of imports. Producers for the domestic market are able to absorb high input costs due to the correspondingly high tariff and NTB protection on final processed food products. However, domestic demand for these products is lower than it would be at international prices and these firms are not competitive on world markets.

#### A Policy Framework for Future Reform

(xxxvi) The strong positive response of the economy to the deregulation measures taken to date, has created a favorable environment within which to pursue further reform. Private sector confidence in the government's

macroeconomic management is strong and there are expectations that further supporting microeconomic reforms will be forthcoming. This has resulted in a marked jump in planned foreign and domestic private sector investment. A further reduction in both the level and variance of protection is needed to attract this investment towards activities where Indonesia has a clear comparative advantage. This will encourage the efficient allocation of scarce investment resources and avoid protectionist pressures building-up in the future.

(xxxvii) Following the rapid growth of non-oil exports during 1986-89, some slowdown in growth rates may be inevitable. This is not surprising as capacity utilization becomes more of a binding constraint. But this underscores the importance of a sound incentive and regulatory framework to achieve the next stage of expansion of non-oil exports. Of particular concern is the recent slight appreciation of the real exchange rate and the continued anti-export bias of the trade regime. There is also some concern that the complex domestic regulatory framework (including the legal system) is slowing the pace at which planned investment is being realized. While Indonesia is now seen as a new low-cost Asian export base, further policy reform will be needed to take full advantage of this opportunity. The current robust macroeconomic conditions would argue for accelerating the pace of reform to capitalize on this opportunity.

(xxxviii) The broad objectives underlying the next phase of reform should be to move towards a more neutral and administratively simple trade regime. This implies that there should be fewer trade policy interventions (e.g., a reduction in restrictive import licenses and export regulations) and that the bias in favor of producing for either the domestic market or the export market should be reduced. It also implies that where trade policy interventions are considered necessary, e.g., externally imposed quotas, the administrative implementation mechanism should be transparent and efficient. More specifically, the next phase of reform should include:

- o Reducing the coverage of NTBs from the current level of 29% of total domestic production, focussing on areas in both the manufacturing and agricultural sector where NTBs provide high protection to domestic production.
- o Initiating a medium-term tariff reform program by eliminating split-tariff positions, phasing out surcharges, and announcing a phased plan to lower the maximum tariff rate from 60% to 20% over a specified time period.
- o Reviewing the economic costs and benefits of the current mix of export regulations (particularly export bans, quotas and approved exporter arrangements) to reduce export restrictions and, where such restrictions are justified, to improve the implementation mechanisms.
- o Improving the efficiency and coverage of BAPEKSTA and the export credit/insurance mechanism, as part of a general move towards placing all export assistance measures on a more commercial basis - including the removal of interest rate subsidies.

- o Strengthening GOI's institutional capacity for analyzing trade policy issues.

(xxxix) In terms of the timing and sequencing of the reform program, the removal of import NTBs remains the first priority. It is recommended here that the removal of these NTBs be accompanied by the initial phase of tariff reform and, if possible, the removal of those export restrictions that are clearly not in the economy's best medium-term interests. Based on the experience of other countries, it is also recommended that the tariff rationalization program be completed over a period of about three years. Other components of the trade reform program, such as developing a stronger institutional capacity for dealing with trade issues, improving BAPEKSTA, reviewing the remaining export regulations, and phasing out export finance subsidies, could also be completed within three years. While domestic political, economic and social factors will determine the actual pace of reforms, studies of other countries indicate that this sequencing of reform steps is likely to achieve the strongest economic results. These studies also indicate that it is important for governments to give the business community a clear signal of the direction of future policy change and to take steps to convince the private sector that the reform program will be implemented. GOI's strong track-record in promptly implementing difficult policy actions has enhanced the Government's credibility and therefore its ability to influence private sector expectations.

(xl) Before elaborating on the recommended reform proposals, two points should be emphasized. First, further trade reform needs to be implemented within a balanced macroeconomic policy framework which takes into account adjustments in the trade regime. As noted in Chapter 1, the consistency of GOI's monetary, fiscal and exchange rate policy has been a central feature of Indonesia's successful economic adjustment to the severe external shocks experienced since the early 1980s. With the immediate economic crisis passed, however, it is no less important to continue to use these macroeconomic measures to maintain external and internal balance. Second, to benefit fully from the proposed trade reforms, complementary action in other areas, such as the domestic regulatory framework and the legal system, will be required. There is some feeling in the business community that reforms in the financial sector and to some extent import regulations have been implemented at a faster pace than in other areas. A concerted effort will be needed to maintain relative progress in deregulating both domestic and foreign trade regulations, including issues of implementation in the provinces.

(xli) Non-Tariff Barriers to Imports. As part of the overall strategy to move to a trade regime based on tariff rather than import license protection, GOI intends to eliminate all non-tariff barriers on imports except for a small group of products that are harmful to health, strategic to national defense or involve special economic and social considerations. The Government's commitment to attaining this objective has been demonstrated by the four trade deregulation packages that have been implemented since 1986. Nevertheless, over 900 items remain on the Restricted Goods List and, as discussed above, the resulting NTBs are the primary cause of important price distortions in manufacturing and agriculture. These price distortions have drawn resources into activities in which Indonesia does not have a comparative

advantage (e.g., sugar or motor car production), increased costs for downstream industries, and lowered the rate of economic growth and employment creation at the economy-wide level.

(xlii) The reduction of NTBs can be approached in two ways. Either the NTB on a particular product can be removed or the restrictiveness of a license category can be reduced. The previous deregulation packages have used both approaches, with an emphasis, quite correctly, on the former. Removing items from the Restricted Goods List (i.e., classifying a good as IU) is administratively simple and, more importantly, it unambiguously opens access to all bona fide importers.<sup>6/</sup> An important objective of Indonesia's broader deregulation drive is to simplify and streamline administrative procedures so as to encourage private sector initiative and reduce the burden on Government departments. The reclassification of products under the General Importer (IU) license fulfills these objectives, and should remain the preferred option. Where this has not been possible, or as an initial step towards deregulation, products have been moved from highly restrictive license categories to less restrictive license categories, and in some cases products have been classified under more than one license category (e.g., IP/IT). One extension of this approach would be to reduce the number of restrictive license categories. For example, the IT license category (which restricts the right to import about 348 items to the six State Trading Corporations) could be merged with the IP license category. This would significantly broaden access to these goods, at the same time as giving the STCs time to adjust to a more competitive trading environment.

(xliii) Partly because of the scope of the previous deregulation packages, the next phase of removing import license restrictions will entail focusing on hitherto difficult areas. The reduction of the coverage of NTBs below the current level of about a third of total domestic sales will involve: (i) the removal of all remaining NTBs in industries that have already been subject to deregulation (e.g., steel, textiles, chemicals, paper and pharmaceuticals); (ii) reducing the trading monopolies that BULOG and the STCs have on agricultural commodities and processed food and beverages and (iii) dismantling the current mix of import license restrictions, import bans and domestic regulations that are used to protect the local mechanical and electronic goods industry, including heavy equipment and motor cars.

(xliv) Tariff Reform. It has been five years since the last major reform of Indonesia's tariff schedule. Since then, the substantial progress made in reducing NTBs has, as intended, increased the relative importance of tariffs in the incentive regime. At the same time, partly in response to the removal of NTBs, ad hoc changes have been introduced in the tariff structure which have increased the level and dispersion of tariffs, particularly in the manufacturing sector. While the detrimental effect that the resulting import tariff schedule has had on exports has been partially offset by an efficient

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<sup>6/</sup> For detailed definition of the various import license types see Chapter 2. Briefly, the IU license is non-restrictive, requiring only a business permit and a tax payers number. All other license categories (i.e., IP, AT, IT and PI) are restrictive to various degrees.

import duty exemption scheme (BAPEKSTA), this facility has been less successful in reaching small-scale or indirect exporters. Moreover, BAPEKSTA cannot assist disadvantaged producers for the domestic market or Indonesian consumers. Given the anticipated removal of more NTBs and the recent increase in private investment, it is opportune to consider a systematic reform of the current tariff schedule.

(xlv) The tariff reform program discussed in this report has been designed to move towards a low and fairly uniform structure of statutory tariff rates. The proposed program has two basic components. The first involves a "tidying up" of the current schedule through the removal of split-tariff positions and the gradual elimination of surcharges. The second is a broad-based strategy involving the reduction of both average tariff rates and the degree of tariff dispersion. The broad-based reform is based on tariff reductions across the whole tariff structure as opposed to reductions in tariffs for particular industries. The industry-by-industry approach is not recommended because it can open the tariff reform process to protracted negotiations with affected groups, and it can result in a temporary worsening of price distortions due to complex inter-industry linkages. Reducing tariffs across the tariff structure is preferable because it appears even-handed, it removes the discretionary element in deciding which industries to focus on first, and it is administratively simple. Finally, establishing a lower more uniform import tariff would also relieve the administrative pressure currently placed on BAPEKSTA. As non-oil exports expand further, the burden on BAPEKSTA to efficiently process a greater number of applications will grow. Lower tariffs would reduce the incentives to use BAPEKSTA, freeing BAPEKSTA's staff resources to extend the scheme to capture small-scale and indirect exporters.

(xlvi) It is proposed that split-tariff positions should be removed by absorbing them back into the base-tariff position. The import tariff applicable to the new unified tariff position should be set as low possible. With respect to surcharges it is recommended that a comprehensive review be undertaken to determine which surcharges should remain. Where it is decided that the case for a temporary surcharge is valid (i.e., due to the recent removal of an NTB), it is recommended that the surcharge is phased out in a systematic manner. Where surcharges were introduced as a mechanism to provide temporary protection, it is proposed that surcharges apply for only one year. After that year, extensions would be granted at a maximum rate equal to 50% of the original surcharge. After the second year, all surcharges would automatically expire, with no exceptions. The use of surcharges as an anti-dumping mechanism is not recommended. Surcharges apply to particular commodities over a period of time whereas anti-dumping procedures constitute essentially legal actions by one party (for example, a firm) against another with respect to a particular shipment. Thus, the appropriate response to dumping is the imposition of specific penalties related to a particular supplier rather than measures which apply to a broad commodity group. If dumping is indeed a significant problem within certain industries, then the appropriate response is to establish anti-dumping procedure aligned with GATT rules.

(xlvii) The above proposals essentially set the stage for a much broad-based reform of the tariff schedule. The proposal here is to reduce the highest allowed tariff rates to a common ceiling, and then to lower the

ceiling tariff over time. This 'tops down' approach results in a reduction in the level and variance of protection at each step. The exact ceiling rates and the phases of reform should be carefully chosen and clearly announced at the outset of the reform program. Such preannouncement sends a clear signal to the business community concerning the direction of future policy change which will reduce investor uncertainty and enable more informed investment decisions to be made. While there is flexibility in the detailed design of the reform program - the timetable, tariff rates, etc. - there is a strong argument to implement the reform in a relatively short period. Given the likely resistance to change from powerful vested interests, the reform program will be more credible if it can be announced at a time of relative macroeconomic stability and robust growth. In addition, the recent significant jump in actual and planned investment, underlines the necessity of creating an incentive framework which channels scarce investment resource into efficient activities.

(xlvi) The proposal explored in this report is to move to a 50% ceiling in year one, 30% in year two and 20% in year three. To establish the credibility of the program, the plan to introduce a phased reduction in maximum tariffs could be announced at the same time as the 50% ceiling is imposed and measures are taken to deal with splits and surcharges. In addition, it may be worthwhile considering rationalizing the tariff structure further by imposing more uniform rates within commodity groups. This would result in some low rates (zero or 5% import duties) being raised. Finally, it would also be desirable to eliminate some of the import duty exemptions, replacing them, where appropriate, with less distortionary corporate or investment tax credits.

(xlix) The loss in government tax revenue resulting from the removal of surcharges and adoption of a 20% tariff-ceiling is estimated at about 1.3% of total tax revenue. Even this low figure should be treated with caution as it is a 'first-round' estimate, which does not reflect the beneficial effects that the reform will have on domestic growth, and hence import capacity. Nor does this estimate take into account the revenue increasing effect that the further removal of NTBs will have. It is estimated that an increase in GDP of around 2 per cent over the three year period of tariff reform would more than offset the reductions in import tariff revenue. In addition, the negative tax revenue effects could be more than offset by the suggested elimination of import duty exemptions and, where appropriate, increases in zero tariffs.

(l) Export Regulation. The trend towards increased export regulation runs counter to the move towards greater deregulation of the economy. Experience in other countries which have imposed export restrictions, indicates that the dynamic effects of these interventions are often negative. These restrictions are particularly worrisome where they create artificial barriers to entry and are non-transparent. Thus, even in those limited instances where there is a case for intervention, the appropriate policy instrument needs to be carefully designed to minimize distortions.

(li) Where external barriers exist (i.e., textiles and tapioca), the key requirement is to create an efficient and equitable quota allocation mechanism. One option would be to improve the transparency and efficiency of the Government's current quota allocation mechanism and the operation of the

quota exchange market. Another option would be to move to an open auction system. Whatever method is used to allocate quotas, the existing administrative capacity to monitor quota utilization for each market should be strengthened.

(lii) Where Indonesia can influence the world market price (e.g., logs, plywood, rattan, nutmeg and rubber), a theoretical case for an optimum tax exists. The primary issue here is to set the tax at a level which maximizes the economy's gains over the medium-term. In the final analysis, the use of an export restriction is an empirical issue, which should be approached at the commodity level. A thorough economic analysis should be undertaken for each regulated product, with the burden of proof lying on the need to regulate.<sup>7/</sup> If it is decided to impose an export restriction, there are strong economic reasons for choosing an export tax rather than imposing a quota or ban.

(liii) Where Indonesia cannot influence the world price, the case for any type of export restriction is weak. The result is to lower returns in activities in which Indonesia is competitive (e.g., crude palm oil, crude coconut oil and copra) in order to provide a subsidy to inefficient downstream processors (e.g., edible oil producers). This will lower investment/technical change, and hence growth, in the taxed activity, as well as forstering the development of an uncompetitive downstream industry. In line with the recommendations made in the Bank's recent Tree Crops report, all export restrictions on commodities in this category should be removed. This should include the removal of domestic market allocations, export or inter-island taxes, and controlled domestic prices.

(liv) Export Assistance. The duty exemption facility operated by BAPEKSTA operates efficiently and has provided essential support to Indonesia's expanding non-oil exports. However, the rapid growth in the utilization of BAPEKSTA's services (currently over 20% of non-oil exports) has placed a strain on staff resources. In addition, the duty drawback mechanism has not been widely used, largely because of the requirement that suppliers furnish information to the exporter on their import costs and duties.

(lv) In the near term, to ensure that the efficiency of the exemption mechanism is maintained, modest additional staff resources and some technical assistance to BAPEKSTA should be considered. This should be coupled with continued efforts to improve the transparency and efficiency of BAPEKSTA's overall operation. BAPEKSTA's operations could also be improved by modifying the system for granting duty drawback to encourage greater participation by indirect exporters. One option explored in this report is to use the domestic L/C system introduced by Bank Indonesia in October 1988 as an administrative mechanism. While every effort should be made to increase the efficiency of BAPEKSTA, this should not be viewed as a substitute for continued action to reduce import policy distortions directly.

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<sup>7/</sup> An example of the type of economic analysis required to determine if an export tax is appropriate is provided in the World Bank's recent report on the Indonesian Tree Crops Sector - No. 7697-IND.

(lvi) The existing export financing, loan guarantee and credit insurance schemes have also supported the rapid growth in Indonesia's non-oil/LNG exports. However, as discussed above, the existing schemes appear to have had only limited impact on broadening the export base or facilitating backward linkages. In order to exploit fully the country's non-oil export potential, especially non-traditional manufactured exports, it may be desirable to extend equal and automatic access to export incentives to all firms that directly or indirectly contribute to export value added. This should be relatively easy to accomplish in the Indonesian context; all the instruments and institutions are already in place and considerable experience has been gained in the administration of incentives in the last several years.

(lvii) With respect to export finance, it is recommended that the export loan disbursement mechanism be modernized and the interest rate differentials and commercial banks' intermediation margin differential between export loans and other commercial loans be substantially reduced and /or eliminated. In addition, Bank Indonesia should no longer pay half of the PEFG premium and half of the losses resulting from exporters' non-performance. The existing practice reduces the premium for the banks to only 0.25%, leaves the banks to absorb only 7.5% of the loan losses, and gives them little incentive to extend efforts to ensure that funds are being used for export purposes.

(lviii) The efficiency of administering PEFG requires: (i) close coordination between pre-shipment export finance guarantee (i.e., PT. ASEI) and the pre-shipment export loan disbursement mechanism (i.e., Bank Indonesia); (ii) PEFG beneficiaries paying the actual cost through appropriate premium rates; and (iii) operational effectiveness in the information-gathering and risk-pooling functions. Over time and after the institution building phase is substantially completed, the PEFG agency can also play an important role in the risk-reduction by channeling technical assistance, either directly through in-house activities or indirectly through other specialized agencies.

(lix) Finally, with respect to the Export Credit Insurance/Guarantee program, the most important step that can be taken is to familiarize the banks and exporters with its availability and advantages through an active, targeted marketing campaign. In addition, new insurance policies would need to be designed to cover specific medium-term transactions, sales of services, unconditional guarantee to banks, etc.

## CHAPTER 1

### TRADE POLICY REFORM AND ECONOMIC ADJUSTMENT

#### A. Introduction

1.01 Indonesia's trade policy strategy has changed significantly during the 1980s. At the start of the decade the trade regime was inward-oriented, promoting investment by both the public and private sector in highly protected activities geared towards supplying the domestic market. Initially the primary instrument of protection was a high and disparate tariff structure. From 1982, the steady weakening in the prices of Indonesia's commodity exports (particularly oil) and the adverse effects of the world recession, resulted in slower economic growth. While the Government responded appropriately at the macroeconomic level, by promptly implementing a stabilization program designed to reestablish financial stability (1982-85), the trade regime became more inward-oriented. Faced with slower growth in domestic activity and many manufacturing plants carrying excess capacity, tariff protection was supplemented by a proliferation of non-tariff barriers (NTBs) in the form of restrictive licenses. By the end of 1985, more than 1,700 tariff positions were subject to import licensing accounting for over 40% of both import value and traded domestic production. In addition, export restrictions in the form of bans, taxes and quotas became more commonplace - particularly for unprocessed agricultural commodities. Thus, while short-term macroeconomic stability was restored by 1985, other medium-term structural problems in the economy had not been adequately addressed.

1.02 The collapse in oil prices in early 1986, and the forecast of continued slow domestic growth, encouraged GOI to reassess this strategy. The rapid decline in oil-related tax revenue and export earnings further curtailed the Government's capacity to finance planned levels of public expenditure and underlined the danger of fostering a 'high cost' domestic manufacturing sector that was uncompetitive on the world market. In response, the Government implemented a series of "deregulation packages" aimed at increasing private sector activity and stimulating non-oil exports. A key component of these packages has been several trade reform measures designed to improve the international competitiveness of the economy and reduce the overall bias against trade.<sup>1/</sup> The primary focus of the trade reforms has been to move away from a trade regime based upon non-tariff barriers towards a less distorted regime based on import tariffs and to provide exporters with access to imported inputs at world prices. Prior to the May 1990 reforms, about half of the restrictive import licenses had been removed, lowering the NTB coverage of total domestic production from 41% in 1986 to 29% by end 1988. These measures occurred within the context of a second macroeconomic stabilization program (1986-88), designed to promptly reduce the external and internal deficits that had resulted from the further decline in oil prices and the adverse effects of currency movements on debt service payments.

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<sup>1/</sup> Since this report was prepared before the May 1990 reforms, the analysis presented here does not reflect the implications of these new measures.

1.03 The economy has responded strongly to the Government's balanced adjustment program. Since 1986, both the current account and budget deficit have narrowed significantly, inflation has been contained at below 9% p.a., and economic growth has accelerated. Of particular note is the strong growth in non-oil exports, which increased from US\$6.7 billion in 1986/87 to an estimated US\$12.1 billion in 1988/89. There has also been a marked increase in private investment, particularly planned investment, and indicators of overall economic efficiency have improved significantly since 1986. Indeed there is mounting evidence that the rate of economic growth during the adjustment period has been above previous estimates.<sup>2/</sup> This is particularly so for manufacturing where most of the improvements in the trade and regulatory environment have occurred. Another important finding is that deregulation has coincided with a strong surge in manufacturing employment. The change in domestic relative prices resulting from both the macroeconomic and trade/regulatory reforms has drawn resources into those relatively labor intensive activities in which Indonesia is competitive in the world market.

1.04 The remainder of this Chapter investigates recent trends in the economy in more detail, examining the changes in trade policy in the context of broader macroeconomic developments. The first section (B), describes the magnitude of the external shock suffered by the Indonesian economy and GOI's corresponding policy response, including trade reform. The second section (C), examines the degree to which these reforms have resulted in a change in the overall pattern of incentives. Particular attention is focussed on the real exchange rate, the incidence of NTBs, the tariff structure, export incentives and the relative price of tradables. The final section (D), assesses the effects that the change in incentives has had on economic performance. Several macroeconomic performance indicators are examined, followed by a more detailed discussion of trends in imports, exports and the performance of the manufacturing sector.

1.05 The following chapters of the report are organized as follows: Chapter 2 provides a detailed discussion of the current trade regime. It takes a policy instrument approach, assessing the incentive effects of each important policy instrument (i.e., NTBs, import tariffs, export promotion measures and export regulations). It concludes by providing an assessment of the overall pattern of incentives created by the current trade regime in terms of nominal and effective rates of protection. Chapter 3 looks at the trade regime from a different angle by focussing on how the range of trade policy instruments affect particular manufacturing activities. Four industries are analyzed, covering a range of inward and outward-oriented activities that have been effected by past trade reforms to different degrees.<sup>3/</sup> Chapter 4 extends the analysis provided in Chapter 3 to cover agricultural activities. It is important to acknowledge that the effects of trade policy are not limited to

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<sup>2/</sup> The revised national accounts show that between 1986 and 1988 GDP grew by 5.3% p.a. and manufacturing by 12.5% p.a.

<sup>3/</sup> The four industries are footwear, textiles, iron and steel, and paper.

the manufacturing sector. This is particularly the case in Indonesia, where trade in agricultural commodities remains highly regulated. Chapter 5 concludes by outlining a framework for reform. It provides a series of both short and long term policy steps designed to reduce the distortionary effects of the trade regime and to create a policy framework conducive to the further development of Indonesia's economy.

## **B. Macroeconomic Developments and Trade Policy Reform**

1.06 Since 1981, Indonesia has experienced a severe deterioration in its external terms of trade. During the period 1982-85, the economy had to adjust to the weakening of oil prices (from a peak of US\$35 per barrel to US\$25 per barrel), the repercussions of the 1982-84 world recession, and a decline in the price of several important primary commodity exports. Then, in 1986, the oil price collapsed from US\$28 per barrel to a low of US\$10 per barrel. Although oil prices did recover slightly thereafter, net oil/LNG export earnings fell by US\$2 billion between 1986 and 1988. These losses were intensified by the adverse effects that international currency fluctuations had on debt service payments from mid-1985. On average, Indonesia incurred an income loss equivalent to some 9% of its annual GNP over the period 1981 to 1988, due to external disturbances.<sup>3/</sup>

1.7 GOI responded promptly to this situation by adopting two successive stabilization programs (1982-85 and 1986-88). While both programs have been based on appropriate macroeconomic policies designed to quickly restore financial stability, the latter program focussed more closely on undertaking microeconomic reforms aimed at reducing the complexity of the regulatory framework and improving the incentive structure. The specific policy responses can be grouped into four categories:

- (a) To restore balance of payments stability and sustain growth over the medium term, the Government adopted an active exchange rate policy. Major devaluations were implemented in March 1983 and September 1986 and the flexibility of the exchange rate was increased through a more actively managed float. In conjunction with prudent fiscal and monetary policies, these measures supported a real effective exchange rate depreciation of about 55% between December 1981 and December 1988. This played a key role in boosting non-oil exports and reducing the current account deficit.
- (b) The objectives both of demand restraint and structural change have been served by the implementation of a number of strong fiscal measures, designed to restrain public expenditure, mobilize public revenues and reduce the overall fiscal

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<sup>3/</sup> See Chapter 1 of the 1989 Economic Report on Indonesia, entitled "Strategy for Growth and Structural Change" for decomposition of the external shock and a more detailed discussion of the Government's macroeconomic policy response.

deficit. Budget austerity and more careful selection of projects reduced public investment by over 30% in real terms over 1984-86, while tax reform measures boosted non-oil tax revenues and improved the efficiency of the tax system.

- (c) Supportive monetary and financial policies have been maintained to contain inflationary pressures, prevent capital flight, mobilize financial resources and improve the efficiency of use of financial resources. A major financial sector reform was introduced in June 1983, which deregulated domestic interest rates and increased the flexibility of monetary management. A second round of financial measures was initiated in October-December 1988, aimed at enhancing financial sector efficiency and boosting capital markets.
- (d) Starting in 1985, the Government also initiated a series of trade and other regulatory reforms to support demand management policies in reducing macroeconomic imbalances and to enable a recovery of economic growth over the medium term. These reforms were aimed at developing a more efficient private sector, that can make a significant contribution to employment generation and non-oil export development.

1.8 A key component of point (d) above has been trade policy reform. The first step towards improving the trade regime was taken in March 1985 when the Government implemented a comprehensive reform of the tariff schedule. The tariff ceiling was lowered from 225% to 60%,<sup>4/</sup> and the number of tariff rates was reduced from 25 to 11. The reform also raised the percentage of items with tariffs below 30% from about 59% to 82%. Although this resulted in an unequivocal improvement in trade regime, its effect was significantly mitigated by the simultaneous proliferation of restrictive import licenses. Subsequently, in April 1985, the Government completely reorganized the customs, ports and shipping operations. It placed the job of certifying imports in the hands of a private firm of surveyors (SGS). This reduced both the numbers of customs officials required and the discretion used at the port of entry. As a result, the average time spent on customs procedures was cut by several weeks, and the cost of freight forwarding both for exports and imports fell substantially.

1.9 Following the sharp drop in oil prices in 1986, the GOI embarked upon a more fundamental series of reforms designed to stimulate non-oil exports and increase economic efficiency. In May 1986, the Government created a duty exemption and drawback facility to enable exporters to access imported inputs at world prices (BAPEKSTA, formerly P4BM).<sup>5/</sup> Indonesia's accession to the GATT Code on Subsidies and Countervailing Duties in 1985 required withdrawal

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<sup>4/</sup> Exceptions to this tariff ceiling were motor cars/cycles, some spare parts, and a range of products with specific duties (e.g., tires) which had high ad valorem equivalent tariffs - see Chapter 2.

<sup>5/</sup> This facility was administered by Pusat Pengolahan Pembebasan dan Pengembalian Bea Masuk (P4BM), which was later expanded and renamed Badan Pelayanan Kemudahan Ekspor dan Pengolahan Data Keuangan (BAPEKSTA)

of the Export Certificate Scheme.<sup>6/</sup> As a result, it became necessary to find an alternative method to protect the competitiveness of Indonesian exporters from the "high-cost" local economy and import license restrictions. The BAPEKSTA facility was designed to do this by allowing "producer-exporters" the option of importing their inputs free of all trade and local taxes. The significance of the program goes beyond allowing imports to be brought in duty free as it also allows exporters to bypass import license restrictions. In addition, a duty drawback facility was created to enable indirect exporters to reclaim import duties.

1.10 In October 1986, following the 31% devaluation of the previous month, GOI took the first step in directly reducing import-policy related distortions by announcing the removal of 197 items from the Restricted Goods List. The Government indicated that this was the first of a series of trade reform packages, designed to move away from a trade regime dependent on NTBs towards one based solely on tariffs. Since 1986 there have been three further packages which have focussed primarily on removing the incidence of NTBs in manufacturing, where both the overall level and the variability in protection is highest. In addition, in 1987 the need to obtain an export license was abolished which opened export trade to all holders of a business license, except those goods that are under special export regulations.<sup>7/</sup> Finally, following the reform of port procedures in 1985, GOI have also taken several steps to deregulate maritime shipping. This culminated in the November 1988 reform package which largely removed the remaining international shipping restrictions, resulting in a marked increase in competition.

### C. The Changing Pattern of Economic Incentives

1.11 One of the major objectives of GOI's adjustment program has been to change the pattern of economic incentives. The rapid and sustained deterioration in Indonesia's terms of trade coupled with high cost local industries, necessitated relative prices to adjust in two ways. First, the price of tradables needed to rise relative to the price of non-tradables - both to encourage domestic resources to switch into the production of tradable goods and to reduce the domestic demand for tradable goods. Second, the price of exportables needed to rise relative to the price of importables - to

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<sup>6/</sup> As a scheme for rebating exports, the Export Certificate Scheme suffered a number of drawbacks. The level of payment often did not relate to actual duty cost and was often viewed in importing countries as a direct subsidy. In addition, treatment was uneven, in some cases actual payment was less than the duties borne: usually for the more competitive exporters able to compete without subsidy. A final difficulty was that, even if import duties were fully rebated, the scheme did not provide a method of bypassing the approved traders, and therefore did not compensate exporters for the costs imposed on them by the restrictive import license system.

<sup>7/</sup> See Chapter 2, Table 2.6 for list of export regulations. Export regulations are particularly common on unprocessed or semi-processed agricultural commodities, e.g., logs, rattan, crude palm oil, and sawnwood.

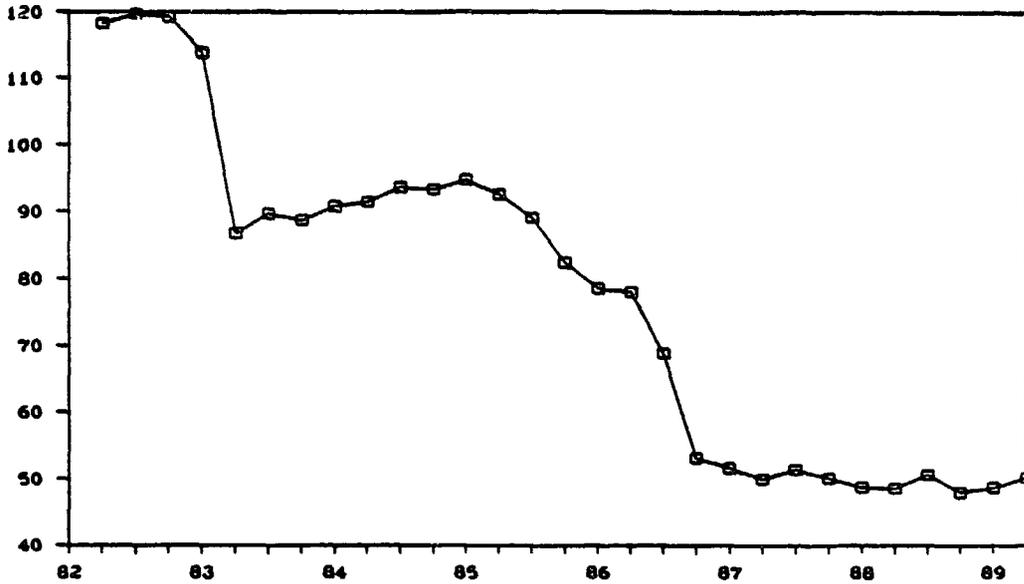
further encourage resources to move into the production of non-oil exports and to increase the pressure on import substitution activities to become more competitive. At a macroeconomic level, the demand dampening and expenditure switching effects of these relative price changes were needed to facilitate a correction in the external current account deficit and to increase economic efficiency. In this section we present several measures or 'indicators' of the degree to which the pattern of incentives have changed in response to GOI's adjustment program. These are: the real exchange rate; the incidence of NTBs; import tariffs; export incentives; the relative price of tradables; and the cost of port clearance and international shipping.

### The Real Exchange Rate

1.12 Indonesia has an unusually strong track record in following consistent fiscal, monetary and exchange rate policies as well as promptly implementing appropriate macroeconomic reforms in response to changed economic circumstances. The maxi-devaluations of March 1983 (28%) and September 1986 (31%), were both taken in response to a significant and lasting deterioration in Indonesia's external terms of trade. In both cases the devaluation of the nominal exchange rate was supported by appropriate monetary and fiscal policies designed to contain inflationary pressures and thereby maintain the gains in international competitiveness.

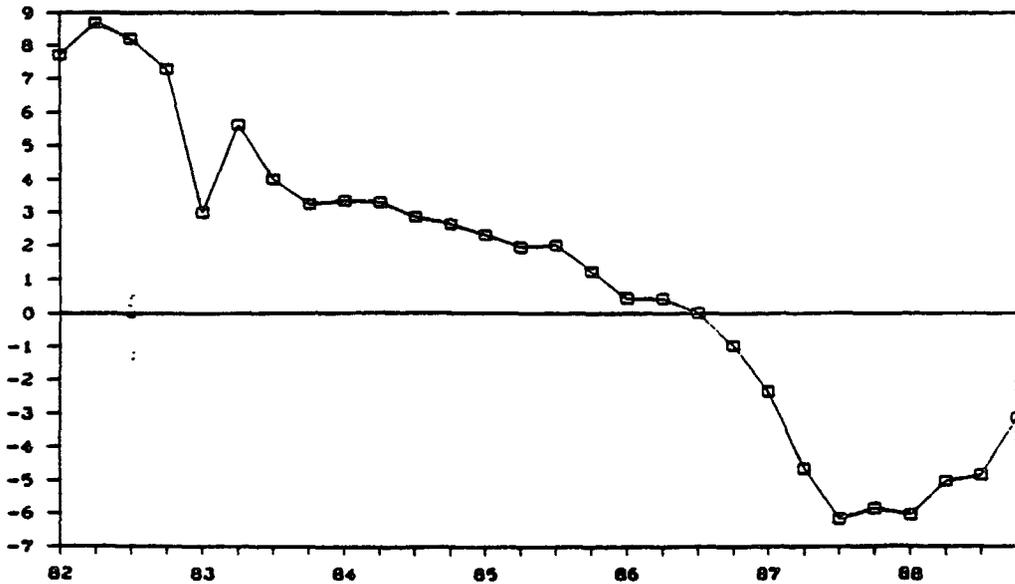
1.13 Two measures of the change in Indonesia's real exchange rate are presented in Graphs 1.1 and 1.2. The first measures the change in the price of Indonesia's traded goods (exports and imports) relative to the price of traded goods in competitor countries. It reflects the degree to which the nominal devaluation and tight monetary and fiscal policies have lowered real wages in Indonesia relative to competitor countries. The second, measures the change in the domestic wholesale price of manufactured goods relative to the domestic wholesale price of construction. This reflects the degree to which the domestic price of traded goods have changed relative to the domestic price of non-traded goods. Both series tell roughly the same story. By following consistent and mutually supportive macroeconomic policies, GOI has successfully maintained the gains from the nominal devaluation thereby increasing Indonesia's competitiveness. As expected these policies have also raised the price of tradables relative to non-tradables. Both effects helped to offset the negative effects that the fall in oil prices had on the current account, by reducing import demand and by increasing the profitability of non-oil exports. One concern in this area is the recent slight appreciation of the real exchange rate resulting from adjustments in the nominal exchange rate not fully compensating for the prevailing rate of inflation (see Graph 1.2).

**Graph 1.1 : REAL EFFECTIVE EXCHANGE RATE  
INTERNATIONAL COMPETITIVENESS**



Source IMF : Defined as a trade weighted nominal effective exchange rate index (based on trade data for bilateral and third country manufactured goods and primary goods for a three year period) adjusted for relative changes in consumer prices.

**Graph 1.2 : TRADED vs NON-TRADED GOODS PRICES**



Source: BPS: Defined as the change in the relative price of the wholesale price index for non-traded commodities divided by wholesale price for manufactured exports.

## The Incidence of NTBs

1.14 By the end of 1986, there were more than 1,700 products (CCCN tariff positions) under NTBs, accounting for over 40% of total import value and traded domestic production.<sup>8/</sup> Although import license restrictions varied considerably in their degree of restrictiveness, by 1986 the import licensing system was the most important distortionary influence in the trade regime, contributing not only to the high level and variability of protection but also fostering unproductive 'rent-seeking' behavior.

1.15 There have been four major trade reform packages since 1986, each one of which has focused on reducing the incidence of NTBs in particular sectors. Broadly speaking the first three packages included complete or partial deregulation of: tires, glass and engineering goods (October 1986 package); textiles, garments and footwear (January 1987 package); steel and mechanical equipment (December 1987 package). The fourth package in November 1988, was the most significant, further deregulating steel and textiles and pushing the reform effort into previously untouched areas such as plastics, fertilizers, and some processed food and beverages. The November package also required all existing import license holders to reregister at the regional offices of the Ministry of Trade. This was designed to assist the non-oil tax drive by bringing more firms on to the tax register and to screen out any illegal importers.<sup>9/</sup> One distinct benefit of the new licenses is that they are valid for as long as the importer remains in business, whereas previous licenses had to be renewed every three to five years.

1.16 The cumulative impact of the trade reform packages announced between October 1986 and end-1988 is shown in Table 1.1. In brief, these measures resulted in the removal of 839 items from license control, accounting for 48% of all items and 52% of total import value previously restricted. More importantly, the share of total domestic production protected by import licensing restrictions has declined by about a third, from 41% to 29%. The reduction in NTBs has been concentrated in the manufacturing sector, where both nominal and effective rates of protection are highest.<sup>10/</sup> The share of domestic manufacturing production covered by NTBs declined from 68% in 1986 to 45% in 1988.

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<sup>8/</sup> Of the 1,700 items, 296 had a formal quota imposed. In addition, there were 24 products under import ban (including automobiles, motorcycles, televisions and radios in their completely built-up form).

<sup>9/</sup> To qualify for a new import license, applicants had to submit their importer identification number (API), their tax registration number (NPWP), and have no record of contravening prevailing legislation and regulations. Before reregistration approximately 4,880 import licenses had been issued. Of these, 3,667 reapplied with 3,645 being approved and 22 being rejected. Access by new importers remained open during, and after, the registration process. New entrants require the same documentation as those reregistering, and some 42 new importers were registered in January and February 1989.

<sup>10/</sup> See Chapter 2, paras 2.49 to 2.54, for estimates of nominal and effective rates of protection.

**Table 1.1: IMPACT OF REFORM PACKAGES ON IMPORT LICENSING COVERAGE SINCE 1986**

	Mid-1986	End-1987	End-1988
% of CCCN items	31.5	21.7	16.3
% of import value	42.9	25.2	20.8
% of total domestic production	41.4	37.6	28.9
<b>Memo item:</b>			
% of domestic production in: /a			
Manufacturing	67.7	58.1	44.5
Agriculture	53.8	52.9	40.9
Mining and minerals	0.2	0.2	0.2

/a The estimates of domestic production under import license protection for manufacturing and agriculture differ from earlier Bank staff estimates due to the reclassification of the food and beverages industry into the manufacturing sector and out of the agricultural sector. This reclassification, which has no impact on the economy-wide share of total domestic sales under NTBs, was done to maintain consistency in sector definitions with the nominal and effective rate estimates.

Source: World Bank staff estimates.

1.17 The removal of NTBs has had three beneficial effects on the pattern of incentives that are difficult to separate. First, the move to tariff only protection has reestablished a direct link between domestic and world prices. This has greatly increased the transparency of the trade regime and established a mechanism by which the level and variance in protection can be lowered over time (i.e., by adjustments in the nominal tariff). Second, as the data in paragraphs 1.29 to 1.31 shows, the price of imports relative to the price of exports has fallen since 1986. At least part of this decline reflects the removal of restrictive import licensing requirements. Third, domestic users of the deregulated imports have benefited not only from lower prices but also from more certain delivery times and improved quality. As the firm level evidence presented in Chapter 3 indicates, such "non-price" factors can be crucial in the export market, and can have important effects on domestic producers encouraging them to become more cost and quality conscious.

1.18 The Import Tariff Schedule. The most significant change in the Indonesian tariff schedule occurred in 1985, when an across-the-board reduction in tariff rates was instituted. This reform lowered the ad valorem tariff rate ceiling for most products from 225% to 60% and collapsed the number of tariff levels from 25 to 11. As shown in Table 1.2, this resulted in a marked decline in the average weighted statutory tariff from 22% to 13% by import value or from 29% to 19% by domestic production value. One negative aspect of the 1985 tariff reform was the introduction of many specific duties which had high ad valorem equivalent rates. This caused the index of dispersion to increase significantly from 61.5 to 107.8.

**Table 1.2: CHANGES IN THE TARIFF SCHEDULE FOR THE WHOLE ECONOMY SINCE 1985/a**

	Pre-1985	1985	1988	1989
<b>Average Tariff Rates (%)</b>				
Unweighted	37.3	27.0	24.0	27.0
Weighted				
- by import value	22.0	13.0	14.5	12.0
- by domestic production /b	29.0	19.0	18.0	19.0
<b>Index of Dispersion /c</b>	61.5	107.8	90.0	92.7

/a "Pre-1985" refers to the 1983 Tariff Law in effect from 1983 to 1985; 1985 reflects rates in effect after the 1985 reform; 1988 refers to rates in effect after the November 1988 package; and 1989 refers to the Harmonized System as provided by the Department of Finance in mid-1989. Tariffs are inclusive of surcharges. Specific duties have been converted to ad valorem equivalents.

/b Based on a sample of 1,200 tariff positions.

/c Measured by the coefficient of variation.

Source: Ministry of Finance, Central Bureau of Statistics and staff estimates.

1.19 From 1985 to 1988 the tariff schedule has been subject to a number of ad hoc changes associated with the series of deregulation packages. These changes have focused on raising some tariff rates to compensate for the removal of NTB protection, and lowering other tariff rates to offset the effect of the September 1986 devaluation and to reduce the costs of imported inputs that are not produced locally. In some instances, a surcharge was also imposed to provide additional protection to products moved off NTBs.<sup>11/</sup> The surcharge provision has also acquired a second function, in that it has been increasingly used as a de facto anti-dumping measure. In some instances, products have been designated as surchargeable but with rates initially set at zero. This has created a potentially 'easy' mechanism by which additional protection can be granted domestic producers and, as discussed in Chapter 5, does not constitute an appropriate anti-dumping mechanism.

1.20 Another important characteristic of recent changes in the tariff schedule since 1985 is the introduction of split-tariff positions.<sup>12/</sup> In many

<sup>11/</sup> Although it is the Government's intention that surcharges should automatically expire after one year (unless a valid case can be presented for their renewal) this does not appear to have happened, with the result that there is considerable uncertainty concerning their validity.

<sup>12/</sup> This is the subdivision of a standard CCCN or HS tariff position into ever finer product descriptions. See Chapter 2 for full discussion.

cases these have been used to maintain protection to sub-groups of products produced domestically. The overall result of the changes since 1985 has been a gradual decline in the index of dispersion, from 108 to 84, with little impact on the overall average tariff rate. The overall dispersion index has declined primarily because the ad valorem equivalent of specific duties have diminished over time (due to the effect of inflation and devaluation) and some specific duties have been replaced with ad valorem rates as part of the deregulation packages. This has not resulted in a corresponding reduction in the average tariff rate because of the offsetting effect of the aforementioned increase in tariff rates (including surcharges) associated with the move away from NTBs.

1.21 In January 1989, Indonesia converted from the CCCN classification system to the Harmonized System. GOI used the opportunity to reduce the number of items with specific tariffs from 498 items to 19.<sup>13/</sup> This has greatly improved the transparency of the tariff schedule. Before this conversion, the ad valorem equivalent of specific duties ranged from 10% up to 100%. In the new HS system most of the specific duties have been replaced with ad valorem rates in the 50% to 60% range. As a result, the move to ad valorem rates has reduced the overall dispersion of the tariff schedule but has also resulted in a clustering of tariff rates at the top of the tariff (see Graph 1.3). A negative aspect of recent developments in the new HS tariff schedule is the increased prevalence of surcharges and split-tariff positions. This has resulted in average surcharges increasing in a number of industries including footwear and basic iron and steel products. In addition, average tariff rates for a number of industries - most notably processed food, footwear, rubber products and glass have increased since 1988. The changes in tariff and surcharges have led to a slight increase in the unweighted and production weighted average tariffs for 1989. Dispersion has also increased, primarily due to the increased use of split-tariff position. It would appear that some of the earlier momentum towards tariff reform has been lost since the conversion to the Harmonized System.<sup>14/</sup>

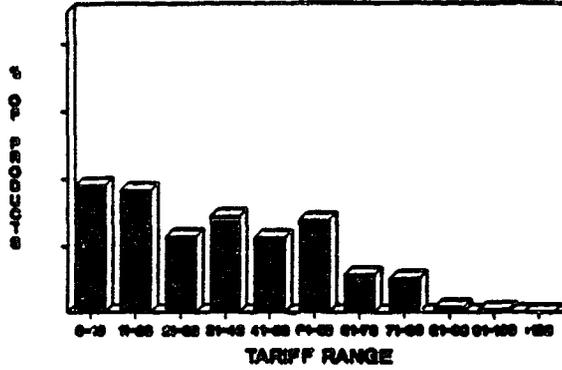
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<sup>13/</sup> The remaining 19 specific duties apply to a sub-group of rubber tires.

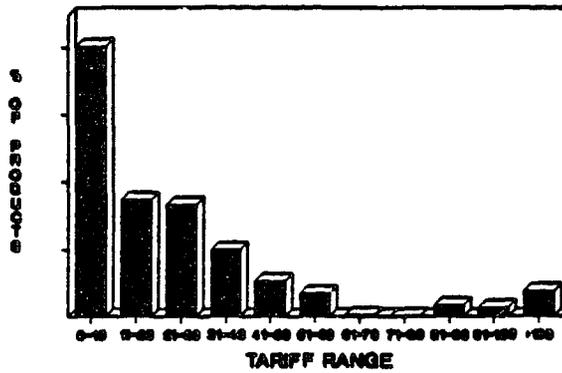
<sup>14/</sup> A more detailed discussion of the incentive effects of the HS tariff schedule is provided in Chapter 2.

Graph 1.3: CHANGES IN THE TARIFF SCHEDULE 1985-89  
(including surcharges)

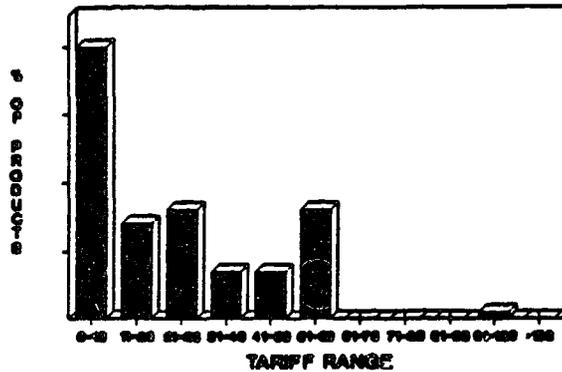
### PRE-1985 CCCN SCHEDULE



### 1985 CCCN SCHEDULE



### 1989 HS SCHEDULE



Export Incentives

1.22 The most important change in export incentives was the creation of the duty exemption and drawback scheme (BAPEKSTA) on May 6, 1986. The BAPEKSTA facility partially protects exporters from the "high-cost" local economy by allowing them to import their inputs free of tax and, just as important, by allowing them to by-pass import license restrictions.<sup>15/</sup> The import exemption scheme has worked extremely well. BAPEKSTA has operated with an "arms length" administration policy which minimizes direct contact with potential applicants and has made continuous efforts to simplify and standardize application and processing procedures. As shown in Table 1.3, the number of firms using the scheme since 1986 has increased rapidly with processing time for applications falling by 50%.<sup>16/</sup> The total value of imports approved or realized under the scheme has more than doubled over the past two years, to a level which accounts for 17.0% and 7.5% of total non-oil imports. The total value of exports which have benefitted from using facility has also expanded rapidly to a level of 24% of total manufactured non-oil exports in 1988.

**Table 1.3: IMPLEMENTATION OF BAPEKSTA SCHEME**

	No. of Firms	Value of Imports (US\$ million)		Value of Taxes/ <sup>a</sup> (US\$ million)		Processing Time (No. of days)	
		Approved	Realized	Duty Exempt	Duty Drawback	For Exempt	For Drawback
1986 (July-Dec.)	242	236	65	76	0	12	24
1987 (Jan.-Dec.)	482	902	297	230	6	7	17
1988 (Jan.-Dec.)	1,098	2,447	626	855	20	6	13

<sup>a</sup> On approval basis.

Source: BAPEKSTA.

<sup>15/</sup> Import duty and VAT exemptions can be given for either a firms total imported inputs (if the firm exports 65% or more of total production) or on a consignment basis (where a particular import order is directly linked to an export order). A duty-drawback facility also exists to assist "indirect" exporters but this has not been used extensively as discussed in Chapter 2.

<sup>16/</sup> In addition to the underlying growth in the scheme, this rapid growth reflects two changes in coverage: (a) the scheme was expanded to incorporate foreign aided public sector projects; and (b) the definition of producer-exporters was changed in December 1987, when the ceiling for qualifying for duty/tax exemption was lowered from 85% to 65% of total production (except for textiles producers).

1.23 It is also encouraging that access to the scheme has broadened since 1986, to include more of the 'emerging' sectors that have recently shown strong export growth (see Table 1.4). In particular, food products, footwear, rubber products, textile and garments producers and wood product manufacturers all use the facility for part of their imported input needs. Firm level interviews with textiles and footwear producers confirmed the importance of BAPEKSTA. Access to good quality and uniform material inputs was regarded as being as important as price considerations by those producers supplying brand-name footwear and garments to overseas buyers. Some foreign producers remarked that access to imported inputs was a more important influence on their decision to relocate to Indonesian than the comparative low Indonesian wage rate. Finally, it is also clear that BAPEKSTA is used primarily to import those items with above average levels of nominal tariff protection. However, as shown in Table 1.5 the facility is also used to import some items - such as chemicals, synthetic fibres, and iron steel products - where the nominal tariff rate is low. In these cases BAPEKSTA is primarily used to overcome NTB protection. Even where the domestic product may sell at close to world prices, downstream users in the steel products and textiles sectors often quoted problems of delivery and quality as reasons to use BAPEKSTA. Indeed some firms indicated that by having BAPEKSTA approval to import ensured better services and more competitive prices from domestic suppliers - hence part of the reason for the discrepancy between approvals and actual imports under the BAPEKSTA facility.

**Table 1.4: MANUFACTURING EXPORTS UNDER BAPEKSTA**  
(As percent of Total Exports)

Description	1986	1987	1989
Food and beverages	1%	5%	6%
Textile, clothing and footwear	9%	28%	30%
Wood products	15%	37%	45%
Paper & paper products	9%	31%	43%
Chemicals, rubber and plastic products	1%	5%	8%
Non-metallic products	2%	8%	11%
Basic metal products	1%	42%	31%
Mechanical and electronical machinery	3%	20%	36%
Other	0%	7%	8%

Source: BAPEKSTA.

**Table 1.5: MAIN ITEMS IMPORTED UNDER BAPEKSTA DUTY EXEMPTION,  
WITH AMOUNT OF EXEMPTION AND AMOUNT OF IMPORT, MAY 1986 - JUNE 1989  
(on approval basis)**

Commodity/Item	Amount Imported (US\$ million)	Total Exemption (US\$ million)	Average Duty (%)
Manioc	49.2	14.7	30%
Vegetable oils	49.1	34.5	70%
Heterocyclic comp.	11.2	0.5	4%
Other chemicals	14.5	0.9	6%
Polycondensated	27.7	3.4	12%
Polymers	62.2	14.0	23%
Plastic containers	14.3	6.1	43%
Cow leather	15.1	3.1	21%
Paper (white)	16.0	4.2	26%
Paper (coated)	10.7	2.3	21%
Synthetic yarn	30.8	6.4	21%
Woven synthetic fabric	31.0	18.8	61%
Woven cotton	123.2	78.1	63%
Synthetic fibers	29.3	4.4	15%
Mixed yarn	25.0	5.0	20%
Woven synthetic fabric	70.2	40.5	58%
Knits, natural fiber	21.3	12.6	59%
Sacks (jute)	136.5	40.5	30%
Refractory bricks	23.8	1.2	5%
Iron/steel pillets/slabs	101.1	5.1	5%
Iron/steel sheets-plates	30.3	2.0	7%
Aluminum ingots	21.1	1.4	7%
Lifts, elevators conveyors	162.9	46.8	29%
Excavators, shovels	21.9	6.9	32%
Slide fasteners	19.0	14.7	77%
Shovels	24.0	7.6	32%
Average tariff			33%
Average manufacturing import tariff			19%

Source: BAPEKSTA, Bank staff estimates.

1.24 Another important policy component of the export incentive regime is the provision of subsidized short-term export financing, pre-shipment export finance guarantee (PEFG) and export credit insurance/guarantee (ECI/G). These measures were announced in January 1982, and are available to all firms that contribute to non-oil export value added. There has been a very rapid increase in official export financing and pre-shipment export finance guarantee limits in the last few years, reflecting the recent surge in non-oil exports. While these measures have provided additional export incentives, the subsidized export credit has been limited to larger, well established

exporters and the PEFG and ECI have not been effective in encouraging banks to provide small or new firms access to credit. The amount of outstanding short term export credit (pre-shipment and post-shipment) increased on an average by 32.5% a year since 1982. Growth has been very rapid especially in the last two years: while the rupiah value of non-oil exports almost doubled, the outstanding export loans almost tripled to reach 21% of non-oil exports in 1988/89 (Table 1.6).<sup>17/</sup> Assuming such loans were revolving every four months,

**Table 1.6: EXPORT LOANS OUTSTANDING, 1985-89**  
(in billions of Rupiah, as of March 31)

	1985	1986	1987	1988	1989
<u>Export Loans Outstanding</u>	<u>969</u>	<u>1,407</u>	<u>1,590</u>	<u>2,986</u>	<u>4,554</u>
(Liquidity Credits)	(635)	(981)	(1,492)	(1,871)	(2,595)
(Percent Liquidity Credits)	(65.5)	(69.7)	(93.8)	(62.7)	(57.0)
<u>Export Loans Outstanding by Sector</u>					
Agriculture	110	119	130	196	242
Industry	360	507	609	1,248	1,866
Trade	467	675	844	1,526	2,438
Other	32	26	215	16	8
<u>As percent of</u>					
Non-oil Exports	14.7	16.1	14.3	18.4	21.3
Net Domestic Credit	8.6	7.0	9.0	10.0	10.9
Rupiah Bank Credit	5.1	6.3	5.8	8.8	10.2
Liquidity Credits <u>/a</u>	9.3	12.6	16.6	18.1	19.6

/a Rediscountable portion.

Source: Bank Indonesia and World Bank staff.

<sup>17/</sup> It is not possible to determine the amount of exports actually supported by the export finance system (and the PEFG cover), since actual loan ceilings, actual export transactions and banks' usage of Bank Indonesia liquidity credit facility cannot be matched. A breakdown of total export loans outstanding as between pre-shipment and post-shipment and by product and industry is unavailable. Because of the prevalence of sales on sight L/C basis, very little post-shipment financing is obtained by exporters (amounts insured with PT. ASEI under the ECI/G scheme constituted less than 4% of outstanding export loans in 1988). Data by product and industry are not compiled; it is thus not possible to determine which products/industries are the major users or to analyze the amount of subsidies accruing to different groups. Interest rate subsidies amounted to about rupiah 315 billion in 1988, equivalent to about 2% of total non-oil/LNG exports.

the share of non-oil/LNG exports supported by the export financing scheme is over 60%, a ratio which compares very favorably with the other countries of the region with similar schemes and partly reflects the inclusion of the main primary products in the export financing scheme in Indonesia.

1.25 While data by product and industry are unavailable, trade and manufacturing account for 95% of total outstanding export loans. Export loans have increased faster than most broad measures of credit. These loans now constitute 11%, 10% and 20% of net domestic credit, total rupiah bank credit and liquidity credits respectively, compared to their share of 8.5%, 5% and 9% only four years earlier. In large part, the relatively rapid expansion in export loans stems from Indonesia's export-led growth of recent years. State banks dominate even though their share of total export loans outstanding has declined from over 90% in 1985 to 75% in 1989.

1.26 At the enactment of the 1982 Export Policy, primary goods exporters were charged an interest rate of 9%, while non-primary goods exporters were charged an interest rate of only 6% to encourage the growth of non-traditional exports. Under the monetary policy reform of June 1, 1983, interest rates were unified at 9% for all non-oil/LNG exports. Since Indonesia's accession to GATT Code on Subsidies and Countervailing Duties in February 1985 and in line with a bilateral agreement with the United States, large adjustments have been made to reduce the interest rate subsidies. The bilateral agreement with the United States calls for complete elimination of interest subsidies on export loans by April 1990, except for certain primary goods which would continue to be eligible for subsidies. The agreed benchmark for unsubsidized interest rate is the 3-month deposit rate of the state commercial banks. In April 1987, GOI raised the interest rate on non-primary goods from 9% to 11.5%. Effective May 1989 the interest rates on export loans were further increased to 14% and 14.5% for primary and non-primary goods respectively. Prior to May 1989 the interest rate on export loans was well below the cost of commercial financing (see Table 1.7). However, while interest rates on export loans have been substantially less than other non-preferential rates, interest rates since 1984 have been positive in real terms when measured in the context of domestic inflation (CPI). With the May 1989 adjustment in the interest rates, real interest rates on export loans are currently in the 6-7% range.

1.27 In line with the increase in outstanding credits, the (obligatory) pre-shipment export finance guarantee (PEFG) limits has also grown rapidly. By contrast, the (optional) export credit insurance (ECI/G) activity has stagnated. Due to difficulties in resolving claims and doubts about the financial viability of the state-controlled insurance company (P.T. ASEI) neither the PEFG or ECI/G have provided incentives to Banks to extend additional credit to exporters.<sup>18/</sup>

1.28 The one policy development that runs counter to the measures considered so far is the increased coverage of export regulations. During 1988, the existing export ban on raw rattan was extended to cover semi-processed rattan and a new export ban was introduced for SIR-50 rubber.

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<sup>18/</sup> See Chapter 2 for discussion of PEFG and ECI/G.

The government have also announced plans to extend the ban on logs to include sawn timber. The objective underlying most export restrictions is primarily to encourage domestic processing or "value-added". In many cases, the more immediate effect is to lower the domestic price of the restricted item, causing export prices to fall relative to import prices.<sup>19/</sup> While this does encourage downstream processing industries, the value added by the downstream processors may not exceed the real costs of adding the value - particularly if the losses incurred by producers of the restricted commodity are correctly accounted for.<sup>20/</sup>

**Table 1.7: LENDING RATES AT DEPOSIT MONEY BANKS**  
(in percentage, in March of year indicated)

	1984	1985	1986	1987	1988	1989
Export Loans <u>/a</u>	9.0	9.0	9.0	9.0	11.5	14.5
Average on Working Capital:						
State banks	18.2	19.9	19.0	18.4	19.7	20.5
Private national banks <u>/b</u>	24.4	26.2	23.8	22.9	23.5	23.5
Foreign banks	21.3	26.4	22.2	22.2	23.1	22.8
All deposit money banks	21.5	23.4	21.8	21.0	22.0	22.3
3-Month Deposit Rate						
(state banks) <u>/c</u>	16.3	16.4	14.3	16.4	17.4	16.7
Domestic Inflation						
CPI	9.8	4.9	6.2	9.5	5.3	7.0
WPI (excl. oil exports)	10.0	5.5	7.8	16.8	10.3	

/a Non-primary exports.

/b Foreign exchange banks.

/c Benchmark rate under the bilateral agreement.

Source: Bank Indonesia.

<sup>19/</sup> In those rare cases where Indonesia can influence world prices, an optimal export tax may raise export prices and, therefore, be to Indonesia's advantage. However, important dynamic considerations must be taken into account such as foreign consumers switching to substitute goods and third countries increasing their output of the restricted export. In addition, a ban is seldom a useful method of exploiting monopoly power, even a monopolist cannot gain from refusing to trade at all.

<sup>20/</sup> See Chapter 2, para 2.23 to 2.33 for a fuller discussion of this issue.

### The Relative Price of Tradables

1.29 If the partial removal of import restrictions and the introduction of BAPEKSTA have had their intended effect, the domestic price of highly protected import substitute activities should have declined relative to exported goods. As noted in the opening paragraphs of this section, one of the major objectives of Indonesia's trade reform is to increase the profitability of exports relative to imports and non-traded goods.

1.30 There are three manufactured commodities for which wholesale price data exist for both import and export competing goods, i.e., textiles, chemicals and processed food. The first two commodities have experienced a significant relaxation of import license restrictions, whereas exporters of the third (processed food) have gained significantly from the BAPEKSTA facility.<sup>21/</sup> The movements in the domestic WPI for export competing goods relative to import competing goods, since 1986, are shown in Table 1.8.

**Table 1.8: CHANGE IN WHOLESALE PRICE OF EXPORTS RELATIVE TO IMPORTS, 1986 = 100**

	Processed Food	Textiles	Chemicals
1986	100	100	100
1987	113	109	104
1988	113	109	107

Source: BPS, Wholesale Price Index.

1.31 These data indicate that since 1986 the domestic prices of exported manufactured products have risen by between 7% to 13% relative to importable manufactured products. These price changes have provided an incentive, in addition to the exchange rate effect, to switch consumption away from exportables while providing firms with an incentive to expand the production of exportables. Both effects tend to raise the exports of the products concern and help redress the external deficit in the balance of payments.

### Port Clearance and Shipping Cost

1.32 The costs of both processing goods through Indonesia ports and maritime transport have been significantly reduced by recent policy reforms. Until the mid-1980s these services were highly regulated with long delays in

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<sup>21/</sup> The effect of trade policy reforms in the textile and processed food industry are discussed in detail in Chapters 3 and 4 respectively.

ports, controls on transport tariffs, licenses on routes and a range of other permits. This restricted new private investment in the sector, reduced flexibility and raised transport costs to very high levels. The most deleterious regulations were in the maritime subsector. A start was made in 1985 to reform the ports when the Government replaced customs services with a private sector organization and restructured port operations. As a result of those reforms, cargo clearance and ship turnaround times were reduced substantially, freight rates for exports and imports declined markedly on many routes, and the quality of services to shippers and consignees improved as international services were extended to more ports. However, the performance of national shipping companies continued to be constrained by excessive controls over investment and operating decisions and by the policy of compulsory scrapping of ships beyond a certain age that was introduced in 1984. The scrapping policy reduced capacity and raised costs even further.

1.33 The Government introduced a sweeping range of reforms in 1988 to address these concerns. First, the compulsory scrapping policy was suspended in February 1988. This was followed by the announcement of a second package of maritime reforms on November 21, 1988. This package:

- o reduced the categories of shipping business licenses from five to two;
- o relaxed vessel ownership restrictions;
- o permitted national and foreign lines to establish joint venture companies to serve domestic and international routes;
- o eliminated the separate shipping operating license;
- o freed companies to transport own products and raw materials without a shipping business license;
- o permitted shipping lines to determine their own route structures, vessel assignments and sailing frequencies without government approval;
- o permitted national lines to charter foreign flag vessels to serve domestic routes without government approval;
- o allowed Indonesian companies to buy or sell Indonesian vessels, or dock them, without government approval; and
- o lifted the freeze on the issue of general cargo shipping business licenses -- in effect since 1976 -- and simplifies and streamlines the application process.

1.34 By reducing and simplifying business licensing procedures, by allowing shipping lines to determine their own route structures and schedules, and by easing entry by both foreign and domestic companies, this set of reforms removed virtually all regulatory impediments to the development of an

efficient and responsive maritime transport industry. A preliminary judgement is that as a result Indonesia now has a more open and unregulated shipping industry than most other maritime nations. In response, over 40 new shipping companies have already been licensed. This resurgence of competition is having a positive effect on the quality of shipping services and transport costs.

#### D. The Effects of Policy Reform

1.35 The response of the Indonesian economy to the Government's adjustment program has been impressive. Overall financial stability has been restored while economic growth has been maintained. Of particular note is the strong increase in both non-oil exports and private sector investment. Macroeconomic indicators of efficiency and factor productivity have also improved. Indeed there is mounting evidence that the rate of growth during the second adjustment period (1986-88) has been significantly above previous estimates. This is particularly so for manufacturing, where most of the improvements in the trade and regulatory environment have occurred. Another important finding is that deregulation has coincided with a strong surge in manufacturing employment. The changes in relative prices outlined in the previous section have drawn resources into labor intensive activities, resulting in an acceleration in the growth of employment in medium and large scale industries.

1.36 This section analyses these recent trends in more detail focussing on what has been the response of the economy to GOI's overall adjustment program. It also explores whether there is any evidence that trade reform has had an additional effect on economic performance. While the broad-based nature of GOI's reform program makes it difficult to attribute changes in economic performance to specific policy reforms, some insights into the effects of trade reform can be gained by comparing the trends in relevant economic indicators for the two stabilization periods (1982-85 and 1986-88). While both periods were characterized by similar external shocks followed by appropriate macroeconomic policies, the latter period included a more determined effort to broaden the reform agenda to include changes in the trade and regulatory framework. In exploring this approach we initially investigate trends in selected macroeconomic indicators of performance over the two stabilization periods. This is followed by a more detailed analysis of recent trends in imports, exports and the manufacturing sector. While it may be too early to determine the full impact of the deregulatory reforms, trends in these three areas may yield some useful preliminary evidence.

#### Macroeconomic Performance

1.37 As summarized in Table 1.9, GOI has made good progress in restoring financial stability and stimulating economic growth. During the initial phase of adjustment (1982-85) the current account deficit was quickly brought down from 7.9% of GNP in 1982 to 2.4% in 1985. As discussed in more detail below,

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1.38 The Government's fiscal and monetary management has been at the center of Indonesia's success in reducing internal imbalances and containing inflation. As a result of a major tax reform effort which was initiated in January 1984, non-oil taxes grew from 7.4% of non-oil GDP in 1982 to 8.4% by 1985 and 10.8% by 1988. Combined with expenditure restraint this has reduced the overall fiscal deficit from 4.9% of GDP in 1982 to 3.4% in 1988. Budget austerity and appropriate monetary policy have contained inflation to less than 10% since 1985, which in turn has preserved the competitive advantage provided by the realignment of the nominal exchange rate in both 1983 and 1986. As noted in the latest Economic Report, the close coordination of exchange rate, fiscal and monetary policies has been a distinguishing feature of the Government's macroeconomic policy framework.

**Table 1.10: MACROECONOMIC EFFICIENCY INDICATORS**

	1973-81	1982-85	1986-88
Rate of return on investment (% p.a.)	31.4	13.1	21.8
ICOR	2.8	7.8	5.2
Total factor productivity change (% p.a.)	0.9	-2.5	1.0

Source: World Bank staff estimates.

1.39 The trend in both private sector investment and aggregate efficiency indicators differ markedly between the two stabilization periods. In the initial adjustment phase, private investment declined due to higher real interest rates and lower aggregate demand. Since 1986, however, private investment has recovered strongly, responding to the improved incentive and regulatory framework created by the post-1985 reforms and the resulting higher level of economic activity. Much of this new investment has been directed towards export activities. As shown in Table 1.10, indicators of efficiency mirror this pattern. The average rate of return on investment increased from 13% during the 1982-85 period to 22% in 1986-88. Similarly, over the same period, the incremental capital-output ratio (ICOR) fell from 7.8 to 5.2 and the average contribution of total factor productivity to economic growth improved from -2.5 p.a. (implying a fall) to 1% p.a.

1.40 The positive effects that GOI's macroeconomic policies and deregulation reforms have had on the private sector is substantiated by the recent surge in both domestic and foreign private investment. Domestic investment approvals by the Investment Authority (BPKM) which had sagged since 1983, rose by 134% in 1987 and a further 45% in 1988. Similarly, after recording a sharp and steady decline since 1983, foreign investment approvals in dollar terms rose by 76% in 1987 and a remarkable 300% in 1988 to US\$4.4 billion, a level that surpasses other East Asian economies. Data for the first six months of 1989, indicate that this higher level is being

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maintained. While this increase in private sector activity is extremely encouraging two important caveats should be noted. First, there are some indications that the realization of investment is lagging appreciably behind approvals, which partly reflects implementation problems associated with the remaining complexities of the domestic regulatory framework, including the weak corporate legal system. Second, it is not clear that all the new investment is being channelled into areas where Indonesia has a solid comparative advantage (see Table 1.11). While the bulk of the growth in domestic investment is in export-competing sectors (e.g., agricultural commodities, food, textiles, wood, and hotels), some of the larger foreign and domestic investments are in import-substitution activities (e.g., chemicals and metal industries). Further measures to reduce import protection (including in import tariffs), will be required to ensure that these import-substitution activities are internationally competitive.

**Table 1.12 TRENDS IN REAL RUPIAH WAGES 1981 TO 1988/a**

	Wages (Rp./day)	Wages/CPI (1981 = 100)	Wages/WPI (1981 = 100)
1981	1,056	100	100
.			
.			
1985	2,116	142	135
1986	2,343	149	139
1987	2,581	150	133
1988 /a	2,851	154	134

/a CPI measures change in consumer goods prices for major cities, the WPI measures change in prices for all industrial sectors.

Source: BPS and staff estimate.

1.41 Despite these caveats, it is clear that the gains in economic efficiency and the mobilization of non-oil resources have sustained a better-than-expected rate of economic growth, despite the loss of oil revenues. The growth in non-oil GDP slowed to 4.0% during the initial adjustment period, resulting in a positive but small gain in gross national income of 1.3%. During the second adjustment period, GNP growth accelerated to 4.6% in 1987 and 5.7% in 1988 with a corresponding increase in the growth of GNY (see Table 1.9). Nevertheless, the adjustment process has inevitably involved short-term costs. Despite the recent recovery in economic growth, per capita income has been adversely affected by the terms of trade loss. Part of the labor market adjustment has resulted in increased open unemployment in urban areas, especially among young school leavers. However, the main adjustment has fallen on earnings. Table 1.12 shows that the deterioration in the terms of trade since 1981 has sharply slowed the growth

of real rupiah wages relative to the CPI, but has not resulted in an absolute fall. At the same time real rupiah wages did fall slightly relative to the WPI for manufactured goods. The different movement in these two indices of real wage since 1986 reflects the depreciation of the real exchange rate, which has allowed average wages to rise relative to consumer prices (which includes many non-tradable items) but to fall relative to the price of manufactured goods (which produces predominantly tradable items).

### Imports

1.42 The pattern in import growth over the period 1983 to 1988, and the two stabilization sub-periods, is summarized by broad economic category (BEC) in Table 1.13. For the period as a whole, imports declined by an average of 6% p.a., but trends during the two stabilization periods differed markedly. In the first period, there was a decline across all BECs, with particularly large falls in processed food and beverages for household consumption (which fell by an average of 43% p.a. between 1983 to 1986), capital goods (down 18%) and passenger motor cars (down 42%). In the second period, both capital goods and intermediate goods have increased, offsetting the continued decline in consumer goods imports.

Table 1.13: GROWTH IN IMPORTS BY BROAD ECONOMIC CATEGORIES, 1983 - 1988

	Real Growth Rates		
	1983-86	1986-88	1983-88
(Percent per year)			
Total imports	-12.5	4.7	-6.0
Capital goods	-17.7	6.6	-8.7
Intermediate goods	-8.7	4.6	-3.6
Consumer goods	-20.9	-3.9	-14.5

Source: BPS.

1.43 The behavior of imports is broadly consistent with the changes in incentives: the overall decline in the period 1983-86 coincided both with the growth in import licensing, the collapse in oil prices and the resultant devaluation of the Rupiah in 1983. The large proportionate fall in imports of capital goods relative to intermediate goods between 1983 and 1986 reflects the decline in investment and overall economic activity. The adverse shock of the oil price decline severely reduced investment plans, in both the public and private sectors, while reducing imports of intermediate goods for existing projects by a lesser proportion. Since 1986, the partial deregulation of imports and the recovery of private sector investment has been accompanied by increased capital and intermediate goods imports. In addition, the boom in

exports since 1986 has stimulated investment and the usage of intermediate imports. These positive effects have more than offset the demand reducing effect of the 1986 devaluation. It should be noted that most of the trade deregulation to date has focussed on lowering the price of capital and intermediate goods and improving the access of exporters to imported inputs. The relatively large falls in imports of consumer goods in the period 1983-86 and the failure of this category to recover in the period 1986-88 are consistent both with the fall in income due to the oil shock, and with the fact that this is probably the area in which there has been least deregulation.

### Exports

1.44 The most striking feature of Indonesia's successful economic adjustment has been the growth of non-oil exports, which increased from US\$3.9 billion in 1982/83 to US\$12.1 billion in 1988/89. This growth more than made up for the decline in export earnings from oil and LNG, which, over the same period, fell from US\$14.7 billion to US\$7.7 billion. As a result, the share of non-oil exports in total exports rose from 21 percent in 1982/83 to 61 percent in 1988/89 (see Table 1.14). It is also encouraging that during the second stabilization the strongest growth in non-oil exports period has been across a wide range of manufactured products.

1.45 This strong performance has been underpinned by the continued rapid expansion in manufactured exports, which grew at an averaged 34 percent per

Table 1.14: GROWTH IN EXPORTS 1983 - 1988

	Value of exports current prices, US\$ billion		Real growth rates (% p.a.)		
	1982	1988	1982	1986	1987
			1986	1987	1988
<b>Merchandise Exports</b>	<b>18.6</b>	<b>19.8</b>	<b>9.4</b>	<b>6.5</b>	<b>7.5</b>
Non-oil exports	3.9	12.1	13.6	25.8	13.6
Oil and LNG	14.7	7.7	6.5	-8.9	0.8
<b>Non-Oil Exports</b>					
Agricultural	2.4	4.6	7.3	15.0	3.7
Minerals & metals	0.7	1.4	9.9	15.0	-3.5
Manufactures	0.9	6.1	33.8	42.6	27.1
Textiles	0.2	1.8	42.0	50.9	26.5
Plywood & panels	0.3	2.0	35.5	29.5	10.4
Other	0.4	2.3	27.1	51.9	45.2

Source: BPS and BI data.

year in real terms over the period 1982/83 to 1988/89 and was diversified across a wide range of sub-sectors. Of particular note is the 47% real growth in the wide range of products grouped together under 'other' manufactured goods during the second stabilization period. The largest absolute increases have been in textiles and plywood: export growth in these sectors taken together has added about US\$3.0 billion to the absolute increase in Indonesia's export earnings over the period 1982/83 to 1988/89. However, the absolute contribution of "other manufacturing industries" has been larger than the individual contributions of either of plywood or textiles. Over the period 1982-88, exports by other manufacturing industries grew by almost US\$1.9 billion, from US\$0.4 billion to US\$2.3 billion.

1.46 Many of the large absolute increases in exports by "other" manufacturing industries have been from very small bases. As a result, many of these industries have grown at very rapid percentage rates: dollar earnings from exports of plastics; ceramics; glass; basic metal products; shoes; furniture; paper products; and rubber products have all grown by more than 80 percent per year during the period 1985 to 1988. The very rapid growth of a wide variety of manufactured exports has been a remarkable achievement. The one negative aspect of this achievement is that a part of the growth in manufactured exports, if only a small part, has been due to export bans and/or taxes on unprocessed primary products, such as logs, raw rattan and low grade rubber.22/

1.47 Two recent econometric studies have tried to decompose the surge in non-oil manufactured exports into two components: (a) the response to the depreciation in the exchange rate; and (b) the response to other changes in the trade and regulatory framework.23/ Both studies conclude that the strong growth in non-oil exports during the second adjustment period (1986-88) cannot be fully explained by the change in the real exchange rate alone. While estimates of the size the additional growth in non-oil exports due to deregulation varies between the two studies, it would appear that there has been a structural break in the growth of manufactured exports which partly reflects the effect of a more open trade regime and domestic regulatory framework. As firm level interviews confirm, the most import components of the deregulation reforms have been the removal of import NTBs, the introduction of SGS to process and certify imports, increased competition in shipping, and the BAPEKSTA facility. These have led to increased utilization of existing capacity and a surge in both domestic and foreign private investment in export oriented activities.

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22/ The effect of the ban on low grade rubber is minimal as SIR-50 rubber accounts for about 0.4% of Indonesia's rubber exports. The concern here is that this is the beginning of a move to restrict all forms of semi-processed rubber.

23/ G. Fane, "Econometric estimates of determinants of non-oil exports in Indonesia" - background paper, 1989; and D. Wheeler and J. Harris "Economic Incentives and the Growth of Indonesian Manufactured Exports between 1977-1988, An Econometric Analysis."

1.48 Finally it is important to note that Indonesia's strong export performance is reflected in rising - but still modest - shares in world markets. Since a low point in 1982, the share of Indonesia's non-oil exports has risen in both world trade and in the exports of the fast growing Asia region, and Indonesia now accounts for about 1.3% of total world exports. Although manufactures have been the most rapidly growing component, Indonesia's share in world exports of manufactures is still small at an estimated 0.4% in 1987 (compared with 0.1% in 1980). Only in textiles and plywood does Indonesia account for a significant proportion of world manufactured exports.

1.49 In relation to other countries in the region the ratio of Indonesia's manufactured exports to GDP has been low, but has expanded quickly since 1986 (see Table 1.15). After hovering around 7.0% of GDP in the early 1980s, the ratio of exports to GDP began increasing in 1986 and had doubled to 15% by 1988. In terms of the direction of Indonesia's manufactured exports, Japan and the EC have been the most buoyant markets in recent years, but even here Indonesia's share of manufactured imports into these countries is only 1.0%. This is consistent with the view that for most of its emerging exports, Indonesia can continue to expand rapidly before market share becomes a binding constraint.

**Table 1.15: SELECTED COUNTRIES: EXPORT/GDP RATIOS, 1980-88**

	<u>Indonesia</u>		Thailand	Malaysia	Philippines	India	<u>Nigeria</u>		Turkey
	Total	Non-oil and gas					Total	Non- oil	
1980	26.7	6.8	20.2	52.8	16.3	5.0	28.5	1.1	5.0
1981	22.7	4.5	20.1	47.0	14.6	4.5	19.4	0.6	8.1
1982	18.8	4.0	19.5	44.9	12.5	5.0	14.4	0.3	10.9
1983	25.3	6.9	16.1	46.8	13.9	4.5	11.8	0.5	11.1
1984	24.6	6.9	17.9	48.5	15.9	4.7	13.0	0.4	14.2
1985	21.9	7.3	19.1	49.4	14.0	4.3	14.2	0.4	13.0
1986	19.2	9.4	21.2	50.2	15.5	4.1	9.6	0.6	12.8
1987	25.6	13.3	24.5	56.0	16.4	4.5	28.1	2.8	15.0
1988	25.1	15.3	28.7	60.9	17.9	4.8	24.6	3.6	16.6

Source: International Financial Statistics, and staff estimates.

#### Manufacturing and Employment

1.50 As the manufacturing sector has been the primary target of the move towards a more open trade and regulatory framework, one would expect the effects of reform to register in this sector first. Table 1.16 shows recent trends in aggregate value added together with a more detailed picture of

employment for all large and medium scale industries. The data shows that while the rate of growth in value added has accelerated over all the sub-periods between 1975-88, the rate of growth in employment varies significantly between the two stabilization periods. The faster rate of growth of manufacturing employment in the second stabilization period reflects a switch in resources both between and within sectors towards those labor intensive activities in which Indonesia is internationally competitive.

1.51 During the first stabilization period the increase in the growth in value added (from 10.4% p.a. between 1975-82 to 15.4% p.a. between 1982-85) reflects the commissioning of several large capital-intensive plants in the iron and steel, pulp and paper and chemicals sectors. Value added in these sectors expanded at an average annual rate of 39%, 33% and 19%, respectively, during 1982 to 1985. However, because their labor intensity was low, the overall level of employment growth in manufacturing slowed from an average 6.1% p.a. over 1975-82, to 5.1% over 1985-88. During the second stabilization period the further acceleration in the rate of growth in value added (to 18.3% p.a.) has been supported by a marked increase in the rate of growth in employment (to 9.9% p.a.). The most significant increase in the rate of growth in value added during this period has been in textiles (from 11% p.a.

**Table 1.16: GROWTH IN VALUE ADDED AND EMPLOYMENT IN LARGE AND MEDIUM MANUFACTURING 1975-1988**

	% p.a.			Labor Intensity <u>/a</u>
	1975-82	1982-85	1985-88	
<u>Value Added</u>	<u>10.4</u>	<u>15.0</u>	<u>18.3</u>	
<u>Employment</u>	<u>6.1</u>	<u>5.1</u>	<u>9.9</u>	<u>1.0</u>
Food processing	2.8	4.3	5.3	1.0
Textiles, etc.	5.3	4.2	13.9	1.8
Wood products	17.4	12.4	16.7	1.2
Pulp & paper	6.5	6.1	15.7	1.0
Chemicals, rubber & plastic	6.3	5.0	10.6	.8
Glass & ceramics	9.8	7.2	5.2	1.0
Iron & steel	26.7	7.8	5.8	.2
Engineering	9.8	1.3	5.5	.7
Other	13.2	5.9	16.6	1.0

/a Labor intensity for each sub-sector is defined as the ratio of the sub-sectors' share in total manufacturing employment to its share in total manufacturing value added.

Source: BPS. Preliminary reestimates of manufacturing output and employment for large and medium scale manufacturing.

in 1982-85, to 23% in 1985-88), with pulp and paper, wood products, food processing and 'other' manufacturing products also performing strongly. All these sectors have an above-average labor intensity ratio. The exceptions to this trend towards relatively labor intensive export oriented industries have been in the iron and steel and engineering sectors. In the case of steel, this reflects the commissioning of the cold rolling mill, whereas the engineering sector has continued to receive a high level of protection from imports relative to other manufacturing activities.

1.52 The stronger growth in manufacturing output and employment (in the second adjustment period) can be attributed to three closely related factors. First, the depreciation of the real exchange rate and the resulting decline in the world price of Indonesian manufactured exports has stimulated export-led growth. Second, the deregulation of imports and the introduction of the BAPEKSTA facility have increased the price of exports relative to imports, reorienting the manufacturing sector away from its reliance on a highly protected but relatively small domestic market. Third, the change in relative prices coupled with the relaxation of investment restrictions has encouraged a marked increase in foreign private investment.

## CHAPTER 2

### THE CURRENT TRADE REGIME

#### A. Introduction

2.01 As outlined in Chapter 1, the deregulation measures taken since 1985 have significantly improved trade policy related incentives. The incidence of NTBs on imports has been cut by half, reestablishing a direct link to world prices and, in many cases, reducing the level of protection afforded domestic producers. In addition, exporters have been provided with a mechanism to access imported inputs at world prices which represents an important step towards a more neutral trade regime. Despite this progress, the trade regime still hampers the efficient allocation and use of domestic resources as well as taxes domestic consumers. Largely due to the effects of the import regime, the pattern of incentives continues to provide high protection to manufacturing relative to agriculture and favors production for the domestic market over exports. Although export assistance measures reduce the overall anti-export bias of the trade regime, their effect is partial, leaving many potential economic activities and the losses incurred by consumers untouched.

2.02 To understand why the trade regime continues to produce this pattern of incentives it is necessary to review the individual policies which comprise the trade regime. This Chapter addresses this issue by providing a detailed discussion of the major trade policy instruments and highlighting which sectors are most effected. With respect to the import regime, two policy instruments dominate; the Restricted Goods List (NTBs) and the import tariff. Despite the significant progress since 1986, NTBs remain the single most important policy related distortion in the trade regime. About a third of total domestic value added remains protected by NTBs, with coverage in the food crops, processed food and beverages, basic metals, and engineering sectors being particularly high. With respect to import tariffs, their importance has increased in direct proportion to the removal of NTBs. Although the tariff reform of 1985 reduced the average tariff level, current statutory tariffs are high and there is a wide dispersion in tariff rates. In addition, a number of ad hoc adjustments in the tariff schedule have occurred as a result of the deregulation packages, including the introduction of a number of surcharges and "split-tariff" positions. As a result there has been a slight increase in both the average level and dispersion of tariff rates since 1988, which has lost the momentum towards lower and more uniform tariffs established in 1985.

2.03 Export policies fall into two categories; those designed to regulate export trade and those designed to assist exporters. Export regulations (bans, quotas, taxes, approved exporter and quality controls) are focused on agricultural goods and have recently shown a worrying trend towards encompassing more products. Export assistance measures (the duty exemption/drawback scheme, export credit, and export insurance) are primarily used by producers of manufactured goods. They have played an important role in

facilitating the current non-oil export boom by circumventing the price distortions created by the import regime.

## B. The Import Regime

2.04 The import regime comprises of two policy instruments: (a) the Restricted Goods List - which limits the right to import listed commodities to holders of a particular type of license, thereby creating a non-tariff barrier (NTB) to trade; and (b) the Import Tariff Schedule - which fixes the statutory import duty (BM) and import surcharge (BMT) for imported goods. These two policy instruments play the dominant role in shaping the incentive effects of Indonesia's trade regime.

### The Restricted Goods List

2.05 All imports into Indonesia are classified under a particular license category. In order to import any product an importer must possess the license under which that product is classified. As shown in Chapter 1, most of Indonesia's imports are classified under the non-restrictive IU/IU+ (Import Umum or General Importer) license. To obtain an IU/IU+ license an importer presents a business permit and tax payers identification number to the Ministry of Trade and pays a small processing fee. There are over 3,000 IU license holders and interviews with the private sector indicate that they are easy to obtain. There are, however, over 900 products which cannot be imported by holders of an IU/IU+ license. These products are listed on the "Restricted Goods List", and can only be imported by holders of the license under which the commodity is classified. The Restricted Goods List accounts for about 21% of total import value and, more importantly, 29% of total domestic production.

2.06 Aside from import bans, there are basically four types of license categories under which restricted goods can be classified. These are the:

- o IP (Importer Producer) license, which is available to those domestic producers who use IP items as inputs into their production process and can demonstrate that domestic suppliers of the same input cannot meet their price/quality specifications - e.g., fabric for garment manufacturers.
- o AT (Agent Trader) license, which restricts the right to import AT items (mostly heavy machinery) to the sole agent of selected foreign suppliers - e.g., bulldozers can only be imported by the appointed sole agent of a designated foreign suppliers.
- o IT (Importer Trader) license, which restricts IT items (mostly consumer food and beverage items) to the six State Trading Companies (STCs)<sup>1/</sup> ; and

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<sup>1/</sup> These are Dharma Niaga, Tjipta Niaga, Mega Eltra, Pantja Niaga, and Kerta Niaga, Sarinah Persero.

- o PI (Producer Importer) license, which restricts PI items to domestic producers of the same product or to a designated sole importer (e.g., some imported steel products are restricted to the major domestic steel producer, and the major imported food products are restricted to BULOG).

2.07 The sectoral distribution of the restricted goods across the four basic license types, together with the banned and unknown items, are shown in Table 2.1. The table also shows estimates of the current proportion of domestic production that is protected from import competition due to these license restrictions. The degree to which the different license categories restrict trade (i.e., the height of the NTB) varies significantly, as explained below.

**Table 2.1: DISTRIBUTION OF PRODUCTS INCLUDED IN THE RESTRICTED GOODS LIST, BY LICENSE TYPE AND SECTOR**

Description	<u>Four License Types</u>				Un- Banned	known	Total	NTB Coverage/b (%)
	IP	AT	IT	PI/a				
Food, beverages & tobacco	0	0	5	233	0	55	293	67
Chemicals, rubber & plastic	3	0	13	4	0	45	65	15
Textiles, clothing & leather	18	0	254	2	0	0	274	25
Non-metal products	0	0	4	0	0	1	5	17
Basic metal products	16	0	3	30	0	0	49	23
Engineering and vehicles	65	70	62	0	18	3	218	53
Other manufacturing	3	0	7	0	0	0	11	25
<u>Total</u>	<u>105</u>	<u>70</u>	<u>348</u>	<u>269</u>	<u>18</u>	<u>105</u>	<u>915</u>	

/a Includes those items restricted to Krakatau Steel (KS), BULOG, selected State Trading Companies (STCs), PERTAMINA, and DAHANA.

/b Percent of domestic sales protected from import competition via the Restricted Goods List.

Source: World Bank staff estimates and Ministry of Trade.

2.08 The import ban and the AT and IP license categories are used collectively to encourage the domestic production of mechanical and electrical machinery, particularly vehicles and heavy transport equipment. The 18 banned items cover motor vehicles, trucks, motor cycles, televisions, and radios, all in their Completely Built-up (CBU) form. With few exceptions, these items can only be imported under an AT license (in the CBU form) or, more commonly, under an IP license (as a completely knocked-down kit, CKD). The AT license

category is used exclusively for engineering and transport equipment in its CBU form.<sup>2/</sup> By allowing only a restricted number of foreign suppliers (i.e., selected brand-names) access to the Indonesian market, GOI hopes to encourage these suppliers to make a long-term commitment to provide back-up services, in terms of repair and spare parts. A supplier may also be encouraged to gradually establish a local assembly plant or spare part manufacturing capacity. If a supplier provides such a commitment the AT license is then granted to an agent who will have the sole right to import a particular brand name.<sup>3/</sup> For example, if it is decided that there will be two suppliers of mechanical shovels, a sole agent will be appointed for each brand name. Although this policy may have benefits, in terms of reducing the variability in maintenance and spare part needs, it also has costs associated with the absence of competition. Designated suppliers have access to a highly protected domestic market, allowing them to price their products above world levels. It also limits choice, as the designated AT suppliers may not be able to provide the particular piece of equipment required by the Indonesian user.

2.09 The IP category covers most of the products under the AT license but in their CKD form.<sup>4/</sup> Producers of these items are granted an IP license specifying the total value of the IP items that they can import, including, in some instances, a timetable indicating when they should reach a certain proportion of "local-content". Thus, there is a direct link here between the trade regime and the domestic regulatory framework, particularly the deletion or local-content program. The primary objective is to encourage local assembly of mechanical and electrical machinery, including the use of local components. Although producers are allowed leeway to source the necessary components from the cheapest supplier, the end result is often costly and poor quality machinery, produced behind high protective barriers from foreign competition. The IP license category also includes some textile and steel items.<sup>5/</sup> The primary objective here is to protect the domestic manufacturer of the IP item, while at the same time allowing some downstream users access to imports. This is used particularly for those industries geared to the export market where price and quality considerations are vital. As the IP license holders are allowed to import only the quantity they require (i.e., they are not allowed to sell the imported IP item to other users), the domestic market is still highly protected. Besides taxing domestic consumers,

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- <sup>2/</sup> The most important products are engines, boilers, mechanical excavators/shovels, electric furnaces, locomotives and some types of motor vehicle.
  - <sup>3/</sup> The appointed sole agent (e.g., for Caterpillar) can appoint other sub-agents to sell this brand on the Indonesian market. This is to enable the sole agent to service different parts of Indonesia.
  - <sup>4/</sup> These include CKD engines for tractors/cars, CKD road rollers and road making equipment, CKD electric motors, CKD telephone sets, mechanical spare parts, and pistons.
  - <sup>5/</sup> The textile items are primarily man-made fabrics. The steel items are basic steel products (ignots, billets, slabs, sheet and plate) plus some semi-processed products (selected tubes, pipes and rods).

the current system creates uncertainty for downstream producers due to the administrative discretion involved in determining whether they will be granted an IP license or not.

2.10 The IT license category restricts imports of all IT items to the six State Trading Companies (STCs). For some products, the Ministry of Trade also determines the amount which the STCs can import. There appears to be two objectives underlying the IT license: (i) by restricting imports to STCs, the Ministry of Trade can (via informal quotas) control the quantity imported; and (ii) it provides a steady source of business to the STCs. As shown in Table 2.1, the IT license covers a wide range of products across all sectors. For example, the 254 textile items classified under the IT license category covers all types of batik fabric and clothing. As the STCs have been informed not to import batik products (to protect the local industry), this is an extreme example of how the informal quota system can work. Other products which fall under the IT license category include: agricultural tools (hoes, scythes, rice hullers), some electronic computer equipment, telephone sets, transmitters, navigation sets, electronic recording instruments, salt, bandages, and some fertilizer types. The non transparent way by which the level and allocation of quotas is determined creates opportunities for abuse and could lead to an inefficient distribution. Even where quotas do not exist, the end result is often to increase the domestic price of these items to users, while protecting local producers (where these exist).

2.11 The PI license category is potentially the most restrictive in that it restricts a fairly wide range of products to designated importers, many of whom are domestic producers of the same product. For example, 25 steel products fall under the Krakatau Steel (KS) license, which restricts the right to import these items to the state-owned Krakatau Steel Company. As defined here, PI also includes those items restricted to particular domestic traders, such as BULOG or selected STCs. Table 2.2 provides a more detailed picture of how the 269 PI items are distributed by product and by designated importer. The items restricted to Krakatau Steel/Tambang Timah (KS/TT) and BULOG are the most important, in terms of domestic production and import value. Although many steel products have been deregulated, approximately 23% of this sector's output remains protected by NTBs. These include steel coils, sheets and plates (particularly cold-rolled products) and tin plate which are restricted to Krakatau Steel, and aluminum plates which are restricted to Tambang Timah. Although the situation has improved markedly since the mid-1980s, domestic users of these products still complain of high prices, poor quality and uncertain delivery.

2.12 BULOG holds the import rights for many agricultural commodities, the most important of which are rice, wheat, wheat flour, sugar, soybeans, and soybean meal. These products account for over half the value of Indonesia's food imports. With the exception of rice, the domestic price of these commodities is usually significantly above world prices. This has taxed consumers and reduced the competitiveness of downstream users in the food and beverage industry. In terms of the number of items, the majority of PI items (mostly processed food and beverage products) are restricted to two of the six

**Table 2.2: DISTRIBUTION OF "PI" LICENSE ITEMS BY IMPORTER AND PRODUCT**

Description	TN/KN	KS/TT	BULOG	Other	Total
<b>Food &amp; Beverages</b>	<u>204</u>		<u>18</u>	<u>11</u>	<u>233</u>
Meat, fish and dairy product	28			6	34
Edible vegetables and fruit	46			2	48
Coffee, tea, mates and spices				2	2
Cereals & milled products			11		13
Processed food products	97		7	1	105
Beverages, spirits and vinegar	33				33
<b>Chemicals</b>				<u>4</u>	<u>4</u>
Mineral fuels, oil				2	2
Explosives				2	2
<b>Textiles</b>			<u>2</u>		<u>2</u>
Jute			2		2
<b>Basic metals</b>		<u>30</u>			<u>30</u>
Iron and steel		25			25
Aluminum		5			5
<b>TOTAL</b>	<u>204</u>	<u>30</u>	<u>20</u>	<u>15</u>	<u>269</u>

Note: TN/KN = PT Tjipta Niaga, PT. Karta Niaga (STCs).  
 KS/TT = PT Krakatau Steel, PT. Tambang Timah.  
 BULOG = Badan Urusan Logistik.  
 Other = Including Pertamina, Dahana, Mega Eltra.

Source: World Bank staff estimates and Ministry of Trade.

STCs - i.e., Tjipta Niaga and Karta Niaga (TN/KN). As in the case of the IT license, TN/KN may be allocated a quota by the Ministry of Trade determining the total value of the imported item that will be allowed. In some instances, TN or KN may sell the right to import these items to private companies for a set fee. Finally, the items grouped under "other" cover a mix of products, including oil (restricted to the state oil company, Pertamina), explosives (restricted to the state ammunition company, Dahana), and a range of food and beverage products (restricted to particular domestic trading companies).

2.13 The 105 products listed under the "unknown" category were included in the 1988 Restricted Goods List but have proved difficult to classify under any license type. This may be due to identification problems arising from the recent switch to the Harmonized System (HS) of classifying traded goods or it could reflect the lapsing of certain restrictions. Whatever the reason, the uncertainty concerning the license status of these products illustrates one of the problems associated with allowing trade restrictions to be both imposed and removed in a piece-meal fashion, through a series of degrees. One of the problems of Indonesia's current trade regime is the ambiguity concerning which trade restrictions or tariffs apply. As discussed in subsequent chapters

there is a need to provide a definitive listing of the existing regulatory framework as one component of the overall deregulation effort.

### The Tariff Schedule

2.14 In January 1989, Indonesia converted from the CCCN classification system (about 5,500 tariff positions) to the new Harmonized System (about 9,000 base tariff positions).<sup>6/</sup> In making this conversion, the intention was to leave the basic structure of the tariff schedule unchanged. However, the Government did use the opportunity to reduce the number of tariff positions with specific duties from 498 under the 1988 CCCN schedule to 19 in the 1989 HS schedule. As discussed in Chapter 1 (see para 1.21) this has improved the transparency of the tariff schedule and, in most cases, lowered the effective tariff rate. Unfortunately, the positive effects of this reform have been more than offset by the increased prevalence of "split" tariff positions and surcharges. Although the original HS schedule did not contain any split tariff position, a series of decrees since January 1st, 1989, have reintroduced 592 splits. As a result, the number of effective tariff positions is now 9,662 compared with 9,070 in the original HS schedule (see Table 2.3). In addition, the number of items with surcharges has increased from 180 in mid-1988 to 376 at the present time.<sup>7/</sup> The overall result of these developments has been a slight increase in the average weighted tariff and a more significant increase in the dispersion of tariff rates.

2.15 With reference to the basic ad valorem tariff schedule, there are 12 different ad valorem rates, ranging from 0% to 200% per cent. Most items (99%) are below the official target tariff ceiling of 60%. The most frequent rates are 5%, 30% and 60%, with just over half the tariff positions accorded a tariff rate of less than 20%. There are 19 items to which a specific rate still applies, all of which are certain types of rubber tyres and inner tubes. The estimated ad valorem equivalent rate for these items is between 50% to 360%.<sup>8/</sup> These estimates clearly illustrate that specific rates can provide high and disparate levels of assistance, and that by their nature they do not easily reveal the extent of assistance provided.

2.16 The 376 surchargeable items attract rates that range from 5% to 40%, with the most frequent rates being 30, 20, and 5. About half of the surcharges are set at 30% and almost all surcharges occur within manufacturing (see Table 2.5). The greatest number of surcharges are within the iron and steel and food and beverage industries. The highest average surcharge rates (weighted by production) accrue to tobacco, footwear, beverages, iron and steel and non ferrous metals.

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<sup>6/</sup> This is in response to a GATT-sponsored initiative to convert all member countries to a standard system for classifying traded goods.

<sup>7/</sup> Of these, 130 apply to split tariff positions, 43 to the base tariff positions where splits have occurred, and 203 to base items that have not been split.

<sup>8/</sup> Calculated using first quarter 1989 import data from BPS.

**Table 2.3: THE 1989 INDONESIAN TARIFF SCHEDULE  
AT A GLANCE**

Number of basic tariff items	9070
Number of tariff items with splits	413
Total number of splits	592
Effective number of tariff items	9662
Number of items with surcharges	376
Average tariff plus surcharge (%)	
Unweighted	27
Import weighted	12
Production weighted	19

Source: Customs and Exercise Report, various government decrees and information from SGS.

2.17 The average level of tariff protection which results from the current tariff schedule (including surcharges and specific rates) is shown by sector and broad industry group in Table 2.4. Examining the unassisted value of production estimates shows that particularly high assistance is given to the rubber industry, primarily due to the aforementioned specific rate tariffs on tires. This is followed fairly closely by ceramic products, weaving apparel, footwear, wooden furniture and glass. The next highest levels of assistance occur within the metal products and machinery industries, especially electric machinery. Surcharges cause a significant boost to the levels of assistance received in tobacco, footwear, basic metals, and the food and beverage industry.

2.18 All of the 592 split-tariff positions occur within the manufacturing sector. As shown in Table 2.5 the majority of splits occur in the metal products and machinery industries (40% of the total number) and the basic metal industry (32%). In almost a third of the cases, the base tariff item is split more than once, with some items being split several times (in one case,

**Table 2.4: 1990 HARMONISED TARIFF SCHEDULE, AVERAGE TARIFF PLUS SURCHARGE RATES**

	Unweighted	Import weighted	Production Assisted value	Weighted Unassisted value	Index of Dispersion
<u>Economy-wide</u>	<u>27</u>	<u>12</u>	<u>22</u>	<u>19</u>	<u>92</u>
Agriculture	16	5	12	10	74
Mining	5	2	9	9	80
Manufacturing	28	12	30	25	91
<u>Manufacturing sector</u>					
<u>Food, beverages and tobacco</u>	<u>30</u>	<u>11</u>	<u>28</u>	<u>26</u>	<u>56</u>
Food manufacturing	29	10	15	13	57
Beverages	43	34	40	49	33
Tobacco	50	48	60	60	37
<u>Textiles, leather and footwear</u>	<u>48</u>	<u>30</u>	<u>41</u>	<u>37</u>	<u>43</u>
Textiles	44	30	37	33	44
Wearing apparel	56	57	59	58	19
Leather products	24	6	23	23	88
Footwear	71	31	74	70	31
<u>Wood, cork and products</u>	<u>30</u>	<u>34</u>	<u>38</u>	<u>38</u>	<u>39</u>
Wood and cork	25	24	30	30	31
Wood furniture	47	50	50	50	18
<u>Paper and printing</u>	<u>22</u>	<u>7</u>	<u>21</u>	<u>20</u>	<u>62</u>
Paper products	23	6	27	26	55
Printing and publishing	18	9	5	4	97
<u>Chemicals, petrol and coal</u>	<u>15</u>	<u>6</u>	<u>22</u>	<u>17</u>	<u>140</u>
Industrial chemicals	9	5	7	6	109
Other chemicals	19	9	35	33	96
Petroleum refining	5	0	0	0	53
Petrol and coal products	6	5	5	5	23
Rubber products	41	26	96	87	143
Plastic products nec	35	33	41	41	36
<u>Non-metallic industries</u>	<u>36</u>	<u>9</u>	<u>36</u>	<u>35</u>	<u>64</u>
Ceramic products	52	34	59	59	35
Glass and glass products	37	17	53	53	64
Other non-metal products	29	7	32	32	69
<u>Basic metal products</u>	<u>15</u>	<u>7</u>	<u>12</u>	<u>11</u>	<u>121</u>
Iron and steel basic metal products	17	7	14	13	107
Non-ferrous basic metal products	11	7	8	8	121
<u>Metal products and machinery</u>	<u>23</u>	<u>15</u>	<u>46</u>	<u>36</u>	<u>124</u>
Metal products nec.	26	22	30	26	62
Non-electric machinery	14	11	42	40	94
Electric machinery	23	24	45	43	83
Transport equipment	49	15	55	37	118
Scientific equipment	15	9	19	19	78
<u>Other manufacturing</u>	<u>36</u>	<u>41</u>	<u>44</u>	<u>43</u>	<u>42</u>
<u>Manufactured products</u>					
Consumer goods	44	27	37	31	56
Intermediate goods	16	7	18	16	96
Capital goods	17	12	39	30	135

Source: Bank staff estimates.

12 times). Comparing the distribution of tariff and surcharge rates between the base tariff item and the split tariff item does not reveal any overall pattern. In most cases the tariff applicable to the base tariff item is higher than that applicable to the split tariff item, but this is offset by surcharges which are generally higher on the split tariff item.

**Table 2.5: INCIDENCE OF SURCHARGES AND SPLITS**

	Number of Items with		
	Splits	Surcharges	Splits and Surcharges
<u>Economy-wide</u>	592	376	130
Agriculture	0	6	0
Mining	0	0	0
Manufacturing	592	370	130
<u>Manufacturing Sector</u>			
Food, beverages and tobacco	26	91	18
Textiles, leather and footwear	15	25	2
Wood, cork and products	1	0	0
Paper and printing	31	36	20
Chemicals, petrol and coal	77	64	11
Non-metallic industries	9	2	1
Basic metal products	187	127	77
Metal products and machinery	239	24	1
<u>Other manufacturing</u>	7	1	0

Source: Bank staff estimates.

2.19 It is also important to note that split-tariff positions have been used to keep a particular size or type of product on the Restricted Goods List while deregulating the base tariff item. To take a hypothetical example, the tariff position for steel plate could be split, with steel plate of more than 0.2 mm kept under license (probably because it is domestically produced) while steel plate less than 0.2 mm is deregulated.

2.20 The effects that split-tariff positions have on the protection of local manufacturers are difficult to measure. Separate production and import data are in general unavailable for split items, so their effect on weighted tariffs or NTB coverage is difficult to quantify. For example, it is quite possible that production is concentrated in the split item with the high tariff, meaning that splits have resulted in increased assistance. Splits also create uncertainty for those involved in administering the tariff as well

as those involved in importing split items. For example, there have been a number of instances when the importer and the government agency responsible for certifying imports have had difficulty in classifying a commodity. Thus while splits remain, the degree of assistance provided to industries cannot be fully measured. Finally, they generate a mechanism for providing "made to measure" assistance, while at the same time hiding the nature of the assistance.

2.21 Another important characteristic of Indonesia's import tariff schedule is the large amount of imports (by value) that are exempt from import duty. As shown in Table 2.6, actual import duty collections range from 3% to 5% of total import value, far below the average statutory tariff rate - which is currently 12%. While the average statutory tariff does not reflect those import tariffs that are lower due to bilateral or multilateral agreements (most importantly ASEAN agreements), the shortfall in actual tariff revenue collections is primarily due to exemptions. The major sources of import duty exemptions are: (a) BAPEKSTA - which grants exemptions on imported inputs used by exporters; (b) BKPM - which grants import exemptions on certain imported capital equipment and inputs (for 2 years after completion of project) for approved investments; (c) most of the machinery and spare parts used by contractors in the oil and gas industry; (d) the imported component of foreign aided government projects; and (e) import exemptions for some selected firms. While the import duty exemptions provided by BAPEKSTA for exporters is justified, the other exemption schemes may warrant review. In some cases the exemptions should be removed, while in other cases the Government's objective may be achieved more efficiently through alternative, less distortionary, tax or rebate schemes.

**Table 2.6: ACTUAL IMPORT DUTY REVENUE**  
(1981/82 to 1988/89, Rps. billion)

	1981/82	82/83	83/84	84/85	85/86	86/87	87/88	88/89
Actual Import Duty Revenue	536	522	557	530	607	960	938	1192
Total Imports	12,709	13,906	17,883	16,659	16,114	17,974	23,342	26,567
Average Import Duty (%)	4.2	3.8	3.1	3.2	3.8	5.3	4.0	4.5

Source: Ministry of Finance and Directorate of Customs of Excise.

### C. The Export Regime

2.22 Indonesia's export regime is comprised of two types of policy interventions. First, there are several export policies designed to regulate, in most cases restrict, the export of designated commodities. These are export bans, quotas, taxes, quality controls and approved exporter arrangements. The government's objectives in regulating export trade include: taking advantage of Indonesia's perceived market power; encouraging domestic processing; and responding to externally imposed quotas. Second, there are a number of measures designed to directly assist exporters. The most important of these are the import duty exemption and drawback scheme (BAPEKSTA) and the provision of subsidized short-term export credit. The objectives of these measures are to offset the anti-export bias created by the import regime and to protect exporters from the resulting 'high cost economy'.

2.23 In contrast to the progress made in deregulating import regulations, domestically imposed export regulations have increased. The product coverage of export bans was broadened in 1988 and the prevalence of approved exporter arrangements appears to be spreading. It is estimated that 50% of total non-oil export trade is affected by some form of regulation, with most of these regulations concerning agricultural or forestry products. There has also been a significant increase in export assistance measures. Almost a quarter of total non-oil exports use the BAPEKSTA facility to access part of their imported input needs, and about 60% of non-oil exports benefit from subsidized short-term export credit. As firm-level interviews have confirmed, these export assistance measures have played an important role in increasing the competitiveness of Indonesia's non-oil exports.

#### Export Regulations

2.24 The main policy instruments, products covered and objectives of domestic export regulations are shown in Table 2.7. Most of the domestically imposed export restrictions apply to unprocessed or semiprocessed agricultural and forestry products. In addition, there are three products that are regulated as a result of quotas imposed in importing countries, i.e., textiles, tapioca and, until recently, coffee.

2.25 Export bans. Export bans are used primarily to encourage domestic processing (e.g., logs, rattan, rubber, and scrap metal), and/or to protect scarce resources (e.g., rare animals/plants, live fish, antiques, and forestry products). In many cases, GOI have adopted a sequential approach, taxing a product before banning it, and gradually broadening the ban to cover the product in its more processed form. In the case of rattan, Indonesia moved from supplying over 70% of the world's raw and semi-finished rattan in the mid 1980s, through a ban on raw rattan, to a ban on all raw and semi-finished rattan in 1988. One effect has been a decline in the domestic price of raw and semi finished rattan relative to world prices. This has reduced the revenue to raw rattan growers/collectors (most of whom are lower paid workers in the outer islands) and increased the revenue to rattan product

manufacturers (most of whom are in urban centres). The world price of rattan has also increased, which has benefitted producers of raw rattan in other countries and raised the incentive to smuggle. While the comparatively low cost of rattan in Indonesian has led to increased investment in the production of rattan products, it is not clear that the economy as a whole has benefited. The full economic costs of producing rattan products - including the losses imposed on raw rattan producers - needs to be taken into account in determining the net economic benefit. In addition, the longer term effects of the ban need to be considered. Although Indonesia did supply most of the world's raw rattan, foreign producers of rattan products have now begun to use alternative sources of supply (e.g., from Burma, Vietnam, China) and there has been an upsurge of investment in raw rattan production in other countries (e.g., in Malaysia). The likely consequences of an export ban are discussed further in Box 2.1.

2.26 Export bans are also used to protect Indonesia's scarce natural resources. For example, the ban on log exports has been related to the need to slow the rate of forestry depletion. While the ban did result in an initial decline in log production, the subsequent rapid growth in the domestic plywood industry has reversed this trend. In addition, other environmental problems have resulted from this policy. For example, there have been difficulties ensuring that plywood factories install appropriate water treatment plants to process their waste prior to disposal into the rivers. Moreover, the ban on all log types has resulted in some higher value rare woods being processed into plywood, reducing the returns to the economy. Thus environmental concerns need to be addressed in a more comprehensive manner. In this instance, it is the total domestic production of logs (and other forestry products) which is the issue, and not the production for export.

2.27 Regulated exports. Many of the products in which Indonesia has a significant market share are restricted to 'approved' or 'registered' exporters. In terms of value, it is estimated that 50% of all food exports are regulated under this system. Exports of textiles, some mineral products and petroleum products are also channeled through approved exporters. The two main objectives of the approved exporter system are to coordinate domestic suppliers/traders to enable them to make the best use of Indonesia's market position, and, in the case of externally imposed quotas (i.e., textiles and tapioca), to distribute and monitor quota allocations efficiently. To obtain an approved exporter license requires approval by the Ministry of Trade, and, where applicable, the Ministry also stipulates the export quota allocation. The number of approved exporters for any given commodity is usually limited,<sup>9/</sup> and is often set in close collaboration with the relevant commodity Trade Association. Finally, the Ministry of Trade can also authorize the establishment of a Joint Market Office (JMO) to market certain products. All products produced on state plantations are marketed through JMOs, including coffee, cocoa, rubber, tea, and crude palm oil. JMOs have also been established for nutmeg and cassia vera.

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<sup>9/</sup> For example, there are an estimated 330 approved exporters for coffee, 43 for nutmeg and maze, 38 and 45 for white and black pepper respectively, and 50 for cassia vera.

**Table 2.7: EXPORT RESTRICTIONS**

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**1. EXPORT BANS**

Objectives: Conserve scarce resources, encourage higher value added, increase employment, preservation.

Goods: Low grade rubber, rare live fish, shr'mp fry, iron and steel scrap, logs, raw skins and hides, fancy wood, raw and semi-finished rattan, remilled and smoked rubber, brass and copper scrap, sawn ramin and other boards, green veneer, rare animals/plants, antiques, kapok seed.

**2. REGULATED EXPORTS**

Can only be exported by approved or registered exporters.

Objectives: To respond to an international quota, or to avoid "counter-productive" competition between Indonesian producers.

Goods: Vegetables, nutmeg/mace, coffee, tengkawang seed, cassia vera, textiles, plywood, sawn wood, processed wood, tin, petroleum oil and liquid natural gas, gold, silver, rattan mats.

**3. SUPERVISED EXPORTS**

Can only be exported with approval of Minister of Trade or officials authorized by Minister.

Objectives: to ensure sufficient supply to meet domestic requirements.

Goods: Salt, wheat flour, soyabean, rice, live animals, fertilizer, kapok seed, newsprint, palm oil, palm kernel oil, coconut oil, copra, palm kernel, Bandeng fry of all sizes.

**4. EXPORT TAX**

Exporters must pay export tax (PE) and where applicable an additional export tax (PET). For some commodities the tax is calculated on the basis of a published check price, not actual FOB.

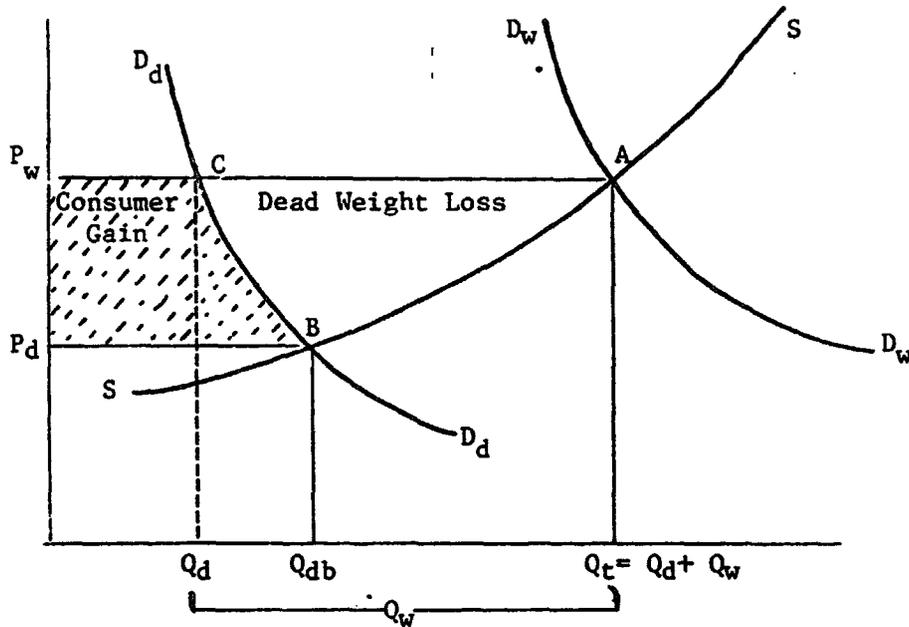
Objective: Tax revenue, low domestic prices.

Goods: Pepper, palm nuts, tengkawang seeds, chinchona bark, metal ores, leather, cork, aluminum waste and scrap, sawn timber.

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Source: Department of Foreign Trade.

Box 2.1: EFFECT OF AN EXPORT BAN



- $D_d$  = Domestic Demand Curve
- $D_w$  = World Demand Curve
- $SS$  = Domestic Supply Curve

Before the imposition of the ban, domestic producers sell at price  $P_w$  and supply quantity  $Q_t$ , where  $Q_t$  is determined by world demand ( $Q_w$ ) plus domestic demand (which is  $Q_d$  at the prevailing world price). After the imposition of the ban, the domestic price drops to  $P_d$  and total output declines to  $Q_{db}$ . As a result, revenue to producers falls from  $Q_t \times P_w$  to  $Q_{db} \times P_d$ . Domestic producers incur a net loss of the area  $P_wABP_d$ . This loss can be divided into two parts: "Consumer Gain" and "Dead Weight Loss". Domestic users or consumers of the banned product gain a transfer of income equal to the area  $P_wCAP_d$ , due to the decline in domestic prices. The remaining part of the loss incurred by producers of the banned product is a 'dead weight loss' for the economy.

1/ If the country imposing the ban supplies a significant part of world demand, foreign producers of the banned item will also gain from higher world prices.

2.28 The actual organization of exports under the approved exporter system varies by commodity. For most of these products the role of the trade association is central. These associations often work with Government to administer the program and to determine who receives or is denied approved exporter status. In those cases where quotas are allocated, e.g., coffee and textiles, the association may also lobby government to direct the allocation of quotas among their members. Once the initial allocation of quotas has been made it may be difficult to change. This has led to a system of 'implicit' quota trading where quota 'deficit' producers buy the required extra quota from holders of 'surplus' quotas. Although the physical handling of the goods is done by the quota deficit exporter, the transaction often occurs in the name of the quota holder. This has created a class of exporters, often referred to as 'briefcase' exporters, who do not actually export their own allocations, but maintain their approval status year after year. For example, it is estimated that almost two thirds of the approved coffee exporters conducted their operations in this way, with less than 100 physical exporters out of over 300 approved exporters. Most coffee exports by the state trading firms are also conducted on a "briefcase" basis. Also many holders of textile quotas have little if any productive capacity, and operate simply by selling quotas.

2.29 In the case of nutmeg and cassia vera, a JMO is responsible for controlling all exports, including those produced by private producers. These JMOs have been created by Government decree as an integral part of the trade association that represents the industry. The nutmeg JMO is primarily a price setting organization, issuing new export prices every month for the different grades of nutmeg. All approved exporters (who are also ASPIN members) are required to export their products at the posted price or face expulsion from ASPIN and the loss of approved exporter status. Recently, ASPIN told its members that they could sell to only one buyer, First Pacific Commodities of Singapore. First Pacific Commodities is part of the Liem Group, and will be responsible for all international marketing of nutmeg. In the case of cassia vera, the JMO determines prices and who can sell to whom. Thus a foreign buyer can only place an order with the JMO, and then the JMO determines which exporter will supply that order. The buyer cannot deal directly with the exporter, nor will he know from order to order which exporter he is dealing with.

2.30 The problems that arise from the current approved exporter arrangements include:

- o The administration and allocation of quotas lacks transparency. This holds for both externally and domestically imposed quotas. The Ministry or trade association responsible for allocating quotas, rarely publishes lists of quota holders and the criteria by which quotas are allocated are not clear. For example, some textile exporters that have fulfilled past orders have inexplicably found their quota allocation for the following year cut back sharply. Administration of the quota allocations can also be slow, which causes some individual firms to miss export opportunities and reduces Indonesia's total non-oil export earnings;

- o The allocation of the resulting quota rent may not be in the industries' or Indonesia's best interests. The existence of a quota necessarily produces a rent and how quotas are allocated determines the distribution of the rent. For products where the trade associations are important, current holders of the quota rights are often closely connected with those that allocate quotas. This creates the danger that the trade associations will restrict entry into the industry or to "approved exporter" status to protect their rents. A more open system of allocating quotas would not only allow new more efficient entrants into the market, but would also clearly identify who receives the quota rent, and whether this distribution meets the Government's objectives; and
- o The current system can result in a level of market power which is detrimental to efficiency and equity considerations. By restricting the right to export to designated approved traders, domestic producers of the restricted item are denied the opportunity to sell to alternative traders or directly to foreign buyers. This can result in lower domestic prices, which is likely to reduce investment incentives and slow improvements in quality and production techniques. While trade associations are common in other countries, these are usually voluntary and not enforced by a government policy stipulating that all exports must be channeled through its members. Aside from creating a non-competitive domestic market it also creates a monopoly supplier on the foreign market, which is against GATT rules.

2.31 Supervised exports. A number of agricultural products and fertilizers can be exported only with the approval of the Ministry of Trade or an appointed agent. The primary objective is to ensure a sufficient supply of these products to the domestic market at reasonable prices. In effect, an informal quota is imposed, which varies in its restrictiveness and how clearly it is defined for different products. For example, rice, wheat, flour and soybean can be exported only by BULOG in consultation with the Ministry of Trade. In practice this has resulted in a negligible exports, with BULOG giving primacy to supplying the domestic market. As imports of these products are also controlled by BULOG, domestic producers are completely isolated from any direct links to world markets.

2.32 In the case of tree crop products (primarily crude coconut and palm oil - CCO and CPO) publicly owned estates market all their output through JMOs, which then allocate the CCO/CPO between the domestic and foreign market. The overall allocation for export (including private sector production) is determined by the Ministry of Agriculture in collaboration with the Ministry of Trade. In the past, the overall export allocation has varied significantly, usually moving in the opposite direction to world prices. All exports are then channeled through a few approved exporters.<sup>10/</sup> The non-transparent way by which these export quotas are determined and allocated,

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<sup>10/</sup> For example, in 1988 although there were 4 approved exporters it was estimated that over 90% of CPO was channeled through one approved exporter.

together with the uncertainty concerning the overall level of the quota, has significantly diminished private sector incentives to invest in CCO/CPO production.

2.33 Export tax. Export taxes are determined by the Ministry of Finance. Currently the export tax (PE) is set at rates between 5% to 30%, and the additional export tax (PET) is set at either 20% or 30%. The combined effect of these taxes is particularly high for leather (50% to 60%) and chincona bark (50%). Specific or lump sum taxes are also levied on some wood products - these vary from US\$3 to US\$2,400 per cubic meter. For a subset of these products, the export tax is based upon an estimated check price rather than the actual FOB price. These check prices are issued by the Director General of Foreign Trade every six months. The objective of export taxes is to ensure an adequate supply of the taxed commodities to domestic users. Check prices are intended to deter exporters from under-invoicing.

2.34 For those products where Indonesia has a negligible share of the world market, (e.g., leather, cork and aluminum waste and scrap) the primary effect of the tax is to provide an indirect subsidy to downstream domestic users at the expense of upstream producers. In the case of leather, there is no evidence to suggest that access to cheap inputs has encouraged the growth of the leather footwear industry. Indeed, the reverse has occurred. That part of the domestic leather footwear industry that is oriented towards selling on the domestic market has stagnated despite access to cheap leather and high import tariffs on its output. By contrast the rest of the shoe industry (i.e., sports and rubber shoes), has shown remarkable growth (over 100% p.a. 1986-1988), using inputs priced at world prices. In this case, the high export tax has reduced incentives to local leather producers to invest in the machinery required to produce the type of high quality leather demanded by shoe manufacturers. In addition to the tax effect, the use of a check price increases the discretionary element of the tax, which further reduces incentives to invest in the taxed activity.

### Export Assistance

2.35 Duty exemption and drawback scheme - BAPEKSTA currently provides two mechanisms by which exporters can access imported inputs free of both import duty/VAT and license restrictions. (i) The Exemption Scheme. To qualify an exporter needs to submit a 12 month production/export plan and, where applicable, documentation of past performance. If the exporter plans to export at least 65% of total output, exemption can be approved for 100% of anticipated import needs. If the applicant plans to export less than 65%, exemption can be granted on a consignment basis linked to specific export orders. Once approved, the exporter provides a bank guarantee or surety bond, equal to the value of duties/taxes payable. The exporter may then import the goods without paying any domestic taxes. When the goods are ready for export they are inspected by a government appointed surveyor and the guarantee/bond is retired. Those firms that have been granted 100% exemption need to submit a "reconciliation report" at year end. Duty/VAT is then paid on that

proportion of output sold on the domestic market.<sup>11/</sup> (ii) The Drawback Scheme. This scheme is intended to assist indirect exporters by allowing the final exporter to obtain a refund of the duty/VAT paid on domestically purchased imported inputs. To qualify, an exporter needs to verify the import content of the purchased goods and obtain a "waiver" from the domestic supplier relinquishing their right to claim an import duty rebate. The goods must be inspected before export and a "Clean Report of Findings" issued. BAPEKSTA will refund 75% of the duties/taxes paid within one month and the remaining 25% once the export has occurred.

2.36 As shown in Chapter 1 (paras 1.22 to 1.23), the exemption facility has worked extremely well. In 1988, approximately 8% of total non-oil imports entered through the scheme, contributing to 24% of total non-oil exports. Major users of the exemption facility are manufacturers of food products, footwear, rubber goods, fabricated metals, electrical machinery, iron and steel products, chemicals and plastics - all of which face either high import tariffs and/or effective non-tariff barriers on some imported inputs.<sup>12/</sup> Interviews with medium and large scale firms confirmed both the effectiveness of the exemption facility and the high regard domestic producers have for BAPEKSTA's efficient administration. However, a recent survey of small-scale export-oriented firms (less than 20 employees), indicates that they benefit less from the exemption facility. The reasons given include: (i) smaller firms often cannot order their imported inputs in a large enough volume to make it attractive for overseas suppliers (e.g., sugar for processed food); (ii) small firms are reluctant to disturb relations with large local suppliers who may supply other inputs that they require; and (iii) some of these firms found the paper work required to submit a request to BAPEKSTA beyond their limited administration capability.

2.37 The duty drawback facility has been less successful. One of the major reasons is that final exporters (the major users of the scheme) find it difficult to document the import content of domestically purchased inputs. Domestic suppliers are sometimes unwilling to provide the 'waiver' which verifies that import duty has been paid, partly because they do not wish to reveal their exact import/duty costs. Also smaller firms find it difficult to persuade large domestic suppliers to provide the necessary documentation. As a result the drawback facility is primarily used by larger exporters with direct links to domestic suppliers.

2.38 Export Credit and Financial Guarantees/Insurance. Short-term export financing has been provided either through pre-shipment export financing or export bill discounting (post-shipment) financing. As discussed in Chapter 2, the rapid growth in non-oil exports and the low cost of export loans relative to commercial rates led to a growth rate of 32.5% per annum in outstanding export credits between 1982 and 1988. The interest-rate differential with commercial money rates narrowed significantly (to a range of 6% to 9%) in May

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<sup>11/</sup> Except for machinery. If any of the incremental output from an imported machine is exported, then all taxes on that machine can be waived.

<sup>12/</sup> The estimated average tariff for major items imported through the exemption facility was approximately 33%.

1989, following GOI's increase in the administered rates on export loans. The May 1989 reform also lowered the proportion of bank loan eligible for rediscount from 70% to 40% for primary goods and from 50% to 37% for non-primary goods. Since the maximum validity of the promissory note is five months, banks can obtain funding from Bank Indonesia for a period of up to 150 days only. If the exporter is unable to realize the value specified in the promissory note, banks are required to reduce the export loan ceiling for the next turnover period in the same proportion as the export shortfall. The exporter can either repay the difference to the bank or renew the same at commercial interest rates. The May 1989 changes partly reflect GOI's concern about misuse and diversion of export loans for purposes other than exports.

2.39 In the Indonesian scheme an exporter can withdraw amounts up to the loan ceiling approved by the bank, i.e., the exporter handles the funds himself. In a typical export financing scheme, banks disburse funds on behalf of the exporter in accordance with actual payment needs. In other words, the actual payment for the purchase of imported and domestic inputs takes the form of the handling bank making payments directly to the foreign and domestic supplier of inputs on behalf of the exporter. Only loans for the value added components are made directly to the exporter, normally after opening of import and domestic L/Cs. The loan is liquidated out of the export proceeds as soon as received from the foreign buyer. These transaction-based disbursement and self-liquidating loan mechanisms minimize the risk of an exporter's deliberate default and misuse or of default stemming from exporters' non-performance. The condition that the exporter use a certain minimum of own resources further reduces exporter's non-performance risk due to mismanagement. The risk covered by PEFG is much smaller and can be administered effectively with reasonable and appropriate premiums. The scheme also encourages banks to lend to small and new exporters, especially since banks are allowed an appropriate margin for their export activities and extend loans at competitive interest rates.

2.40 The most common reason for loan defaults or market failures are adverse selection -- the difficulty in banks' determining sound projects -- and moral hazards --- the inability of banks' to assess which borrowers operate in good faith. These issues prompt banks to require physical collateral. In the typical trade financing scheme, these issues are resolved through PEFG and ECI/G. Since disbursements are transaction-based and loans are self-liquidating, the adverse selection and moral hazard issues related to pre-shipment loans are substantially reduced since only the value-added loan component carries this risk. Part of the non-performance risk is covered by collateral created by import L/C and domestic L/C and the self-financing requirement. The task of a PEFG agency is to provide a substitute for collateral to cover the remaining risk.

2.41 The Indonesian system of export financing is based in a large measure on banks' extending revolving working capital loans to firms who have confirmed export orders or plans for the production or accumulation of goods for exports.<sup>13/</sup> The enterprises control the use of funds after loan limits have been approved by the handling banks. This system is subject to potential

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<sup>13/</sup> Plan-based loans constitute over three-fourths of total outstanding export loans.

misuse. The system also does not create sufficient collateral for the lending banks. The large differential in interest rates on commercial loans and export loans also encourages misuse of the export loan whereby funds are employed by the borrower for purposes other than exports. There is also no basis for checking whether the borrower has met the 15% self-financing requirement. The system not only is subject to potential misuse but the rationing of credit restricts its use to large direct exporters and is also more risky. The impact of preferential interest rates on export growth has been insignificant even where this has been used extensively. Instead, the emphasis should be on resolving the "access" issue, especially for small and medium-sized firms and indirect exporters, rather than on the provision of subsidies.

2.42 Viewed from the perspective of the lending banks, export loans rediscounted at Bank Indonesia appear to offer a cheap source of liquidity. Until May 2, 1989 between 50% and 70% of the loan has been rediscountable to Bank Indonesia at 3% and banks have held Bank Indonesia credit to maturity (180 days) while export loans extended had a much shorter maturity. Nevertheless, banks do not consider export loans to be very profitable business as the gross margin between effective lending and funding rates for export financing is much lower than the gross spread on other commercial lending. This has tended to discourage banks from extending export financing to small and new exporters. In addition, PT. ASEI has indemnified losses averaging only about one-third of the claims filed by PEFG users. The low credibility of the PEFG scheme implies that it has not achieved its main objective of providing a substitute for collateral to assure access to export financing for all exporters. Banks in Indonesia do reject loan requests from potential exporters even if they have firm export orders. At the same time they do not guarantee all export loans with PT. ASEI given their difficulties with resolution of claims. This tends to undermine the risk-pooling function of PEFG as well as GOI attempt to prevent pre-rejection by banks which is the main reason for the automatic and compulsory nature of PEFG.

2.43 Pre-shipment Export Finance Guarantee (PEFG). The PEFG cover is obligatory for all exporters who obtain officially supported export loans from the commercial banks. The PEFG guarantee fee is shared equally by the handling bank and Bank Indonesia, with Bank Indonesia rebating its share to the bank after the bank pays the full amount. The guarantee is automatic and PT. ASEI does not review the credit decisions of the handling banks. The amount of indemnification is fixed at 85% of the loss sustained as long as the loss constituting the basis for indemnification does not exceed the credit ceiling. Bank Indonesia assumes risk for one half of the 15% of the loss not covered by the PT. ASEI guarantee, while the other half is borne by the lending bank.

2.44 Between 1982 and July 1989, 174 claims were filed, of which 107 were completely rejected and 49 were still in process. Compared to earlier years, PT. ASEI's responsiveness to claims has shown considerable improvement. In 1986, PT. ASEI paid claims equal to only 5% of total claims filed and in-process, and had a backlog of claims in-process equivalent to Rp. 25.6 billion. In 1988, PT. ASEI paid claims equal to 41% of outstanding claims and

had worked the backlog of claims down to Rp. 16.4 billion. In the first seven months of 1989, claims paid equalled only 20% of outstanding claims and the backlog increased to Rp. 18.7 billion.

2.45 PEFG claims paid by PT. ASEI since inception have averaged 22% of premium income and 34% of claims filed. This does not take into account the Rp. 62 billion in claims filed by the banks but denied in whole or part by PT. ASEI. If PT. ASEI had paid all these claims, total claims would have equalled 64% of premium income or 62% if recoveries are taken into account. If claims in-process were also included, claims paid would equal 76% of premium income. This represents a dramatically different situation compared to 1986-87, when the ratio was in excess of 100%.

2.46 PEFG claim resolution, including the amount of documentation required, the claim scoring system, and the time required to settle claims, is considered a major problem by banks. Even more damaging is the frequent denial of claims and the practice of paying only part of a claim. The claim scoring criteria and the basis for using these criteria are not well known to the banks. Some of the criteria used, such as evaluating the banks' access to collateral outside the stocks and receivables related to the export loan, are seen by banks as contrary to the rules for granting export financing. The claim scoring system includes an evaluation of : the initial conditions for granting of loan by the bank; action taken by the bank to control the loan, such as periodic inspections and credit reviews; exporters' actions that show the intent to pay; and, possibility of recovery. To the extent a full score is not obtained on any area, the amount of claim paid is reduced accordingly.

2.47 As mentioned above the existing system of export financing imposes a substantial amount of risk on PT. ASEI. This is borne out by an analysis of the 194 claims filed on PT. ASEI during 1986-88. About 20% of the claims in value (54 claims in number) were clearly related to loan misuse and abuse by borrowers (diversion of funds, false information and fraudulent export plans, borrowing from more than one bank for the same transaction, etc.), who obtained export financing on the basis of production plans and controlled the use of funds rather than having banks' make the payments to the suppliers on their account. The failure rate due to unintentional mismanagement (i.e., exporters non-performance) is also probably higher for loans made and disbursed on the basis of export ' plans' since buyer has not yet been identified at the time of export loan compared to a firm that already has a confirmed export order or irrevocable bank L/C. Out of the 194 claims on PT. ASEI analyzed, 166 claims (93% of claims in value) were related to the so called revolving loans granted on the basis of production plans. Such loans accounted for 75% of all export loans in the sample. The remaining 7% of claims in value were related to the 25% of total export loans made on the basis of export L/C or other firm export order. The risk of exporters non-performance has been more than three times higher for plan-based loans than for L/C-based loans.

2.48 The Export Credit Insurance/Guarantee Scheme. The ECI/G scheme supports about one-half percent of Indonesia's total non-oil/LNG exports. The number of policies is very small in comparison to the number of firms in

export activities, and virtually all policies have only one buyer in one country. The limited coverage contributes to a portfolio that does not provide PT. ASEI with a reasonable spread of risk between risky and less risky buyers and markets, and exposes it to potentially large losses relative to premium income. Most of Indonesia's non-oil/LNG exports are traded on sight L/C terms which results in the low volume of ECI/G business and non-L/C type payment terms. The requirement that banks can access liquidity credits for non-L/C export transactions only if ECI/G has been obtained for the transaction or the foreign buyer has already paid, encourages sales on sight L/C terms and discourages exporters and banks from supporting sales on usance L/C or less secured credit terms.

2.49 While the ECI/G program has not been aggressively marketed and is little known by the exporting community, risk-aversion on the part of both PT. ASEI, which frequently reduces the amount of cover requested, and the exporter, who is not interested in diversifying the markets, may have also contributed to the lack of growth in the ECI/G program. Since non-L/C payment methods are considered more risky, the low indemnification under PEFG may also have caused potential users of ECI/G to not insure because of doubts regarding PT. ASEI fully covering losses under insurance coverage. Other problems of the ECI/G program are the excessive complexity of policy forms (running to dozens of pages) and the lack of experienced, trained staff to underwrite. If ECI/G activities are to expand and new policies and procedures developed, PT. ASEI will have to find ways to increase skill levels of its staff through training.

#### D. The Current Pattern of Incentives

2.50 The range of trade policy instruments outlined in this chapter and the complex price effects which these instruments produce, make it difficult to capture the overall incentive effects that the trade regime has in one simple measure. This is particularly the case where NTBs on imports or the regulations on exports are implemented via non-transparent mechanisms and the height of the trade barrier varies significantly between products and over time. One approach to this problem that has been usefully employed in a number of countries, is to analyze the pattern of both nominal and effective rates of protection. Nominal rates of protection (NRPs) measure the difference between the observed domestic price of a product and the prevailing world price (adjusted for quality differences and transport costs to a common point of sale). NRPs provide a useful measure of the tax imposed on domestic consumers (i.e., the difference between world and domestic prices) and a partial picture of resource pulls. One major drawback with NRPs, however, is that they do not take account of the protection on the inputs needed to make the product. To address this problem it is common to use effective rates of protection, which measure the protection to net value added in an activity, i.e., taking into account the taxes and subsidies imposed on both inputs and outputs. ERPs provide a more complete assessment of the degree to which resources are attracted towards a particular activity. The ERP's presented

here attempt to capture the aggregate effect of trade and commercial policies including NTB's, import tariffs, export taxes and subsidies.<sup>14/</sup>

2.51 Estimates of NRPs and ERPs for 1988 together with the sectoral coverage of NTBs in 1989 are presented in Table 2.8. They show that the net effect of trade and commercial policies is a heavy tax on trade. The overall anti-trade or anti-export bias of these policies is clearly shown by comparing the aggregate ERP for all import-competing goods (44%) against that for all exporting-competing goods (-2%). This bias in favor of import-competing activities also applies for comparisons between sectors and for broad industrial groups. Thus, manufacturing is highly protected relative to mining and quarrying, and agriculture is less highly protected than manufacturing. A recent partial update of these NRP and ERP estimates shows that while there has been a marginal decline in the aggregate level of protection, the same overall pattern of incentives still holds.<sup>15/</sup>

2.52 The bias against export-competing sectors is also a feature of each broad industrial grouping. In primary industries (agriculture, forestry and mining), export-competing activities - such as logging, rattan, rubber, coffee and vegetable oils - have low ERPs and are subject to bans, quotas and taxes; whereas import-competing sectors - such as milk, soybeans and sugar have high ERPs and receive direct or indirect subsidies. In the manufacturing sector, the pattern is more complex but the same overall bias exists. High protection

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<sup>14/</sup> Two important caveats to the data should be noted. First, many of the price comparisons that were used in estimating ERPs were done in 1987/88. Where NTBs have been subsequently removed the price comparison has been replaced by the world or a relevant nominal tariff. To the extent that domestic prices below the prevailing nominal ERPs overestimate the level of protection. Second, the effects of BAPEKSTA are not directly taken into account. To the extent that BAPEKSTA lowers the cost of imported inputs, its effect will be to raise the ERPs of many export-competing activities (e.g., wood and paper products, textiles, footwear, etc.). On the other hand, domestic sales by export-competing firms may also have exerted downward pressure on the domestic price of some finished products, which would lower the estimated ERPs. Both of these caveats can only be satisfactorily dealt with by establishing an institutional capacity within Indonesia which undertakes price comparisons on a regular basis. The sketchy information on current price comparisons that we have obtained indicates that the broad pattern of incentives discussed here is generally accurate.

<sup>15/</sup> "Updated Estimates of Nominal and Effective Rates of Protection", by P. Wymenga, Ministry of Industry, Technical Note 15. This study has updated the Bank's earlier work by revising the production and export weights, and by using a more up-to-date version of the nominal tariff structure. A full update is planned, once an ongoing exercise to collect current price comparison is completed.

**Table 2.8: THE PATTERN OF INCENTIVES IN 1988**

	NTB Coverage <u>/a</u>	Nominal Rate of Protection <u>/b</u>	Effective Rate of Protection <u>/b</u>
<u>Agriculture</u>	<u>40.9</u>	<u>12.6</u>	<u>20.7</u>
Food crops	65.9	13.9	24.6
Estate crops	28.2	3.9	11.3
Livestock	8.0	22.9	35.2
Forestry	0.0	-4.9	-6.8
Hunting and fishing	14.9	22.3	27.6
<u>Mining and Oil</u>	<u>0.2</u>	<u>0.1</u>	<u>-0.8</u>
Mining and quarrying	0.0	2.4	0.7
Oil refining and LNG	0.4	0.0	-0.9
<u>Manufacturing</u>	<u>44.5</u>	<u>19.8</u>	<u>73.3</u>
Food, beverages and tobacco	67.4	21.3	149.5
Textiles, clothing and footwear	25.2	25.0	79.1
Wood products	0.0	-1.4	-2.9
Paper products	47.6	13.3	16.8
Chemical products	14.6	13.0	39.6
Non-metallic manufactured goods	16.7	17.5	63.3
Basic metals	23.5	5.6	8.3
Engineering products	53.3	39.6	148.0
Other manufactured products	24.9	28.9	86.1
<u>Total Economy (Ex-Oil &amp; Gas)</u>	<u>28.9</u>	<u>16.2</u>	<u>31.1</u>
<u>Memo Item</u>			
Average for importables	-	20.7	43.7
Average for exportables	-	-1.0	-1.9

/a NTB coverage estimated as percent of domestic value added (at unassisted prices) protected from import competition via the Restricted Goods List.

/b Background paper, "An Update of the Effective Rate of Protection Study" by G. Fane.

is afforded import-substitution activities - such as mechanical and electrical machinery, motor vehicles/cycles, tyres and processed food and beverages - whereas low protection is afforded export-competing industries - such as some wood products, paper and a range of other manufactured goods. However, there are important exceptions to this overall trend as illustrated by the low ERP for basic iron and steel and the high ERP for textiles and footwear.

2.53 The complexity of the pattern of incentives within manufacturing reflects GOI's efforts to stimulate non-oil exports at the same time as continuing to protect existing import substitution activities. This dichotomy is clearly illustrated in the textiles and footwear industries which have recently switched to primarily export-competing activities and yet receive high levels of protection on the domestic market. This reflects the dual structure of incentives where exporters are protected from the 'high-cost' local economy by export assistance measures (primary through BAPEKSTA and BKPM), while producers for the domestic market continue to receive high tariff and/or NTB protection. Also some export industries receive input subsidies (primarily in the form of export bans, quotas and taxes on upstream inputs) which raises their ERPs - particularly on domestic sales (e.g., rattan or wooden furniture).

2.54 The strong connection between the share of domestic production protected by NTBs and relative ERPs is also shown in Table 2.8. In manufacturing, four of the five most highly protected activities in terms of NTB coverage also rank highest in terms of ERPs (i.e., food and beverages, engineering products, textiles and other manufactured goods). In agriculture, the link is less strong. This primarily reflects the importance of rice in the agricultural sector, and the fact that although rice is under an NTB this has not resulted in domestic prices varying widely from international prices. The large weight of rice in agricultural value added is reflected in the high aggregate NTB coverage ratio for food crops, while the parity with world prices reduces the aggregate ERP estimate. More disaggregated estimates show that this is not the case for other food crops. For example, soybean and sugar have the highest ERP's within the food crop sector (about 100%), and both are under NTB protection. Also for those goods which have a high import tariff rate, the ERP is likely to be high even where the NTB coverage is low. This is most clearly illustrated for non metallic and other manufactured goods, both of which have low NTB coverage ratios but relatively high ERPs due to high import tariffs.

2.55 Finally, one other characteristic of the current pattern of incentives that is not captured in Table 2.8, is the wide variance of protection within both the manufacturing and agricultural sector. This is also a feature at a more disaggregated level for particular industries. Thus, even though the average ERP for basic iron and steel products is relatively low, this industry has one of the highest rate of dispersion.<sup>16/</sup> In this case the high dispersion reflects the effect of NTBs on selected products (which have a relatively small production weight) and the use of surcharges/split-tariff positions. Thus, while there is a general move towards deregulation, in some instances this has been accompanied by more precise targeting of assistance to specific domestic producers within an activity. This wide range of protection will slow the process of restructuring within an industry as resources will not be encouraged to move out of less efficient activities.

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<sup>16/</sup> The index of dispersion for the iron and steel industry is 120, compared with an average of 42 for the whole manufacturing sector.

CHAPTER 3

EFFECTS OF THE TRADE REGIME ON SELECTED MANUFACTURE ACTIVITIES

A. Introduction

3.01 In the proceeding chapter the trade regime is discussed in terms of how individual policy instruments effect a range of economic activities. This chapter takes an industry approach, analyzing how particular industries are effected by the range of trade policy instruments. Four industries are analyzed: Steel, Paper, Textiles and Footwear. These industries have been selected to represent the spectrum of manufacturing activities in terms of their trade orientation.<sup>1/</sup> A stylized picture of the different trade orientation of these industries, determined primarily by the most important source of demand growth since the early-1980s and an analysis of the prevailing trade regime, is shown below. This classification should not be interpreted too literally as it is only intended to capture the broad trade orientation of each industry. For example, some parts of the steel industry have become export oriented, just as some parts of the footwear industry are geared towards satisfying domestic demand. Other industries are in a period of transition, where the primary source of demand growth has switched, or is in the process of switching, from the domestic to the export market - i.e., paper, and, in particular, textiles. Thus, the trade orientation of an industry will alter in response to changes in the incentive regime and developments in the domestic economy.

<u>Trade orientation</u>	<u>Industry</u>
Inward-oriented	Steel
↕	Paper
↕	Textiles
Outward-oriented	Footwear

3.02 All of the selected industries have maintained positive growth rates since the early 1980s, ranging from a high 43.1% p.a. for the paper industry to 11.1% for the footwear industry (1983-88). All of the industries have grown more rapidly in the second adjustment period (1986-88) than in the first adjustment period (1983-86), with the increase in the rate of growth in value added being highest in the more outward-oriented industries: paper, textiles, and footwear. As these industries are more labor intensive than the inward-oriented industries there has been a corresponding acceleration in the rate of growth in employment. There is also some evidence of a move towards

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<sup>1/</sup> It is important to stress that these industries have not been selected because they are any "better" or "worse" than any other industries in the manufacturing sector. The intention is purely to capture a representative of inward and outward oriented activities.

more labor intensive products within industries - particularly in textiles. Most of the increase in growth since 1985, has derived from the rapid growth in exports. While textile exports remain by far the most important in terms of value, each of the other industries attained higher export growth rates in the second adjustment period, albeit from a relatively small base.<sup>2/</sup> Even those industries that are classified as being inward-oriented (e.g., steel, and to a lesser extent paper), demonstrated that there are certain products within these industries which can compete on the international market. Finally, in three out of four of the industries which experienced positive growth (i.e., textiles, paper and steel) exports also increased.

3.03 The major trade policy issues that arise from these industry studies differ according to the trade orientation of the industry. For those industries, or parts of an industry, that are primarily geared towards import-substitution, the most important trade policy issues are: the remaining incidence of NTBs, high tariff protection on 'upstream' inputs, and the increased use of split-tariff positions and surcharges. While the sequential approach to trade reform has suited the Indonesian context, it has allowed some manufacturing activities to maintain their highly protected status. Some non-competitive activities remain under NTBs (e.g., cold rolled steel products) or have been partially deregulated (e.g., moved to the less restrictive IP license) but accorded high import tariffs. In these cases tariff positions have often been split to target the remaining NTBs or surcharges to particular products or producers. This has resulted in a fragmentation of the trade regime and a loss in transparency. It has also significantly increased the dispersion of protection within an industry and reduced competitive pressures to restructure. Downstream users of these commodities that produce for the domestic market, such as galvanized steel sheet producers or tin can users, are particularly disadvantaged as they cannot use the BAPEKSTA facility to obtain imported inputs.

3.04 Broadening the reform program to encompass those activities that rely primarily on supplying a highly protected domestic market will be difficult - particularly where there is considerable existing capital stock. Nevertheless, the hidden costs of not tackling these anomalies are high in terms of both slowing the further efficient development of the manufacturing sector and reducing the tax on Indonesian consumers. In addition, there are strong indications that import-substitution industries do have the capacity to restructure when faced with increased competition. The recent expansion in steel exports and reports from downstream steel users of a more 'businesslike' attitude from large domestic steel suppliers support this hypothesis. Where restructuring is not possible, alternative steps will need to be taken to deal with the financial implications of further trade reform.

3.05 For those industries that are outward-oriented the most important trade policy issues are: high tariffs (and a few NTBs) on their imported inputs and the dependence on BAPEKSTA that this creates, the increasing use of

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<sup>2/</sup> Between 1986-88 footwear exports increased 246% p.a., paper 104% p.a., and steel 82% p.a.

export bans and taxes on upstream unprocessed domestic inputs, and continued high import tariffs on their outputs. Some of Indonesia's fastest growing export industries receive levels of protection on their domestic sales well above the manufacturing sector average. This reflects the continued prevalence of relatively high import tariffs (and in some cases NTBs) on imported inputs and, as a consequence, even higher tariffs on outputs. In some instances, these high levels of effective protection also reflect export bans and taxes on upstream domestic inputs (e.g., leather for footwear or rattan for furniture). Medium to large-scale exporters have been able to circumvent tariffs and NTBs on imported inputs by using the BAPEKSTA facility. Firm level interviews confirm BAPEKSTAs administrative efficiency and how important the scheme is for reducing import costs and increasing the pressure on domestic suppliers to become more competitive. Nevertheless, BAPEKSTA has been less successful in assisting small-scale and indirect exporters, and it cannot assist producers for the domestic market. In addition, high tariffs on the output of some export industries (e.g., textiles and footwear) has reduced the competitive pressure on high cost producers for the local market.<sup>3/</sup> This has penalized the Indonesian consumer who cannot buy goods at the export price.

3.06 If non-oil exports are to double in the next five years, as projected in Repelita V, the trade reform program needs to take a more direct approach to reducing import trade barriers. The removal of all remaining NTBs on imported inputs into export activities and a general lowering of tariffs would reduce the pressure currently being put on BAPEKSTA. Such a move would also assist small-scale and indirect exporters and begin to share the benefits of Indonesia's increased competitiveness with domestic consumers. Finally, the use of export barriers to lower the cost of domestic inputs needs to be reviewed. If downstream users of domestic raw materials (e.g., furniture makers) cannot compete on world markets with inputs purchased at world prices, there is a question concerning whether this is an efficient use of Indonesia's resources. Even if one takes the view that these downstream users will become competitive overtime, this would support a low export tax and not, as is currently happening, the imposition of bans and extremely high export taxes.<sup>4/</sup> In addition, full account needs to be taken of the income loss for primary goods producers and the damaging medium-term effects on efficiency enhancing investments in the taxed activity (e.g., raw leather production).

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<sup>3/</sup> Exporters must pay the import duty on that part of their imported material inputs that are sold on the domestic market.

<sup>4/</sup> For example, an export tax of US\$250 to US\$2,400 per m/ton was imposed on sawn timber exports in October 1989. This has resulted in many sawn timber mills facing severe financial difficulties because of their inability to export profitably at these tax rates.

## B. TEXTILES

3.07 The textiles industry is Indonesia's most important export-oriented manufacturing activity. According to the 1986 Economic Census, textiles accounts for 12.3% of non-oil manufacturing value added, and almost a fifth of Indonesia's factory labor force. Along with footwear, the textiles industry is often considered the "litmus-test" of the country's export promotion strategy - success in textiles is seen as an important step in attracting other 'footloose' manufacturing activities.

3.08 Textiles actually comprises of three distinct sub-industries; spinning/fibres, weaving/fabrics; and garments. These sub-industries differ in a number of respects including their capital intensity (high in spinning/fibres, through to low in garments), export orientation (low in spinning/fibres, through to high in garments), and ownership (significant foreign ownership in spinning/fibres to high domestic ownership in garments). Internationally, the industry is distinctive for the high regulation in importing nations, principally North America and the European Community. This regulation occurs under the auspices of the Multi-Fiber Arrangement (MFA), which has been described as, "the most trade-restraining international agreement for manufactured products in existence."<sup>5/</sup>

### Recent Performance

3.09 Indonesia's textile industry has performed strongly, with value added increasing by an average 16% p.a., and employment by 9% p.a. over the period 1975 to 1988. Growth was particularly rapid after 1985. The growth in value added increased from an average 15.7% p.a. in the import substitution phase of 1980-85 to 24.2% in the more outward-oriented phase of 1985-88, with the growth in employment increasing from 5.3% p.a. to a strong 15.7% p.a. Although the expansion in employment has always been lower than output, due to the adoption of more capital intensive technologies and the shift to higher value products, there has been a shift towards more labor intensive activities in the period since 1985. This reflects the rapid growth of the garments sub-industry which employs more labor per unit of output than the industry average and a shift to more labor intensive products within each sub-industry (see Table 3.1).

3.10 All three sub-industries have grown rapidly since 1975, at annual rates of 22%, 12% and 39% for spinning, weaving and garments respectively. In spinning and garments, the high growth rates shown in the first sub-period (1975-80) in Table 3.1, reflect the initial small base and the "easy" import

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<sup>5/</sup> William R. Cline, "The Future of World Trade in Textiles and Apparel", Institute for International Economics, Washington, 1987.

**Table 3.1: OUTPUT AND EMPLOYMENT IN THE TEXTILE SECTOR  
1975-88**

	<u>Spinning/Fibre</u>		<u>Weaving/Fabric</u>		<u>Garments</u>		<u>Total</u>	
	Value Added	Employment	Value Added	Employment	Value Added	Employment	Value Added	Employment
	----- Growth p.a. -----							
1975-80	29.6	16.9	4.8	2.1	52.9	39.5	12.4	6.6
1980-87	14.7	4.5	13.8	1.5	28.9	17.9	15.7	5.3
1985-88	23.9	14.2	21.6	12.7	32.1	22.2	24.2	15.7
1975-88	22.4	11.3	11.8	4.2	38.5	26.8	16.3	9.2
	----- Shares -----							
1975	15.9	9.1	82.0	86.7	2.1	4.2	100	100
1980	14.9	14.4	72.2	69.7	9.5	15.9	100	100
1985	31.2	13.9	52.1	58.1	16.7	28.0	100	100
1988	31.0	13.4	49.0	53.7	20.0	33.0	100	100

Source: BPS and staff estimates.

substitution period of development.<sup>6/</sup> In the second more inward-oriented sub-period (1980-85) the faster growth in weaving more than offset slower growth in both spinning and garments. However, as the growth in weaving was accompanied by a shift in the commercial sector from hand-loom to power-loom, the rate of growth in employment declined during the import-substitution phase. In the third more outward-oriented sub-period (1985-88) the rate of growth of output and employment in all three sub-industries accelerated, primarily due to the expansion in exports. Growth was particularly strong in garments.

3.11 The major transformation in the industry has been the recent boom in exports (see Table 3.2). Exports first began to increase in the late 1970s, following the November 1978 devaluation. But the benefits of devaluation were quickly eroded by the appreciation of the real exchange rate resulting from the second oil price increase. More sustained growth occurred after 1982, in response to the April 1983 devaluation and implementation of the Government's

<sup>6/</sup> The lower growth of weaving in 1975-80 reflected the completion of much of the import-substitution possibilities prior to 1975. The slow

**Table 3.2: EXPORT PERFORMANCE OF TEXTILES SECTOR 1975-88**

	<u>Current Prices (US\$ Million)</u>				<u>Real Growth Rate</u>		
	1975	1980	1985	1988	1975-80	1980-85	1985-89
Spinning/Fibre	neg.	3.1	12.6	119.6	-	28.4	107.9
Weaving/Fabric	2.0	42.7	227.1	571.1	73.8	35.9	33.4
Garments	2.4	98.3	339.2	796.7	98.0	24.6	30.4
Total	4.4	144.1	578.9	1,487.4	89.4	28.5	34.3

Source: BPS and staff estimates.

Sertifikat Ekspor (Export Certificate) scheme. The growth of exports accelerated again (from a much larger base) after 1986 following a further devaluation in September, and the implementation of trade reform measures designed to increase producers access to imported inputs at world prices. Export growth rates in excess of 30% p.a. have been attained in all sub-industries since 1985, although the spinning export base was very small. The relative export magnitudes reflect the factor endowments in the three sectors, with garment exports some 50% greater than those of fabric and about 900% greater than fibre exports.

3.12 The import data (Table 3.3) reflects the interplay of economy-wide and policy factors. During the initial period (1975-80), imports of fibre and fabric increased moderately, but garments declined primarily as a result of the growth of the domestic industry behind high import tariffs. In the second period (1980-85), lower overall economic growth, coupled with the imposition

**Table 3.3: IMPORT PERFORMANCE OF TEXTILES SECTOR 1975-88**

	<u>Current Prices (US\$ Million)</u>				<u>Real Growth Rate (% p.a.)</u>		
	1975	1980	1985	1988	1975-80	1980-85	1985-89
Spinning/Fibre	120.5	186.1	102.5	201.4	3.0	-13.7	22.8
Weaving/Fabric	66.1	126.2	74.7	168.8	7.5	-12.4	28.7
Garments	4.8	3.1	3.8	6.5	-45.5	1.1	17.5
Total	191.4	315.4	181.0	376.7	4.4	-12.9	25.2

Source: BPS and staff estimates.

of NTBs led to an average 13% p.a. decline in total textile imports. The decline was particularly marked in the upstream fibre and fabric sub-industries where most of the NTBs were focussed and large domestic weaving capacity came on-stream. In the period since 1985, imports in all three sub-industries have grown strongly. This reflects the strong growth in garment exports and the change in trade policy - particularly the introduction of the duty exemption and drawback scheme (BAPEKSTA).

3.13 That export growth has had a dramatic effect on the textiles sector is evident from the decomposition of sources of demand growth provided in Table 3.4. Indeed the data understate the importance of exports, as much of the growth in domestic demand since 1985 has reflected the expansion in fibre and fabric capacity designed to supply inputs to garment exporters. Table 3.4 also shows the period of import-substitution (1980-85) when many of the more capital intensive upstream fabric and fibre plants were commissioned. Since 1985, import-substitution has been a "negative" source of growth, implying that the total growth in export and domestic demand outstripped domestic capacity. The simultaneous growth in domestic output and imports has been facilitated by the deregulation of import controls and the expanded use of BAPEKSTA. Garment exporters have increasingly used imported cloth both as a means of establishing product reputation in international markets and in response to the specific requirements of global brand-name garment outlets which begun sourcing from Indonesia during this period.<sup>7/</sup>

**Table 3.4: SOURCES OF GROWTH IN TEXTILES SECTOR:  
PRODUCTION, TRADE AND CONSUMPTION**

	Export	Import Substitution	Domestic Demand	Exports as % of Total Domestic Production <u>/a</u>
1975-80	17.1	-7.5	90.4	0.6
1980-85	70.4	30.8	-1.2	7.9
1985-88	62.2	-13.2	51.0	21.6
1975-88	49.2	-2.2	53.0	35.0

/a Period average.

Source: BPS and staff estimates.

<sup>7/</sup> Some garment exporters expressed the view that they use foreign imports for a portion of their fabric to forestall any pressure from domestic fabric producers to dilute BAPEKSTAs current liberal provisions. These exporters fear that fabric producers may invoke the "domestic content" arrangement to persuade the Government to tighten trade restrictions on the grounds of demonstrated local competitiveness. This would, they argue, greatly reduce the pressure on domestic fabric producers to remain price/quality competitive.

3.14 Indonesia's major export market is the OECD bloc and, to a lesser, extent other Asian NICs. For garments, the United States is the dominant market, absorbing over 40% of the five largest garment items. The second market is the UK or West Germany depending on the product. Indonesian exports to the EC have been considerably smaller than those to the US, partly because import demand is less, but also because markets and distribution channels are more complex and fragmented. A notable feature of Indonesian garment exports is the unimportance of Japan as a market. Japan is not a signatory to the MFA, so Indonesia must compete against all countries in this market. The principal reasons for the low export volumes are, Japan has only recently become a major garment importer and, the Asian NICs have been better placed to take advantage of the much more quality conscious Japanese market, with its intricate marketing networks. Several Indonesian firms have active plans to penetrate the Japanese market, drawing on their commercial contacts with major Japanese trading houses. This could be major source of future growth, but it will require continued access to high quality fibre and fabric.

3.15 Export markets for fabric and fibre are diverse, and export quotas are not such a handicap. In the case of fabrics Singapore is a major market, reflecting its continuing role as the entrepot centre for Southeast Asia, together with its tourist demand. Industry sources suggest other markets are often determined by periodic supply shortages necessitating fabric imports e.g., Malaysia and UAE.

#### Effects of the Trade Regime

3.16 The trade regime directly effects the textiles industry in three principal ways: (i) the quota allocation mechanism; (ii) import tariffs/NTBs on imported inputs and outputs; and (iii) the BAPEKSTA facility.

3.17 Until the mid 1980s the need for an efficient quota allocation mechanism was not pressing - the country was under quota ceilings in most items and the MFA had 'perverse protective' effects for newcomer exporters (such as Indonesia) through the restraints imposed on other established exporters (principally to Asian NICs). However, as shown in Table 3.5, export quotas have begun to 'bite'. Future sales to the US and EC will, therefore, be constrained to agreed quota increases and a shift to higher value items. This makes it essential that quota allocations are distributed as efficiently and equitably as possible.

3.18 The current system for allocating textiles quotas has been subject to much debate in Indonesia. But before discussing its shortcomings it should be noted that the high and rising quota ratios shown in Table 3.5, demonstrate that most of the quotas are eventually allocated to firms. Nevertheless, even a minor underutilization of quota (of say 5%) can result in a substantial loss in export revenue (about US\$50 million).

**Table 3.5: TEXTILE QUOTA UTILIZATION RATIOS**

	1984	1985	1986	Ratios
USA				
Group 1 items	77	93	96	99
Group 2 items	n.a.	95	106	122
EC	76	68	74	85

Source: Department of Trade.

3.19 The major shortcomings of the current allocation system include: (a) Administration is non-transparent. The Department of Trade allocates 80% of its allotted quotas according to past performance, 10% to newcomers and 10% to cooperatives. The criteria for deciding which firms receive initial quota allocations are not clear, and the Department rarely publishes a comprehensive list of current quota holders. Some firms with satisfactory past performance have had their quota allocations cut without explanation, and the definition of 'newcomer' exporters is particularly unclear. The annual growth in quotas (between 3% and 6%) has been predominantly allocated to the ill-defined 'newcomer' category, and there have been complaints that the additional allocations have been made too late in the quota year. It has also been observed that some quota holders possess little, if any, productive capacity, and operate simply by reselling quotas; (b) The quota exchange mechanism deters open trading. Although the Government did establish a Textile Quota Exchange, the penalties for using it constitute an incentive for transferring the quotas outside the Exchange. Currently the quota holder loses 20% of the quota sold on the exchange. As a consequence, quota holders only trade low volumes on the Exchange to gather price signals. Quota holders that neither use or transfer their quota rights are penalized at a rate of 200% of the unused quota. These unused quotas are returned to the Government to be reallocated by the Ministry of Trade; and (c) Administration is slow. Quotas are generally not allocated until after the quota year has commenced; in some cases, according to firm interviews, this can be up to three months into the quota year. This adversely affects exporters, who can miss lucrative contracts early in the year. In addition, the MFA has several flexibility clauses that enable the exporting country to 'switch' quotas from one product to another (or one country to another within the EC) and to 'carry-over' quotas from one period to another. These flexibility clauses demand accurate monitoring and forecasting capacities, which apparently are not well developed in Indonesia.

3.20 The present quota allocation and trading mechanism has several weaknesses. The non-transparent nature of the system encourages firms to allocate resources to wasteful rent-seeking behavior to preserve or increase

their export interests. In addition, the degree of administration discretion increases uncertainty for investors and creates opportunities for abuse.<sup>8/</sup> Both these factors are enhanced by the incentive to trade quotas informally outside the Exchange. Furthermore, the allocation of quotas based on past performance can act as a barrier to entry, and thereby impede dynamic efficiency gains over the medium term. Finally, the current system makes it difficult to identify who receives the quota rent, and therefore, difficult to decide whether the distribution is equitable or in the textile industries best interests.

3.21 With respect to import tariffs and NTBs, GOI have removed all restrictions on one of the major inputs into the textile industry - cotton. In 1986, cotton imports were moved from the approved import category to the more open IP license category, which enabled domestic users to import cotton directly. In the January 1987 package, cotton imports were deregulated further by being moved off the restricted goods list and reclassified as an IU item. Cotton imports were still not completely deregulated, however, as importers had to purchase 1 ton of domestic cotton for every 10 tons of imported cotton. This restriction was lifted in November 1987. Interviews with firms have confirmed how important having non-restricted access to cotton has been in allowing them to be competitive in terms of both price and quality.

3.22 The only major imported inputs that remain on the Restricted Goods List are some types of synthetic fibres, which are listed under the least restrictive IP license.<sup>9/</sup> The need to protect domestic synthetic fibre producers may itself be due to an "informal" trade restriction on one of the most important inputs into synthetic fibre - PTA. The domestic synthetic producers have informally agreed to source about half their PTA needs from the Pertamina plant which was opened in 1986. In return Pertamina have agreed to sell at import-parity levels. However, some producers claim that poor delivery and quality raises their actual costs, and that the price is often high due to unnecessary middle-men between themselves and Pertamina. Domestic synthetic fibre producers are also concerned that Pertamina's plan to expand the domestic PTA plant to supply all domestic requirements will be followed by lobbying to increase trade barriers. If this occurs, fibre products will also be forced to seek more protection to stop fabric manufacturers importing all their needs through BAPEKSTA.

3.23 While most of the 'upstream' inputs into fibre production receive low import protection, this is not the case for finished products. The current

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<sup>8/</sup> The value of quotas should not be underestimated. For example, in July/August quotas for profitable items such as jeans were being sold 'informally' for up to US\$12 per dozen. Thus, a quota of say 50,000 dozen would be worth US\$600,000.

<sup>9/</sup> This allows downstream users of synthetic fibre to import it if they can establish that the domestic product is not competitive in terms of price or quality.

tariff schedule provides escalating tariff protection for the textiles industry, increasing from an average 33% for fibres and fabrics to a high 58% for garments.<sup>10/</sup> In addition, all batik textile items are on the Restricted Goods List, and can only be imported by the State Trading Companies (STCs). In effect, this has resulted in an informal ban on batik textiles. Both the escalating tariff and the restrictions on batik are designed to protect high cost local producers that sell primarily on the domestic market. Textile exporters are able to circumvent the cost of raising effects of this import policy by using the BAPEKSTA facility. Given the dominance of competitive textile producers that sell at world prices, the case for continuing to offer high protection on final products seems weak. Unless producers for the domestic market are forced to compete the industry will become dualistic, with one highly efficient part geared to supply foreign consumers, and another high cost part geared to supply domestic consumers.<sup>11/</sup>

3.24 The BAPEKSTA facility has played a key role in the growth in the textile industry since 1986. It has not only allowed textile producers to access imports at world prices, but, just as important, it has also allowed them to by-pass any remaining import license protection. In 1988, approximately a third of Indonesia's textile exports utilize inputs imported through BAPEKSTA, up from a tenth in 1986. This figure may understate the real impact of the facility as some producers indicate that they use BAPEKSTAs approval to negotiate with local suppliers to obtain more competitive prices. Firm level interviews confirm the importance of BAPEKSTA, with many producers considering it to be of more importance (in terms of competitiveness) than the September 1986 devaluation. There was also widespread praise for the efficient administration of the scheme.

3.25 There are two sets of issues concerning BAPEKSTAs future role. The first relates to improving the coverage of the scheme to include small scale textile producers and indirect exporters. Interviews with firms employing less than 20 people indicate that they often find BAPEKSTAs application procedures beyond their limited administrative capacity. Also, as documented in Chapter 2, BAPEKSTA does not have an easy mechanism for assisting indirect exporters. Both these constraints need to be addressed by simplifying application procedures further and using domestic letters of credit as a vehicle to assist indirect exporters. Even if these improvements are made, it is unlikely that BAPEKSTA will ever reach all potential exporters. In addition, and this raises the second set of issues, BAPEKSTA cannot assist producers for the domestic market or help reduce the tax on domestic

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<sup>10/</sup> Average tariff plus surcharge rate under the 1989 Harmonized System - weighted by domestic production.

<sup>11/</sup> It should be noted that exporters are required to pay import duty on the portion of their output sold on the domestic market. Nevertheless, producers for the domestic market are already under some competitive pressure due to "leakages" from export-oriented firms. As a consequence current import tariffs are probably higher than domestic prices require (i.e., there is water in the tariff).

consumers. While the efficient operation of BAPEKSTA is crucial to the textile industry given the current trade regime, it should not be seen as a substitute for more fundamental reforms - particularly the lowering of import tariffs.

### C. STEEL

3.26 In the early 1980s, the steel industry was at the centre of the Government's import-substitution strategy for 'upstream' manufactured goods. High protection, mainly in the form of NTBs, coupled with direct public investment, encouraged the development of an inward-oriented steel industry dominated by the state-owned Krakatau Steel plant. Since the mid-1980s, however, there has been a significant improvement in the industry's competitiveness in many steel products. This has resulted in increased exports, particularly since 1986, and the selective relaxation of import controls. Nevertheless, some important steel products remain highly protected, which has raised costs for downstream users. Steel provides a useful case study of the type of problems likely to occur in moving established industries from an inward-oriented to an export-oriented or more neutral trade regime.

#### Recent Performance

3.27 The steel industry has shown strong growth over the entire period 1982-1988, expanding by an average 22% p.a. (see Table 3.6). The fastest growing part of the steel industry has been in basic upstream steel products, such as billets, slabs and basic hot rolled products, which grew at 33% p.a. over the period. Most of the growth up to 1986, was geared towards supplying the domestic market. Between 1983 and 1985, the nominal value of steel imports fell by 36%, reflecting both the rapid growth in domestic output and the increased imposition of NTBs. As a result, since 1983, the ratio of imports to domestic output has declined from 109% and 128% for basic steel and metal products respectively, to 49% and 47% by 1986 (see Table 3.7).

**Table 3.6: OUTPUT GROWTH IN THE STEEL INDUSTRY  
1983 - 1986**

	<u>Current Prices (Rp. Billion)</u>			<u>Real Growth Rates (% p.a.)</u>	
	1983	1986	1988	1983-86	1986-88
Total steel sector	<u>1,157</u>	<u>2,442</u>	<u>4,361</u>	<u>21.4</u>	<u>23.5</u>
Basic steel	466	1,169	2,324	31.7	35.5
Metal products	691	1,273	2,037	13.5	9.6

Source: BPS.

**Table 3.7: RATIO OF IMPORTS AND EXPORTS TO STEEL DOMESTIC PRODUCTION**

	1983	1984	1985	1986	1987	1988
<b>Imports</b>						
Basic steel	109.3	68.3	38.6	48.5	47.7	47.4
Metal products	128.0	96.1	72.0	46.2	53.8	42.4
<b>Exports</b>						
Basic steel	1.4	1.4	4.2	7.4	18.0	17.0
Metal products	-	-	-	-	2.7	5.1

Source: BPS and staff estimates.

3.28 Since 1986 there have been two major developments. First, the publicly owned Cold Rolling Mill (CRMI) was commissioned in 1987, reflecting the latest phase in the import-substitution strategy. Second, efficiency gains within the more established parts of the industry, combined with the price effects of the devaluation, increased Indonesia's competitiveness in some product areas. Thus, in contrast to the earlier period, continued strong output growth has been accompanied by an expansion in the international trade of steel products (both exports and imports). This expansion reflects gains in competitiveness and the partial removal of import restrictions.

3.29 Exports of basic steel products increased from about US\$67 million in 1986 to US\$245 million in 1988, with metal products exports increasing from US\$2 million to US\$62 million. While most of the expansion has been in established parts of the industry (e.g., hot rolled coil and wire rods), there has also been growth in other steel products - primarily produced by the private sector. One of the smaller private producers, who relies on imported imports for half his material needs, reported exporting 50% of his output in 1988, having increased capacity utilization from 35% to 70% since deregulation. In the larger volume hot rolled coil market, Japan accounts for about 80% of Indonesia's sales and their purchases have risen 15-fold since 1986. Another source of increasing demand has been China.

3.30 Imports have increased by 30% in nominal terms since 1986, with stronger economic growth and deregulation more than offsetting the demand reducing effect of the devaluation. Some producers reported a significant fall in scrap and pig iron import prices following the removal of these items these products were removed from the Restricted Goods List. This has increased the profitability of billet making for both the domestic and foreign markets. Access to cheaper and more readily available inputs were also stressed by two manufacturers of reinforcing steel products as major benefits of deregulation. They cited delivery delays from Krakatau Steel and the

subsequent post-reform ability to by-pass these, as the major reason underlying their ability to compete in export markets. Imports of steel sheet and plate, the largest import category, have continued to grow, but at a slower rate due partly to the commissioning of CRMI. As Krakatau steel cannot produce sufficient hot-rolled products to meet CRMI's needs, there has been a change in the composition of imports towards hot-rolled products.

### Effects of the Trade Regime

3.31 Steel has been one of the most heavily regulated industries in the manufacturing sector. It is also the only industry which has been included in all of the major trade deregulation packages, which reflects GOI's awareness of the issues involved. The resulting pattern of trade policy related incentives is mixed. Some products have been completely deregulated and sell at world prices, whereas others remain protected by NTBs and/or high import tariffs. Much of the continued protection relates to remnants of the import-substitution period - particularly cold rolled sheets and the associated downstream products. While a further restructuring of the industry should be encouraged by continued trade policy reform, other issues related to how to compensate investors in the existing stock will also need to be addressed.

3.32 The dominant trade policy instrument in the steel industry has been NTBs on imports, which have restricted imports to Krakatau Steel (KS). With the gradually relaxation of these restrictions, tariffs and surcharges have become more important. Recent developments in these two policy areas are discussed first, followed by an investigation of the role of BAPEKSTA.

3.33 In 1986 the incidence of NTBs in the steel industry was amongst the highest in the manufacturing sector, covering 86% and 91% of the domestic production of basic steel and metal products respectively. The progressive removal of these restrictions is chartered in Table 3.8. Of the products deregulated in the early trade reform packages (October 86 and January 87), one of the most important was waste and scrap iron and steel. This gave domestic producers, other than KS, better access to a basic steel making raw material. As noted earlier, this has led to a marked increase in scrap imports by some of the private sector steel producers. While many of the basic steel inputs required by downstream users remained under the restrictive KS license (e.g., slab, billets, sheets), the December package focussed on removing NTBs on a range of goods produced by downstream private producers. These included steel rods and bars, most pipes, nails, screws and bolts. The December 1988 package pushed the removal of NTBs on basic steel products further. Some types of steel billets and slabs were removed from license protection, while others were moved off the KS license to the less restrictive IP license.<sup>12/</sup>

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<sup>12/</sup> If those items that are classified as IP were discounted, the domestic production coverage estimate for basic steel shown in Table 3.8 would decline from 54% to 38%.

**Table 3.8: COVERAGE OF IMPORT LICENSE RESTRICTIONS - SELECTED BASIC STEEL AND STEEL PRODUCTS, 1986-1988 (Percentage of Domestic Production)**

Industry	Pre Oct. 1986	Post Oct. 1986	Post Jan. 1986	Post Dec. 1987	Post Nov. 1988
Basic iron and steel	86	84	72	54	50
Structural metal products	91	83	83	38	38
Agricultural tools, cutlery	29	12	12	12	12

Source: Staff estimates.

3.34 The overall pattern that emerges from the reforms to date is a substantial relaxation of NTBs on basic steel inputs (scrap, billets and slabs); less progress on the products in the next processing phase (coils and sheets), and a significant removal of NTBs on final downstream products (albeit with high tariff protection). The general approach has been to move most basic steel inputs to the less restrictive IP license category, to make it possible for downstream users to access their inputs at world prices, and to place higher tariffs (plus in some cases surcharges) on those products that have been completely removed from the restricted goods list (i.e. IU products). Those products that require the highest level of protection remain restricted to KS, usually with a low nominal tariff (see Table 3.9). The consequences of the current pattern of incentives can be illustrated by developments in the galvanized steel sheet industry. Faced with NTBs on cold rolled steel sheets, this industry purchases domestic sheets at about 20% to 30% above import parity levels. As a result of the high cost inputs, the industry itself suffers a price disadvantage in relation to imports of a similar magnitude and operates at 40% of capacity behind an import tariff of 30%. Furthermore, because effective substitutes in the form of asbestos - cement sheets are available (one steel firm having diversified into their production) the price elasticity for galvanized sheets is high and further contraction of the industry is likely.

3.35 With respect to tariff protection, the average level of statutory tariffs in the steel industry is not high by either Indonesian or international standards. Nevertheless this low average masks a wide dispersion in tariff rates and a much higher average tariff for downstream metal products. There has also been a trend towards slightly higher tariff protection for basic steel products following the relaxation of NTB protection (see Table 3.10). More importantly, the escalating tariff pattern needs to be assessed in conjunction with the use of NTBs discussed above.

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3.36 One of the major concerns with the tariff structure in the steel industry is the increasing prevalence of split-tariff positions and surcharges. This practice of subdividing the existing 9 digit level product description into ever more finer product descriptions enables protection to be targeted (either in the form of an NTB or tariff protection) to specific products (i.e., those produced domestically). The proliferation of split-tariff position has been associated with an increased reliance on surcharges. As a consequence, the steel industry has the highest incidence of surcharges (in terms of number of products) in the manufacturing sector.

3.37 Use of the BAPEKSTA facility for steel products has increased recently, following the expansion of exports. While exports account for only a small proportion of the steel industries output, BAPEKSTA serves two useful functions. First, as the nominal tariff on basic steel products is low the schemes primary benefit for users of these products is in allowing exporters to circumvent the remaining import license restrictions. Although the listed price of these steel items is often at import parity levels, users complain of uncertain delivery and poor quality. In addition, one exporter of concrete steel commented that the possibility of using BAPEKSTA, has encouraged a more competitive and business line attitude from Krakatau Steel. The second function of BAPEKSTA is to provide users of downstream products with import duty exemptions. Given the cascading nature of the import tariff structure, the duty savings of about 20% to 30% are a significant part of producers costs.

3.38 In conclusion, the next phase of trade reform in the steel industry will need to focus on reducing the wide range of protection provided to different producers and products. The increasingly fragmented character of the current trade regime reflects efforts to lower domestic prices on some items to encourage the development of downstream industries, at the same time as continuing to protect less efficient domestic producers. The result has been to slow the process of restructuring the industry and raise input costs for some downstream users e.g., galvanized steel sheets. The priorities for reform are the removal of remaining NTBs, followed by a move towards a more uniform tariff structure (free of either split-tariff positions and surcharges). For cold rolled products this will require supporting measures to directly address the financial problems that CRMI will confront.

#### D. FOOTWEAR

3.39 The footwear industry provides a useful case study in a number of respects including:

- o it is representative of the type of non-traditional manufactured exports that have underpinned Indonesia's strong non-oil export performance since 1986;
- o it has been effected by recent reforms in both the import and export policy framework;

- o it has benefitted from a large inflow of foreign investment; and
- o it has one of the highest levels of nominal and effective rates of protection, at the same time as the industry has clearly shown its capacity to compete on world markets.

Recent Performance

3.40 The footwear industry has performed well since 1983, growing at an average 10% p.a. between 1983-86, and at least 12.0% between 1986-88.<sup>13/</sup> As the data in Table 3.11 shows, most of this growth has derived from the extremely rapid expansion in exports. Starting from a small base, exports have expanded at an estimated 246% p.a. over the past two years, increasing their share of total domestic footwear output from about 7% in 1986 to 61% in 1990.<sup>14/</sup> Most of this growth has occurred in sports shoes and in the cheaper form of plastic and rubber footwear items. By contrast, imports stagnated in real terms during the period 1983-86, before declining significantly between 1985-88. Footwear imports are now largely comprised of high quality fashion footwear and special brand-names not manufactured locally.

Table 3.11: FOOTWEAR: GROWTH IN OUTPUT, EXPORTS AND IMPORTS, 1983-88

	<u>Current Prices</u> (Rp. Million)			<u>Real Growth Rates</u> (% p.a.)	
	1983	1986	1988	1983-86	1986-88
Output	89,726	152,623	225,819	9.9	12.0
Exports	2,484	9,991	137,428	46.5	246.1
Imports	4,126	7,710	4,946	13.4	-25.3
Exports as % of output	2.8	6.5	60.9		

Source: BPS and staff estimates.

<sup>13/</sup> The published data on output, exports and imports would indicate a marked decline in domestic consumption between 1986 and 1988. Although the domestic price of footwear has probably declined relative to international footwear prices since devaluation, this shift in relative prices is unlikely to fully account for the observed trend. As the trade data are considered to be robust, it is probable that the growth in domestic output is underestimated. This would not be unusual for an industry which has recently experienced large inflows of new investment.

<sup>14/</sup> To the extent that output has been underestimated (see footnote 8), this ratio is obviously too high.

3.41 The rapid growth in exports has been accompanied by a large inflow of foreign investment, particularly from Taiwan and South Korea. In calendar year 1988 a total of 32 new companies received BKPM approval for investment in the rubber shoe industry alone, 13 of which were foreign investors. There has also been a significant re-orientation of export destinations for Indonesian footwear, partly because many foreign investors have brought ready access to foreign markets with them. Most notable among these changes has been the rise in the US market in several product categories, and the growth of the EC market (see Table 3.12). Penetration of the British market has been particularly successful in the cheaper forms of rubber and plastic footwear and textile sports shoes. Finally, there has also been an increase in the unit value of men's leather shoes, indicating a move into the higher quality end of the market.

**Table 3.12: CHANGING EXPORT MARKETS FOR LEADING INDONESIAN FOOTWEAR EXPORTS - 1986 TO 1988**  
**PRINCIPAL DESTINATIONS BY VALUE (US\$'000)**

	----- 1986 -----		----- 1988 -----	
Rubber/plastic Footwear	Middle East	35	UK	4,269
	France	14	UK	562
	Malaysia	2	France	412
Mens/boys shoes Leather with rubber soles	UK	570	US	10,876
	Eire	130	Singapore	1,014
	Hongkong	62	UK	926
Leather sport shoes Rubber soles	UK	231	US	1,701
	West Germany	24	France	1,049
	Netherlands	21	UK	1,018
Women's textile Shoes, rubber soles	Netherlands	91	UK	1,844
	West Germany	85	US	529
	UK	31	Netherlands	93
Textile sport Shoes, rubber soles	UK	2,935	UK	9,862
	Netherlands	161	US	7,602
	Belgia/Luxembourg	91	France	3,918

Source: Central Bureau of Statistics - Exports, Various Years.

### Effects of the Trade Regime

3.42 The rapid growth in Indonesia's footwear exports since 1986 is the result of many factors besides changes in the trade regime. The decline in Indonesian real wages relative to competitor countries and the removal of GSP rights for Taiwan and South Korea are two important factors. In addition, the relaxation of business regulations has played an important role in facilitating the inflow of foreign private investment. Nevertheless, as firm level interviews confirmed, the series of trade reforms undertaken since 1985 have been central to the rapid development of the industry. Further reforms of the trade regime will be needed to encourage and to maintain the momentum towards increased efficiency and competitiveness.

3.43 The trade policy reforms that have effected the recent performance of the footwear industry are: (i) the removal of NTBs on imports, particularly leather; (ii) export bans and export taxes on domestic leather production; (iii) the introduction of the BAPEKSTA facility; and (iv) continued high protection from foreign competition via high import tariffs on final footwear products.

3.44 The removal of NTBs on leather imports in the first trade deregulation package (October 1986) was an essential step in providing producers with access to competitively priced good quality leather. Footwear producers response to this opportunity are borne out by the rapid growth in leather imports over the past two years (see Table 3.13). Of more concern, has been the simultaneous provision of indirect subsidies on inputs to leather product producers (including leather shoes) in the form of a ban on exporting hides and a tax on semi-processed leather. One integrated domestic manufacturer of leather shoes and bags, who is also involved in tanning, estimates that these policies have reduced the price of inputs to leather making by as much as 50 per cent in the past year. It seems likely that Indonesian leather is now available to domestic users at or below world prices for comparable quality. While this does provide an indirect subsidy to footwear manufacturers it is likely to hamper the development of the domestic leather industry by reducing incentives to invest in quality enhancing animal stock or machinery.

**Table 3.13: LEATHER IMPORTS BY INDONESIA, 1983-1988**  
(US\$'000)

1983	1984	1985	1986	1987	1988
120	81	493	406	1,747	9,050

Source: Central Bureau of Statistics -  
Imports, Various Years.

3.45 Aside from the negative impact on the incomes of domestic leather producers, the extent to which this subsidization has assisted exporters is not clear. While one small manufacturer of leather shoes, exporting products in the low to medium quality range to Europe and the Middle East, stressed the adequacy of domestic leather quality for his products, large manufacturers pointed out that much of the shoe export boom has been associated with international brand names resourcing to Indonesia. Such brand names often dictate complete shoe specifications, including all material inputs and, at the top end of the market, insist on entirely imported leather. One large domestic manufacturer indicated that for manufacturers not entirely specialized for export, shoes for the domestic market would be produced using largely domestic inputs while export markets would often be sourced from imported materials.

3.46 Given this behavior and the effect of P4BM discussed below, it would appear that the main beneficiaries of these subsidies have been domestic tanneries and leather shoe manufacturers producing for the domestic market rather than for export. These producers are also in receipt of some of the highest tariff protection in the manufacturing sector. This combination of subsidized inputs and high import tariffs on outputs, produces the high effective rates of protection for footwear referred to earlier. As a result, the traditional domestic shoe industry is not being directly encouraged to restructure towards being a more efficient and low cost producer. In addition, domestic consumers have not directly benefitted from the increased competitiveness of the Indonesia footwear industry via lower prices, and domestic hide and semi-finished leather producers have incurred a significant loss.

3.47 Since its inception in May 1986, the BAPEKSTA facility has played a crucial role in supporting the growth of exports which has dominated the industry over the past two years. The widespread use of the facility is reflected in the fact that about 77% of footwear exports utilize inputs imported through BAPEKSTA. With average duties on imported inputs in the range of 30% to 40%, the cost saving resulting from gaining duty exemption is significant. While cheap Indonesian labor has been a powerful impetus to resite production from other neighboring countries, access to inputs at world prices was considered to be a more important factor by many firms.<sup>15/</sup> Given that labor costs probably account for between 10% to 20% of non-fuel material costs, it is easy to overstate the importance of cheap labor when compared with the cost saving associated with being exempted from import duty.

3.48 The level of import tariffs has been, and remains, high for footwear products (see Table 3.14). In an economy which has, by developing country standards, a moderate average tariff rate on manufactured imports, footwear tariffs remain well above the average. Whereas the 1985 reform brought a significant decline in the average level of tariff protection, there was a

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<sup>15/</sup> It was estimated that Indonesian labor cost are about one-tenth of those in Korea, and productivity was about two-thirds after 2 years on-the-job training.

marginal increase in the footwear tariff. This partly reflected the use of specific duties rather than ad valorem tariffs for some footwear products. Although there was some decline in tariffs up to 1988 (due primarily to the effect of the devaluation on specific duties) this trend has been reversed under the 1989 Harmonized System. In the current tariff schedule, the combined effect of both the high ad valorem tariff and surcharges has been to raise the overall level of nominal tariff protection to about 70%, compared with an average for the manufacturing sector of about 25%.

**Table 3.14: AVERAGE FOOTWEAR TARIFF RATES - 1985 TO 1989**

	Pre-1985		Post-1985		1988		1989	
	Footwear	Manuf.	Footwear	Manuf.	Footwear	Manuf.	Footwear	Manuf.
Production-weighted tariff	64	27	65	19	52	16	56	21
Surcharge	0	0	0	0	0	3	14	4
Unweighted tariff	62	38	67	28	48	24	58	27
Surcharge	0	0	0	0	0	1	13	1

Source: Bank staff calculations.

3.49 Both the high specific duties in the pre-1988 tariff structure and the incidence of surcharges in the current Harmonized System tariff schedule have focused on protecting domestic leather shoe producers. As noted above, these producers also receive an indirect subsidy via the ban on unprocessed leather and export taxes (up to 50%) on semi-processed leather. The only real pressure on domestic oriented firms to increase efficiency has come through domestic sales from exporters. While this has lowered domestic prices for some shoe types, the domestic market is receiving shoes at the low quality end of the spectrum (some rejects) at prices above international levels.

3.50 There seems little doubt that firms with appropriate technology, Indonesian labor, and material inputs at world prices can effectively compete on world markets. The more efficient domestic firms appear eager for joint venture relationships and the technical expertise and market entrance accompanying this. Reduction of the very high tariffs (with surcharge removal a priority) on outputs, combined with the removal of remaining NTBs and lower tariffs on inputs (i.e. PVC, nylon cloth), would encourage the further restructuring of the industry. Such an evolution would seem preferable to the present situation whereby international competitive (and pressures on domestic firms to restructure) is dependant on the continued efficiency of the BAPEKSTA facility.

E. PAPER

3.51 Indonesia's paper industry has been strongly influenced by the trade regime. At the start of the decade, the industry primarily produced "downstream" paper and paper products for the highly protected domestic market. Low or zero tariffs on inputs (i.e., pulp and waste paper) and high tariffs on final products, reduced incentives to build integrated paper mills which utilized Indonesia's large forestry resources. By the end of the decade, however, the growing importance of export markets and less protection on the domestic market have encouraged the industry to restructure itself. The need to become more price competitive has led to larger more integrated paper-making plants. One of the interesting aspects of the paper industries development has been the growth of an efficient domestic pulp industry, without recourse to import tariff or NTB protection.

Recent Performance

3.52 The paper industry is one of Indonesia's fastest growing industries, expanding by 38% p.a. between 1983-86, and 51% p.a. between 1986-88. This growth has occurred across a range of paper products, with particularly strong growth in HVS paper (see Table 3.15). Initially, much of this growth derived from import-substitution for final paper products. Imports as a share of total domestic output declined from about 88% in 1983 to 34% in 1986. Since then, the nominal dollar value of imports have increased, with the primary source of growth for the domestic paper industry switching to the export market. Total dollar export earnings increased from US\$33.3 million in 1986 to US\$138.7 million in 1988, resulting in the ratio of exports to domestic production rising from 7.0% in 1986 to 21.5% in 1988 (see Table 3.16). Most of Indonesia's export growth has been oriented towards regional markets, particularly the large printing and publishing centre of Hong Kong.

Table 3.15: PAPER AND PAPER PRODUCTS OUTPUT  
1983-1988

	<u>Current Prices (Rp.billion)</u>			<u>Real Growth (% p.a.)</u>	
	1983	1986	1988	1983-86	1986-88
Paper	123.3	373.2	1,187.2	37.3	64.3
Paperboard	1.2	7.0	12.7	70.1	23.8
Containers/Boxes	27.2	78.3	110.7	35.3	8.3
Other Products	29.2	94.7	176.0	40.9	25.0
<u>Total</u>	<u>181.0</u>	<u>553.2</u>	<u>1,486.5</u>	<u>38.1</u>	<u>50.8</u>

Source: BPS and World Bank staff estimates.

3.53 The industry has expanded from about 30 paper mills in 1983 to 40 paper mills, 15 of which are now integrated. Installed capacity has more than doubled, with utilized capacity increasing from a low of 59% in 1985 to 80% by 1988. Approximately a third of this capacity is in the public sector, but most of the recent expansion has occurred in the private sector. Foreign joint-ventures and some merging of existing private firms have been a feature of recent developments in the industry.

3.54 Another important recent development has been the rapid expansion in domestic pulp making capacity. In the early 1980s, the paper making industry was heavily reliant upon imported pulp. From 1985 the expansion of existing pulp capacity and the establishment of new pulp making plants has resulted in pulp imports as a ratio of domestic production falling markedly (see Table 3.16). This has led to increased integration of the paper making industry, which due to both scale and quality effects has made Indonesian producers more price competitive. Industry experts suggest that Indonesian wood pulp production competes favorably with Australasian products, and is being produced at higher quality utilizing more recent technology and cheaper wood. Nevertheless one of the issues that has delayed the establishment of integrated mills, i.e., access to clear land title for a commercially viable time period, continues to slow the further expansion of the industry.

**Table 3.16: PAPER AND PAPER PRODUCTS:  
EXPORTS AND IMPORTS, 1983-1988**

	<u>Current Prices (US\$ million)</u>			<u>Real Growth (% p.a.)</u>	
	1983	1986	1988	1983-86	1986-88
<b>Exports</b>					
Paper	5.6	32.7	128.1	70.9	82.1
Paper products	neg	0.6	10.6	108.3	297.4
<b>Imports</b>					
Paper	159.2	97.7	114.5	-19.1	-0.4
Paper products	15.1	30.0	40.2	19.7	6.4
Exports/output	2.9	7.0	21.5		
Imports/output	87.5	34.4	24.0		
<b>Memo Item</b>					
Pulp and wastepaper as % of paper output	69.0	35.0	29.0		

Source: BPS and World Bank staff estimates.

Effects of the Trade Regime

3.55 The paper industry developed in the 1970s and early 1980s behind a highly distorted pattern of import tariff protection. Basic inputs into paper making were placed under a relatively low 10% import tariff, while major paper products were protected by tariffs of 60%.<sup>16/</sup> Although the high tariffs on paper products were cut by a half in the 1985 tariff reform package (see Table 3.17), the reduction in protection was offset by a proliferation of import license restrictions. Thus the industry continued to expand behind high tariffs supplemented by NTBs. A World Bank subsector study in 1986, reported that only 9 of 30 paper mills were integrated and that the industry was generally uncompetitive. At that time (i.e., based on 1984 data), the estimated implicit subsidy provided to non-integrated mills was 71%, compared to 43% for integrated mills. White newsprint was the most competitive, with an estimated implicit subsidy of 17%.

**Table 3.17: TARIFFS AND SURCHARGES: MAJOR PAPER AND PAPER PRODUCTS ITEMS**

Product	Pre 1985	Post 1985	Post 1986	1988 (+surchg)	1989 (+surchg)
White Newsprint	20	5	5	5	5
HVS	60	40	60	30+5	35+5
Duplicating Paper	60	30	50	30+5	30+5
Coated Writing/ Printing Paper	60	30	60	30+5	30+5
Kraft Liner	60	30	60	30	30
Sack Kraft Paper	60	30	30	30	30/ <sup>a</sup>
S.C. Fluting Paper	60	30	60	30+5	30+5
Cigarette Paper	60	30	30	30+5	30+5
Paper Board	60	30	30	30+5	30

<sup>/a</sup> Other than for cement bags, where the rate is 5 per cent.

Source: World Bank, RSI Data Base.

3.56 Since 1986, the industry has gradually been exposed to more competition. First, most import license restrictions were removed in October 1986 (except for newsprint) and replaced by (higher) import duties. Second, import duties were progressively reduced between 1986 and 1988 towards a target of 30%. Import protection on inputs (waste-paper and pulp) also

<sup>16/</sup> The exception was 'white newsprint', which was already covered by a special import license restriction.

underwent some changes. While the tariff on pulp was lowered (from 10% to 5%, and then to 0% for some pulp types), the tariff on waste newspaper was raised to match a relaxation of import license restrictions. As with paper products, this tariff increase has been subsequently removed (see Table 3.18).

**Table 3.18: TARIFFS: MAJOR PAPER-MAKING MATERIALS**

Product	Pre 1985	Post 1985	1988	1989
Waste Issued Newspapers	10	40	0	0
Other Waste Paper	10	40	40	0
Mechanical Wood Pulp	10	5	5	5
Chemical Wood Pulp	10	5	0	0

Source: World Bank, RSI Data Base.

3.57 The growing importance of the export market coupled with the move to a 30% import duty (with no NTB protection), has encouraged the industry to restructure. Given that the 1986 Bank study estimated that the minimum implicit subsidy for small mills was 34%, it seems likely that many of these smaller mills have increased efficiency to survive under a 30% import duty. The recent BPS industrial survey indicates that some smaller firms have invested in pulp making machinery to lower costs via vertical integration and increased capacity, while others have merged. The increase in competitive pressure has also resulted in a lobbying of the government for surcharge protection, which so far has been restricted to 5% on some products. At the same time, it would appear that the larger more integrated mills are receiving tariff induced quasi-rents on that proportion of their output sold on the domestic market.

3.58 Firm level interviews indicated that the 1986 devaluation played a major role in increasing the industry's international competitiveness. In a sense the devaluation ratified the large expansion in capacity that had occurred between 1982 and 1988 by allowing the most efficient Indonesian producers to export at a profit. Industry figures show an increase in capacity utilization from 63% in 1986 to 84% in 1988.

3.59 Overall the industry is in a state of transition. While some firms have modernized to take advantage of Indonesia's potential international competitiveness, other firms have done just enough to remain competitive on the domestic market. The general feeling in the industry is that a lowering of tariffs below 30% would cause many of the smaller non-integrated producers out of business or encourage them to invest in new plant, perhaps specializing in particular products. Nevertheless, most of the larger firms could compete with lower tariffs, as is evidenced by the rapid growth in exports.

## CHAPTER 4

### EFFECTS OF THE TRADE REGIME ON SELECTED AGRICULTURAL ACTIVITIES

#### A. Introduction

4.01 Agriculture plays a central role in the Indonesian economy, accounting for almost a quarter of GDP, about 38% of non-oil exports, and employing about 55% of the labor force. After strong growth of 4% p.a. in the late 1970s and early 1980s, the agricultural growth rate has begun to slow. With the expansion in rice output unlikely to match past levels, attention has focussed on encouraging the development of a more broad based and diversified agricultural sector. This has raised many issues related to the network of administrative controls and price interventions that GOI currently uses to direct agricultural production. Trade policy is one of the major policy instruments through which GOI intervenes in agricultural markets.

4.02 International trade in Indonesia's agricultural products is more highly regulated than trade in industrial products. While the share of domestic production protected from import competition through NTBs is similar in both sectors (about 40%), agriculture differs from manufacturing in that most agricultural exports are also regulated. However, despite the prevalence of trade restrictions, the aggregate level of protection provided to agriculture is lower than that for manufacturing.<sup>1/</sup> Put another way, agricultural prices depart less, on average, from free trade prices than those in manufacturing. This primarily reflects two important characteristics of the trade regime as it pertains to agriculture. First, although international trade in rice is highly restricted, domestic rice prices have been maintained close to world prices.<sup>2/</sup> Given the weight of rice in total agricultural production (about 65%), this lowers production-weighted estimate of protection. Second, some of the important trade interventions in agriculture result in a tax on domestic producers rather than providing assistance (e.g., edible oils, wood, leather, rattan, and rubber). This is rarely the case in manufacturing.

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<sup>1/</sup> The average effective rate of protection for agriculture is 21% compared to 73% for manufacturing. However, it should be noted that, in contrast to some other oil surplus nations, GOI have channeled a large share of direct public investment into agriculture to offset the bias in the incentive structure.

<sup>2/</sup> It should be noted that the international market in rice is small in relation to world production, and that any large participation by Indonesia (either on the import or export side) would influence the world price.

4.03 While the aggregate level of protection for agriculture is low relative to manufacturing, there is an almost equally wide dispersion around this average. Thus, while many agricultural products sell at close to world prices, others trade well above (or below) import/export parity. The first part of this Chapter identifies the most important trade policy interventions for both imports and exports. The overall conclusion is that substantial economic gains would result from relaxing and simplifying the current restrictions on the international trade of agricultural commodities. More specifically, the removal of NTBs and lowering of import tariffs on agricultural commodities would improve the allocation of agricultural resources, increase competitive pressures on traders and producers, and benefit domestic consumers (see paras. 4.10 to 4.14). This should be accompanied by a review of the current coverage of export regulations. Where appropriate export restrictions should be removed. In those rare instances when export restrictions are in Indonesia's best interest, the primary issue is to design the policy intervention so as to minimize the negative effects on producers (see paras. 4.18 to 4.24). In regulating exports, it is also important not to reduce domestic competition by creating domestic barriers to entry into either trading or producing agricultural commodities. While an export tax is preferable to other forms of export regulation, where a quota is used it is important to use a transparent and efficient quota allocation mechanism.

4.04 The second part of the Chapter presents an analysis of how the current trade regime affects the production of some processed food products. These products are examined because it is an area where Indonesia is thought to have a potential comparative advantage and the government is keen to encourage further growth. The analysis shows that the current trade regime provides high levels of protection on both important inputs (e.g., tin plate, sugar and tetrapak) and outputs (processed meat, fruit and vegetables). As a consequence, it is primarily the larger firms that can compete on world markets because they are capable of using the import duty exemption and export credit facilities to access inputs at world prices. Smaller-scale and indirect exporters are disadvantaged the most by the current trade regime because they have much more difficulty avoiding the high cost of imports. Producers for the domestic market are able to absorb high input costs due to the correspondingly high tariff and NTB protection on final processed food products. However, domestic demand for these products is lower than it would be at international prices and these firms are not competitive on world markets.

#### **B. Agricultural Imports and the Trade Regime**

4.05 During the first stabilization period (1982-85), the nominal value of agricultural imports fell by almost a third as a result of the government's efforts to reduce external and internal imbalances following the decline in oil prices (see Table 4.1). While most of this adjustment was achieved by corrective macroeconomic policies and solid gains in domestic rice production,

**Table 4.1: AGRICULTURAL IMPORTS BY COMMODITY 1983 - 1988**  
(millions of US dollars)

	1983	1984	1985	1986	1987	1988
<b>Food &amp; beverages</b>	<b><u>1,263</u></b>	<b><u>902</u></b>	<b><u>708</u></b>	<b><u>770</u></b>	<b><u>866</u></b>	<b><u>1,049</u></b>
Live animals	15	12	8	18	26	27
Dairy products	91	70	65	56	53	75
Wheat	334	276	259	272	244	229
Rice	384	132	9	6	12	9
Corn	5	10	7	6	25	8
Vegetables	35	22	18	26	26	60
Sugar	134	2	4	19	31	40
Feedstuffs	71	101	87	130	133	127
Beverages	8	4	4	6	4	5
Tobacco & products	20	25	17	22	29	29
Oilseeds	89	145	96	114	113	162
Vegetable oil	12	52	36	18	97	207
Other	68	51	98	77	73	71
<b>Non-food</b>	<b><u>331</u></b>	<b><u>426</u></b>	<b><u>315</u></b>	<b><u>345</u></b>	<b><u>493</u></b>	<b><u>593</u></b>
Wood pulp	138	184	96	152	207	268
Cotton	175	214	180	172	266	302
Other	18	28	39	21	20	23
<b>Total</b>	<b><u>1,594</u></b>	<b><u>1,328</u></b>	<b><u>1,023</u></b>	<b><u>1,115</u></b>	<b><u>1,359</u></b>	<b><u>1,642</u></b>

Source: Central Bureau of Statistics.

import demand was also suppressed by the increasing use of NTBs. Over this period most of Indonesia's largest import items became restricted to particular traders, partly in an effort to broaden the move towards self-sufficiency beyond rice (e.g., to include sugar and soybean). Since 1986, however, the faster rate of economic growth coupled with the move towards deregulating trade (particularly BAPEKSTA), have reversed this trend, with the nominal value of agricultural imports increasing from US\$1.1 billion in 1986 to US\$1.6 billion in 1988.

4.06 Although the deregulation measures taken to date have not focussed on agricultural products, there are a few important exceptions. Cotton was deregulated to assist the growth of the textiles industry and over 100 processed food items, that were formerly restricted to the STCs, were moved off the Restricted Goods List. More recently, BULOG's import monopoly on corn has been removed, allowing private traders to import. In addition, the duty exemption and drawback scheme (BAPEKSTA) has provided a useful mechanism by

which some producers of processed agricultural products have been able to avoid trade restrictions. Nevertheless, agricultural imports (particularly consumption items) have grown at a slower pace since 1986 than almost any other import category. This reflects the continued prevalence of trade restrictions and above average import tariffs.

4.07 Food imports are highly regulated, with most major products being restricted to BULOG and the STCs (particularly Kerta Niaga and Tjipta Niaga). BULOG holds the exclusive import rights for rice, wheat, wheat flour, sugar, soybeans, and soybean meal. Imports of these products account for about half the value of Indonesia's total food imports. The STCs hold the import rights for a range of more processed food products, mostly tinned fruit, vegetable and meat products. These trade restrictions have been a contributory factor in encouraging a misallocation of agricultural resources into low return activities, such as sugar, in which Indonesia has no comparative advantage. In addition, trade restrictions have supported higher consumer prices for a range of agricultural consumer goods including wheat, sugar, edible oils, and processed foods.

4.08 In the case of rice, having attained self-sufficiency in the early 1980s, GOI has been reluctant to continue to use international trade. In 1984 and 1985, with total rice production exceeding domestic consumption, GOI allowed a large build-up of stocks, restricting exports to a minimum. This imposed high stock costs on BULOG and made it difficult to maintain rice quality due to low stock-turnover. Since 1986, two successive years of below average rain fall have reversed this situation, with the growth in domestic rice output falling below consumption trends. Although BULOG was able to drawdown stocks to partially compensate for the supply shortfall (1.8 million tons excluding allocations to budget groups), this was not sufficient to prevent a marked increase in rice prices. For example, the retail price for medium-quality Cisadane rice increased by 22 percent in 1987 and a further 26 percent in 1988. During this period Indonesian prices were more volatile than world prices, with domestic prices for some rice types exceeding cyclically high world prices by early-1988.

4.09 Higher rice prices also reduced the demand for non-food agricultural products because of the inelastic demand for rice and the large share of rice (17%) in the consumer budget. With access to imports restricted, the burden of maintaining self-sufficiency was carried by consumers via higher rice prices. The negative effect on real incomes was particularly marked for the urban poor and landless laborers. Although the government has responded by allowing some imports, the recent experience with rice illustrates the dangers of severing the link with international markets. Even a large public stock of 3.5 million tons (built up in the 1984-85 period) proved insufficient to offset the deficit caused by the 1987 drought and subsequent weak recovery in rice production. One alternative approach explored in Chapter 5, would be to auction a fixed import quota for rice to the private sector. This would reestablish a more direct link with world prices, exert competitive pressures on BULOG and producers (in terms of price and quality), and provide a useful safety-value during periods of below trend production levels. This would still allow BULOG to play the role of stabilizing domestic prices by market interventions.

4.10 The resource allocation and consumer's costs of existing trade restrictions are probably highest for sugar and soybean. In the case of sugar, BULOG makes up for the domestic short fall in production by importing through foreign agents. BULOG's sugar purchases are made through direct negotiations with these agents rather than by using open international tenders. According to trade sources, BULOG pays commissions of up to US\$15 per ton as compared with average commissions of less than US\$1 per ton. The final cost of sugar in the Indonesian market in 1989 was maintained at close to 40% above the import parity price to protect the high cost domestic sugar industry. In the case of soybean and soybean meal, BULOG has periodically allowed private importers to import soybean meal under a special license. In 1988, however, this facility was withdrawn, in order to protect a new soybean crushing plant (PT. Sarpindo). Currently, BULOG import soybeans which are then crushed by Sarpindo. Sarpindo is paid Rp. 20 per kg to crush the beans and is allowed to keep the resulting soybean oil.<sup>3/</sup> The meal that

**Table 4.2: COMPARATIVE RETURNS TO FOODCROP PRODUCTION, 1987**

Crop/location	Yield (Kg./ha)	Net Returns <u>/d</u> ( '000 Rp./hectare/season)
Irrigated rice <u>/a</u> (Klaten, C. Java)	7,000	958
Corn <u>/b</u> (Kediri, E. Java)	4,200	395
Soybeans (Kediri, E. Java)	1,400	370
Sugarcane <u>/c</u> (Kediri, E. Java)	8,000	186

/a Gabah = rough rice

/b Dry hulled kernels

/c Net return to sugarcane calculated as return on 18 month cropping cycle converted to 3 1/2 months so as to be comparable with other crops.

/d Net returns refer to the difference between the gross value, at farm prices, cash costs and an implicit charge for family labor and capital, all at economic prices. Net returns includes profits and returns to land. Calculated on basis of irrigated land cultivated by progressive farmers.

Source: Food Research Institute, Rural Income and Employment Effects of Rice Policy in Indonesia, prepared for the Ministry of Agriculture, October 1988.

3/ Assuming a domestic soybean oil price of Rp. 700 per kg and that a ton of soybeans yields 84% meal and 16% oil, Sarpindo receive US\$73.00 per ton for crushing the oil. This is very high by international standards.

Sarpindo produces is sold by BULOG on the domestic market at a US dollar equivalent price of about US\$321 per ton. Although meal prices have fluctuated since Sarpindo begun operation, the average CIF price of imported meal in the first 6 months of 1989 was about US\$275 per ton.

4.11 The high domestic prices of sugar and soybean meal have two major effects. First, consumers (including the downstream food processing industry) pay a higher price for these products than they would if trade was not restricted. This has diminished the competitiveness of agro-processing, for which sugar is an important input, and raised the cost of feed to the livestock industry. Second, distorted domestic prices have encouraged farmers to grow sugar and soybean on land where this may represent an inefficient use of agricultural resources.<sup>4/</sup> Table 4.2 provides an estimate of the comparative returns to major food crops when all inputs and outputs are priced at their economic value. As shown, the use of irrigated land on Java to cultivate sugar is an inferior use of resources than cultivating any of the other crops. The low returns to soybeans and corn relative to rice shown in Table 4.2 reflect both the inferior technological package used for these crops and their use as rotation crops with rice. The rotation of corn and soybeans with rice may prevent pest attacks and improve rice yields.

4.12 Wheat imports, which account for over one fifth of all food-imports, are also restricted to BULOG. Except for purchases made under the PL-480 program, BULOG purchases wheat in a similar way as sugar and soybean, through directly negotiated contracts. The wheat is then sold to PT. Bogasari at a fixed price (usually below the world price) for milling. Bogasari then sell the flour to licensed distributors at a price determined by BULOG. Part of the sales revenue is returned to BULOG, with Bogasari retaining its fixed milling fee plus the bran by-product which results from milling. The difference between Bogasari's purchase and selling price (including the value of the bran) has been estimated as US\$116 per ton. By contrast, milling costs in the United States, where labor costs are much higher, are between US\$35 and US\$45 per ton. Given the trade restrictions on imported wheat flour, the resulting high cost of locally produced wheat flour reduces the competitiveness of a range of food processing industries (e.g., bread and noodles) and taxes consumers.<sup>5/</sup>

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<sup>4/</sup> It should be noted that trade policy is not the only instrument used to encourage domestic production. "Production targets" have also been employed to induce farmers to produce sugar and soybean.

<sup>5/</sup> The high cost of wheat also has resource allocation effects, by indirectly increasing the demand for wheat substitutes - primarily rice. Lower wheat prices would, depending on the cross-price elasticities, reduce the demand for rice, making rice self-sufficiency easier to attain at the same time as freeing agricultural resources for use in alternative crops. The extent to which resources would be switched into other crops depends on relative profitability.

4.13 Another important imported food item is vegetable oil, which has expanded from US\$18 million in 1986 to US\$207 million in 1988. This rapid growth coincides with the gradual relaxation of import controls, culminating in the complete removal of license protection during 1988. However, an import tariff of 30% was imposed on refined vegetable oils. Although Indonesia is a major producer and exporter of crude palm and coconut oil, the tariff on refined oil has been imposed to protect the high cost domestic refining industry. Before deregulation, imports of refined edible oils were restricted to a few designated traders, where the most important trader was also the largest single domestic producer of refined edible oil. This firm has been able to maintain its dominance of the import trade, by being allowed an exemption from the 30% import duty. Thus, while the removal of license protection has been a progressive step, the imposition of a fairly high tariff has maintained high domestic edible oil prices for consumers and reduced the pressure on domestic edible-oil refiners to increase efficiency.

4.14 Most of Indonesia's other food imports are relatively minor in value terms, partly because of the prevalence of informal quotas. Dairy product imports are limited to a few companies, as are tobacco imports. The bulk of the remaining food imports are restricted to the STCs, particularly Kerta Niaga and Tjipta Niaga. The STCs hold restrictive import licenses for about 300 items, most of which are processed vegetable, meat and fruit products. While the STCs do import directly, they also allow private firms to import for a fee of between 3% to 5%. Interviews with the STCs indicate that the Ministry of Trade often imposes a quota on the total value that the STCs can import. Although these quotas are not published, the STCs ensure that private importers do not exceed the overall allocation. In the November 1988 deregulation package, GOI took the first step in reducing these restrictions by removing about 100 processed food items from the Restricted Goods List. The price effects of this reform were moderated, however, by the imposition of high import duties. Over half of the products deregulated in November 1988 have been accorded an import tariff (including surcharge) of over 50%.

4.15 Non-food imports have grown at about twice the rate of food imports reflecting the strong growth of the domestic textiles and paper industries. This rapid growth has resulted in increased demand for imported cotton and wood pulp.<sup>6/</sup> In the case of cotton, the expansion of the textiles industry has been accommodated by a complete relaxation of trade restrictions. In 1986, cotton imports were shifted from the approved importer category to the more open IP license category.<sup>7/</sup> This enabled domestic fabric producers to import cotton directly. In January 1987, cotton imports were deregulated further by being moved off the Restricted Goods List and classified as under the IU non-restrictive license category. The effect of this reform was moderated, however, by the requirement that importers purchase 1 ton of local cotton for every 10 tons of imported cotton. Because of the limited supply and inferior quality of domestic cotton this restriction was lifted in November 1987. The relaxation of trade restrictions on cotton has been an

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<sup>6/</sup> See Chapter 3 for a detailed discussion of the textile and paper industries.

<sup>7/</sup> For definition of license types and degree of restrictiveness, see Chapter 2.

important factor underpinning the rapid growth in Indonesia's textile industry. Total textile exports increased from US\$0.8 billion in 1986 to US\$1.7 billion in 1988. Interviews with textile producers confirm the important role that having non-restricted access to cotton has played in allowing them to maintain their price and quality competitiveness.

4.16 Wood pulp imports have never been under a restrictive license. The expansion in imports reflects the growth in paper and paper products exports at a rate of over 100% per annum since 1986. Indeed, the ratio of imports to output in the paper industry has declined substantially due to the expansion of the domestic pulp industry. As noted in Chapter 3, the domestic pulp industry has developed without NTB protection and with a low import tariff of 5% on imported pulp. The development of an efficient domestic pulp industry has been crucial in enabling paper product producers to compete on world markets.

### C. Agricultural Exports and the Trade Regime

4.17 The performance of Indonesia's agricultural exports has been mixed, reflecting a combination of strong output growth for some products (e.g., shrimp, wood) and wide price swings for others (coffee, rubber and spices). For some products, Indonesia is one of the world's largest suppliers. Trade in agricultural exports is highly regulated with about 40% of export value directly affected by some form of regulation.<sup>8/</sup> These trade regulations are intended to achieve a range of objectives including taking advantage of Indonesia's large market share, encouraging domestic processing, meeting domestic requirements and conserving scarce resources. The trade deregulation measures taken since 1985 have not focussed on agricultural exports and, with few exceptions, there has been an increased incidence of products that are either banned (e.g. rattan), heavily taxed (sawn timber), or restricted to approved exporters (plywood, CPO, CCO and copra). An exception to this trend is pepper, which was removed from the approval exporter list in October 1989.<sup>9/</sup>

4.18 Indonesia's food exports have doubled in nominal terms since 1983, with most of the increased earnings deriving from shrimp, vegetables and vegetable oil exports (see Table 4.3). The rapid growth in shrimp exports occurred after the reorientation of production away from ocean shrimp towards in-land pond production in the early 1980s. There are no export restrictions on shrimps, and a lowering of the import tariff on shrimp feed-meal since 1986 has increased profitability.<sup>10/</sup> Many of Indonesia's other food exports

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<sup>8/</sup> See Chapter 2, para 2.23 to 2.33, for a discussion of these regulations.

<sup>9/</sup> The quota restrictions on coffee have also been lifted following the collapse in the I.C.A. agreement. Nevertheless, it would appear that coffee exports must still be channeled through approved exporters.

<sup>10/</sup> There are quality controls on exports, but private traders are primarily self-monitoring.

(including vegetable oils) are regulated through a system of export licensing or "approved exporter" arrangements. This system restricts the right to export to designated traders approved by the Ministry of Trade. The number of approvals is often limited, and once the initial list of approved exporters has been decided upon, it is difficult for new entrants to gain access. Usually these licensing procedures are determined in close collaboration with the commodity trade association - and in many cases membership of the trade association is a prerequisite for acquiring approved exporter status. For food exports, approved exporter regulations apply to cassia vera, nutmeg, tengkawang seeds, vegetables from Sumatra, vanilla, and coffee.

**Table 4.3: AGRICULTURAL EXPORTS BY COMMODITY 1983-88**  
(millions of US dollars)

Product	1983	1984	1985	1986	1987	1988
<b>Food and beverages</b>	<b><u>1,304</u></b>	<b><u>1,592</u></b>	<b><u>1,851</u></b>	<b><u>2,011</u></b>	<b><u>2,054</u></b>	<b><u>2,613</u></b>
Fish	20	15	19	24	45	84
Shrimp	204	202	207	297	369	528
Vegetables	35	40	53	60	101	151
Fruit	7	13	22	23	29	37
Coffee	430	568	562	822	539	552
Cocoa	42	53	64	61	66	82
Tea	120	226	149	99	119	125
Spices	94	112	126	209	240	222
Feedstuffs	86	65	65	72	74	89
Tobacco	47	43	49	68	71	65
Vegetable oil	148	175	414	166	290	539
Other	71	80	121	110	111	139
<b>Non-food</b>	<b><u>1,335</u></b>	<b><u>1,465</u></b>	<b><u>1,109</u></b>	<b><u>1,140</u></b>	<b><u>1,579</u></b>	<b><u>1,914</u></b>
kubber	848	952	718	713	961	1,246
Wood, lumber	348	366	244	281	416	534
Crude vegetable fiber	122	110	112	118	192	124
Other	17	37	35	28	10	10
<b>Total</b>	<b><u>2,639</u></b>	<b><u>3,057</u></b>	<b><u>2,960</u></b>	<b><u>3,151</u></b>	<b><u>3,633</u></b>	<b><u>4,527</u></b>

Source: Central Bureau of Statistics.

4.19 Other food products fall under the classification of "Supervised Exports". These include, vegetable oils, salt, wheat flour, soyabean and rice. The primary objective is to ensure a sufficient supply for the domestic market at reasonable prices. In effect an informal quota, or sometimes a tax, is imposed which varies in its restrictiveness and how clearly it is defined. In the case of vegetable oils, state-owned estates must market their entire output through JMOs, which then allocate the edible oil between the domestic and foreign market. A share of private sector output is also channeled through JMOs. The overall allocation for export (including private sector exports) is determined by the Ministry of Agriculture in collaboration with the Ministry of Trade.11/

4.20 The degree to which the current mix of policy instruments has achieved GOI's objectives varies across products. Generally speaking, for those goods subject to external quotas (currently only tapioca) or where Indonesia has a large enough market share to influence world price (e.g., plywood and to a lesser extent rubber) some form of government intervention may be appropriate.12/ For those products where Indonesia cannot influence world prices (e.g., vegetables, salt, and edible oils) the case for any type of intervention is weak.

4.21 Where external quotas have been imposed the primary issue is the design of an efficient and equitable allocation mechanism. Experience in other countries indicates that a transparent and simple allocation mechanism (e.g., public auction) is more likely to achieve the government's objectives of fulfilling the quota while also making it possible to identify who earns the quota rent. The quota allocation can be designed to channel the rent to government, the trade association or to individual traders. The important point is to maintain open entry into production and trading, so that competition between buyers allows price signals to reach farmers. This should encourage both traders and growers to improve quality, without the assistance of a government quality inspection service (see Box 4.1, Allocation of Coffee Quotas).13/

4.22 Where the primary objective is to exploit Indonesia's market position, care needs to be taken to distinguish between short- and long-term advantages. In the short-run, restricting domestic supply may result in an increase in the world price where Indonesia controls a large share of the

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11/ For a comprehensive discussion of trade and other government policies related to the tree crop sector see "Indonesia - Strategies for Sustained Development of Tree Crops" - Report No. 7697-IND.

12/ As discussed in more detail in Chapter 5, even where a country has a large market share, important long-term dynamic effects on both the supply and demand side should be taken into account when deciding upon the optimum tax.

13/ For example, the role of JMOs needs to be reviewed as they appear to pay below market prices to captive suppliers (i.e., state owned suppliers). See World Bank Report No. 7697-IND.

world market (e.g., nutmeg). If an export tax is used the price gain is captured by the Government, whereas, if a quota or domestic purchasing cartel is used the price gain is captured by the quota holder or members of the cartel. In those instances where a quota is used, there is little justification for limiting access to the quota to selected traders. This allows quoter holders to capture all of the price gain, and therefore is unlikely to benefit smallholder producers. In the case of a cartel, members of the cartel can use their market power to capture most of the price gains and to protect themselves during a market downturn (see Box 4.2: The Marketing of Nutmeg).

4.23 In the longer-run, even an export tax may not be to a countries advantage.<sup>14/</sup> Experience in other countries indicates that the negative demand and supply effects of an export tax on agricultural commodities is often underestimated. Foreign consumers reduce consumption or switch to alternative suppliers, while producers in low tax countries are encouraged to increase production. An export tax also reduces returns to producers of the taxed commodity, which may slow the pace of technological change and reduce the incentive to improve quality (see Box 4.3: Longer Term Effects of Export Restrictions on Agricultural Commodities).

4.24 There is also concern that the high rents that are sometimes associated with "approved exporter" arrangements are encouraging the spread of these restrictions to commodities where there is even less justification. For example, trade associations in the frozen prawn and tapioca industries have begun lobbying Government for restrictive arrangements to limit 'harmful' domestic competition. It will, therefore, be important for GOI to develop a clear overall policy strategy to respond to these pressures. Such a strategy should be designed to optimize the economic gains over the medium-term, while ensuring that producers of the regulated commodity are not penalized through the creation of domestic purchasing cartels.

#### D. Case Study: Processed Food Products

4.25 The export of processed food products is a relatively new, but rapidly expanding activity in Indonesia.<sup>15/</sup> After slow and erratic growth between 1982 and 1986, exports have quadrupled over the past two years from US\$35 million to US\$135 million. It is also an industry in which Indonesia is thought to be potentially competitive and one which the government is keen to promote. The direct links with agriculture and the potential of adding value

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<sup>14/</sup> For an example of the type of analysis required to determine whether a low export tax is in Indonesia's advantage, see World Bank Report No. 7697-IND.

<sup>15/</sup> Processed food products are defined as products that in the process of preparation undergo a substantial change in form. Thus, canned fish/vegetable products, refined vegetable oil or instant coffee are considered processed whereas frozen shrimp, coffee beans or crude vegetable oils are not.

to domestic resources are both important government priorities. To investigate the effects of recent trade deregulation measures and the current trade regime a case study of selected processed food producers was undertaken.

4.26 The study was based on interviews with two of the largest business groups that are solely involved in exporting, and an equally large third group that is oriented primarily towards supplying the domestic market. In addition, the preliminary findings of a separate survey of 30 small-scale food processors has been drawn upon. The most important findings were:

- o Much of the increase in competitiveness, and hence export growth, since 1986, has been derived from the depreciation of the real exchange rate.
- o The larger, more well established firms, have gained significantly from the duty exemption/drawback facility, access to subsidized export credit, and the relaxation of investment regulations - although they could increase exports further with less regulation of their imported inputs.
- o The smaller emerging firms continue to find it difficult to circumvent current import barriers (e.g., for sugar and tin plate), and are, therefore, hampered in taking advantage of their potential competitiveness on world markets.

4.27 The two large export oriented food processors exported a total of over US\$17 million canned fruit and vegetables in 1988, up from negligible exports prior to 1985. One of the groups exports under its own product name, while the other relies on marketing its products under an internationally known brand-name. Both groups were attracted to Indonesia by the low land/wage costs relative to alternative countries (primarily Philippines, Thailand and Taiwan). With domestic inputs accounting for an average of 60% of total production costs, the devaluation in 1986 significantly increased competitiveness. One of the largest companies remarked that the devaluation occurred at a time when they had just started to export, and that it gave them a useful cost advantage in gaining a market foothold.

4.28 Both groups also stressed the importance of the import duty exemption/drawback facility with respect to gaining access to tin plate for can-making. As explained in Chapter 2, tin plate imports are restricted to Krakatau Steel in order to protect the domestic tin plate producer. Users of this domestic tin plate indicate that it is of poor quality and is usually sold at significantly above (40%) the world price.<sup>16/</sup> Both firms have been able to use BAPEKSTA to import their tin plate or tin-can needs directly. As the cost of the tin-plate accounts for between 30% to 45% of total production cost, depending on the product, being able to access tin plate at the world

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<sup>16/</sup> In late 1988, imported tin plate was priced at US\$710 per ton compared with the domestic price of US\$982 per ton.

price is a significant saving. In addition, one company stressed the importance of maintaining uniform quality, particularly if the product is marketed under an international brand-name.

4.29 Neither of these groups have been able to use BAPEKSTA to obtain another important input - sugar. This is primarily because sugar is normally traded for minimum orders of 12,000 tons, whereas the annual consumption of the largest food procession group is about 4,000 tons. As users of the BAPEKSTA facility are prohibited from selling sugar to other exporters, there is no choice but to purchase the sugar from BULOG. However, one of the largest exporters was able to negotiate a special price with BULOG which lowered the cost to about 25% (as opposed to 40%) above world prices.

4.30 Both groups have used the Preshipment Export Finance Facilities extensively, which has provided credit at 11% (now 14.5%) compared with commercial rates of over 20%. In one case this financing was used to finance approximately 80% of the value of export orders. As both groups are considered as very credit worthy by their banks, neither had any problem in being granted the credit. While grateful for this added assistance, at least one company did not feel that the subsidized interest rate made an appreciable difference to their competitiveness on world markets. Having access to credit, rather than the subsidy element, was considered of most importance.

4.31 The domestic oriented processed food producer, exported about 10% of production in 1988. The major reason for entering the export market was to establish a market presence to guard against a domestic downturn. As a much larger proportion of this groups inputs are imported, the devaluation was felt to have had a small beneficial effect on international competitiveness and, more importantly, a negative effect on domestic demand. The group reported that it found BAPEKSTA easy to work with and that the duty drawback on imports was essential if they were to maintain any level of exports. The group also made full use of subsidized export financing. The group did not plan to extend production for the export market much beyond current levels. High import protection in the domestic market made it more profitable to sell locally. They also felt that they could not compete on world markets in some of their major products, particularly where other countries were seemingly selling below costs (e.g., milk products).

4.32 The three firms discussed above are among the largest and most well organized in the sector, accounting for about 38% of total processed food exports. They have used their expertise and creditworthiness to make best use of the prevailing trade and financial services to increase competitiveness. The survey of 30 smaller processed food producers was designed to determine whether their experience in exporting was similar to these larger firms. The respondents to this survey felt that exporting was good business, and they wanted to expand their activities. In large part, however, they did not feel that they have benefitted from the deregulation to the same extent as the larger exporters. Of the thirty firms interviewed, most exported under US\$1 million in 1988, the average export level being US\$870,000. Most of these firms were not established with an export orientation. Exporting had

become important to them, however, increasing from 28 percent of total sales in 1987, to a projected 46 percent in 1989. As such these firms are committed to exporting, and are looking for ways to improve their performance.

4.33 Almost universally, smaller exporters complain about their inability to take advantage of the duty drawback scheme.<sup>17/</sup> As smaller exporters, it is not financially attractive to manufacture their own cans. They, thus, have to turn to the more expensive, locally produced cans. Nor are most of these businesses able to negotiate special deals with BULOG to obtain sugar at cheap prices. They are forced to buy from wholesalers at prices well above the world level. For fully refined sugar, the wholesale price can be up to US\$600 per ton, compared with an import price of about US\$400 per ton. Where they do have the opportunity to apply for duty drawbacks, smaller businesses have a great deal of trouble with the paperwork involved. Smaller companies often find this insurmountable, and do not bother to make an application.

4.34 While large companies are able to take advantage of the export credit programs, smaller exporters also find this more difficult. Bankers report that many small companies are not good credit risks. Banks can protect themselves against default by the exporter by purchasing insurance from the Bank Indonesia under the Preshipment Export Finance Guarantee Program, but they have found collection quite difficult. As a result, bankers have a tendency to apply very strict rules to the Preshipment Export Financing Program, and will restrict it to companies with proven records of credit worthiness.

4.35 Both the large and small companies felt that they did not receive much direct assistance from the various government-run export agencies. The government had not provided any marketing support, other than a display for one company at a NAFED<sup>18/</sup> organized trade show. Several respondents stated that they have approached various government agencies for assistance, but had not been provided with any useful information on competitor pricing or labelling requirements in different countries. They also commented that the quality supervision capacity of the government laboratories was poor, and that monitoring and enforcement of regulations was weak. Finally, many commented that shipping costs were a problem, even after the maritime deregulation that took place in 1988. There is a shortage of refrigerated containers, which makes shipping some processed food stuffs expensive.

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<sup>17/</sup> This is less a criticism of BAPEKSTA than it is a comment on the problems of using an indirect mechanism to redress price distortions caused by high import tariffs and NTBs.

<sup>18/</sup> National Agency for Export Development.

BOX 4.1

ALLOCATION OF COFFEE QUOTAS

1. Indonesia is now the third largest supplier of coffee after Brazil and Colombia, exporting approximately 80% of total domestic output valued at US\$550 million in 1988. Indonesian coffee is primarily produced by smallholders, with about 95% of production on plots of three hectares or less. The beans are sold through a series of traders from the village to the provincial level, with provincial level wholesalers selling to "approved exporters". It is at this final stage where most of the cleaning and sorting is done. The techniques employed vary tremendously from exporter to exporter, some using modern scanning machinery and others employing hundreds of workers to sort by hand. Since the quality of the coffee going into this process is poor, exports are generally Grade 4 under the coffee defects standards.

2. Coffee exports from Indonesia are restricted to approved exporters. When the International Coffee Agreement (ICA) was in effect, an export license with quota was issued quarterly by the Ministry of Trade. The quota was based primarily upon past export performance, including exports to non-quota countries. The Ministry of Trade usually held about 25% of the quota in reserve to distribute to exporters that fulfilled their quota allocation early in the quarter. About 10% of the coffee quota was held by the six State Trading Companies (STCs), who, for the most part, were 'briefcase' exporters.<sup>1/</sup> It is estimated that

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<sup>1/</sup> 'Briefcase' exporters is a term used to describe those quota holders that derive most of their income from trading the quota right as oppose to trading coffee. See Chapter 2.

70 percent of the STCs allocation was sold to other exporters. What coffee they did export was usually of poor quality, reflecting their poor sorting and packing facilities.

3. Indonesian exports to non-quota countries have taken an increasing share of total coffee exports in recent years (see Table 4.4). Exporters were encouraged to export to non-quota countries, via an incentive of receiving additional quota allocations from the Ministry of Trade's quota-coffee reserve. Exports to non-quota countries is also restricted to approved exporters. The main markets for this trade is Algeria, Eastern Europe and China.

**Table 4.4: INDONESIA COFFEE EXPORTS TO QUOTA AND NON-QUOTA COUNTRIES (thousands of 60 kgs bags)**

Destination	1986/87	1987/88	1988/89 <u>/a</u>
Quota countries	3,754	3,232	2,237
Non-quota countries	1,154	1,353	2,905
Total	4,908	4,585	5,142

/a Through mid-February only.

Source: United States Department of Agriculture, Foreign Agricultural Service.

4. In July 1989 the International Coffee Agreement expired and was not renewed because of disagreements between its two most important members, the United States and Brazil. Breakdowns such as this have occurred before, and in the past the agreements have been renewed after

a year or two hiatus. Although Indonesia suspended its quota system to coincide with this, trade has continued to be restricted to approved exporters.<sup>2/</sup> Coffee exporters and the Ministry of Trade have supported keeping this system on the basis that it prevents "unhealthy" competition, and that it provides security for exporters.

5. The system of appointing approved exporters and the past allocation of quotas has several drawbacks. The opaque way by which quotas were allocated created the opportunity for abuse and apparently allowed certain groups to maintain their quota rights (and hence quota rents) without having much direct involvement in coffee. The security provided to current quota holders diminished performance incentives, (e.g., to increase quality) as there was a low probability that the quota would be withdrawn. The barriers to entry to trade in coffee have reduced competition on the domestic market resulting in lower farm gate prices. Lower prices have not encouraged farmers to invest in quality improving growing or sorting techniques.

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<sup>2/</sup> Minister of Trade Decree No. 265/Kp/X/89 states that although quotas have been lifted one must still be a registered coffee exporter to be allowed to export.

BOX 4.2

THE MARKETING OF NUTMEG

1. Indonesia dominates the world market for nutmeg, supplying over 70% of the world's trade volume. The only alternative major source of supply is Grenada. Over 90% of Indonesia's nutmeg is grown by smallholders who sell it through district buyers to provincial level wholesalers. Exports are restricted to approved exporters, who must be members of the Nutmeg Trade Association (ASPIN). Nutmeg was the last major spice moved in to the approved exporter list (after pepper and cinnamon), and there are now about 43 approved exporters. A Joint Marketing Board (JMO) was also created in 1986, at the same time as the product became restricted to approved exporters. The objective of these regulations is to prevent "unhealthy" competition and thereby secure the highest possible price for Indonesia's nutmeg exports.

2. Between 1986 and early 1989 ASPIN entered an agreement to sell all of Indonesia's nutmeg through a single foreign spice trading firm at an agreed price. With the implicit cooperation of the Grenadan Nutmeg Association, this firm was able to restrict supply and increase world prices. However, as there was no official overall quota, approved Indonesian exporters increased their demand for nutmeg, causing domestic prices to increase from about Rp. 2,000 per kg in 1986 to Rp. 4,000 per kg in 1988. In response to these higher prices, the domestic output of nutmeg expanded. In order to maintain high world prices the foreign spice trading firm refused to purchase the increased volume of nutmeg, which encouraged approved exporters to find alternative buyers. As a result the agreement collapsed in early 1989, with the control of exports reverting to the JMO. The JMO attempted to defend current prices by posting a monthly price which all ASPIN members were to adhere

to or face expulsion from the trade association. As this price is high in relation to current world demand and supply conditions, ASPIN members have been forced to hold stocks or sell outside the agreement. This has resulted in domestic farmgate prices falling drastically to Rp. 1,500 per kg, which is below the world price. Domestic prices are being held low to allow approved exporters to sell-off local stocks.

**BOX 4.3**

**LONGER TERM EFFECTS OF EXPORT RESTRICTIONS ON**

**AGRICULTURAL COMMODITIES**

**Cocoa and Palm Oil**

1. In the early 1960s two African countries supplied nearly 60% of the world cocoa and palm oil markets. During the next twenty years,

**Table 1: PERFORMANCE OF COCOA AND PALM OIL EXPORTS UNDER ALTERNATIVE EXPORT TAX REGIMES**

Commodity and Country	Export Tax /a	Export Market Share		Growth Rate 1961-84 (% p.a.)	
		1961-63	1982-84	Output	Exports
<b><u>Cocoa</u></b>					
Ghana	High	40.1	14.4	-3.7	-4.2
Nigeria	High	18.0	11.2	-2.0	-1.9
Cote d'Ivoire	Low	9.3	26.3	7.3	6.0
<b><u>Palm oil</u></b>					
Nigeria	High	23.3	0.2	1.4	-23.6
Zaire	High	25.1	0.1	-1.8	-15.5
Indonesia	Moderate	18.4	8.2	9.7	6.2
Malaysia	Low	17.9	70.6	19.0	18.0

/a The export tax includes both the explicit export tax plus an estimate of the overvaluation of the exchange rate.

Source: World Development Report, 1986.

these countries imposed high export taxes to exploit their perceived monopoly positions.<sup>1/</sup> These taxes seriously eroded domestic producer profitability, resulting in lower levels of investment and output growth. Over the next twenty years their market share fell to 25% for cocoa and below 1% for palm oil (see Table 1). The contrast with the performance of Cote d'Ivoire (cocoa) and Malaysia (palm oil), over the same period is striking. Both countries avoided high export taxes and both have achieved dramatic output growth, capturing growing shares of the world market. Experience from other countries (e.g., Argentina) indicates that it is easy to underestimate the longer run effect that an export tax will have on relative incentives and hence on domestic investment, efficiency and competitiveness. This is particularly true for those commodities where entry costs are not prohibitive or where close substitutes exist.

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<sup>1/</sup> These export taxes were imposed via both crop specific taxes plus the effects of misaligned exchange rates.

## CHAPTER 5

### A POLICY FRAMEWORK FOR FUTURE REFORM

#### A. The General Objectives of Reform

5.01 Since the mid-1980s, GOI has implemented several policy initiatives intended to create a more open and less regulated trade environment. These reforms are part of an on-going broader deregulation program designed to decentralize economic decision-making and encourage greater participation by the private sector. The guiding principles of the trade reforms have been to move towards a trade regime based on tariffs rather than restrictive import licenses and to reduce the bias in incentives against exports. While significant progress has been made, further steps are necessary to complete the transition away from a 'high-cost' inward-oriented economy. As discussed in Chapter 2, the net effect of the current trade regime is to impose a heavy tax on trade. The continuing overall anti-trade or anti-export bias can be gauged by comparing the aggregate ERPs for import-competing goods (+44%) against that for export-competing goods (-2%). The same bias applies across sectors and within broad economic groups. This pattern of incentives has detrimental effects on economic growth and employment creation in manufacturing (Chapter 3) and agriculture (Chapter 4).

5.02 The strong positive response of the economy to the deregulation measures taken to date, has created a favorable environment within which to pursue further reform. Private sector confidence in the government's macroeconomic management is strong and there are expectations that further supporting microeconomic reforms will be forthcoming. This has resulted in a marked jump in planned foreign and domestic private sector investment. A further reduction in both the level and variance of protection is needed to attract this investment towards activities where Indonesia has a clear comparative advantage. This will encourage the efficient allocation of scarce investment resources and avoid protectionist pressures building-up in the future.

5.03 Following the rapid growth of non-oil exports during 1986-89, some slowdown in growth rates may be inevitable. This is not surprising as existing capacity becomes more of a binding constraint. But this underscores the importance of a sound incentive and regulatory framework to achieve the next stage of expansion of non-oil exports. Of particular concern is the recent slight appreciation of the real exchange rate and, more importantly, the continued anti-export bias of the trade regime. There is also some concern that the complex domestic regulatory framework (including the legal system) is slowing the pace at which planned investment is being realized.<sup>1/</sup> While Indonesia is now seen as a new low-cost Asian export base, further policy reform will be needed to take full advantage of this opportunity. The

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<sup>1/</sup> See Chapter I, for discussion of recent trends in approved and realized investment.

current robust macroeconomic conditions would argue for accelerating the pace of reform to capitalize on this opportunity.

5.04 The broad objectives underlying the next phase of reform should be to move towards a more neutral and administratively simple trade regime. This implies that there should be fewer trade policy interventions (e.g., a reduction in restrictive import licenses and export regulations) and that the bias in favor of producing for either the domestic market or the export market should be reduced. It also implies that where trade policy interventions are considered necessary, e.g., externally imposed quotas, the administrative implementation mechanism should be transparent and efficient. More specifically, the next phase of reform should include:

- o Reducing the coverage of NTBs from the current level of 29% of total domestic production, focussing on areas in both the manufacturing and agricultural sector where NTBs provide high protection to domestic production.
- o Initiating a medium-term tariff reform program by eliminating split-tariff positions, phasing out surcharges, and announcing a phased plan to lower the maximum tariff rate from 60% to 20% over a specified time period.
- o Reviewing the economic costs and benefits of the current mix of export regulations (particularly export bans, quotas and approved exporter arrangements) to reduce export restrictions and, where such restrictions are justified, to improve the implementation mechanisms.
- o Improving the efficiency and coverage of BAPEKSTA and the export credit/insurance mechanism, as part of a general move towards placing all export assistance measures on a more commercial basis - including the removal of interest rate subsidies.
- o Strengthening GOI's institutional capacity for analyzing trade policy issues.

5.05 In terms of the timing and sequencing of the reform program, the removal of as many import NTBs as possible remains the first priority. It is recommended here that the removal of these NTBs be accompanied by the initial phase of tariff reform and, if possible, the removal of those export restrictions that are clearly not in the economy's best medium-term interests. Based on experience in other countries it is also recommended that the tariff rationalization program be completed over a period of about three years. Other components of the trade reform program, such as developing a stronger institutional capacity for dealing with trade issues, improving BAPEKSTA, reviewing the remaining export regulations, and phasing out export finance subsidies could also be completed within three years. While domestic political, economic and social factors will determine the actual pace of reforms, studies of other countries indicate that this sequencing of reform steps is likely to achieve the strongest economic results. These studies also

indicate that it is important for governments to give the business community a clear signal of the direction of future policy change and to take steps to convince the private sector that the reform program will be implemented. GOI's strong track-record for promptly implementing difficult policy actions has enhanced the Government's credibility and therefore its ability to influence private sector expectations.

5.06 Before discussing the recommended reform proposals in more detail, two further points should be made. First, further trade reform needs to be implemented within a balanced macroeconomic policy framework which takes into account adjustments in the trade regime. For example, the removal of most of the remaining NTBs coupled with a significant lowering of the import tariff will exert pressures on the external account. The economic repercussions of this type of microeconomic reform may need to be accompanied by appropriate macroeconomic measures. As noted in Chapter 1, the consistency of GOI's monetary, fiscal and exchange rate policy has been a central feature of Indonesia's successful economic adjustment to the severe external shocks experienced since the early 1980s. With the immediate economic crisis passed, however, it is no less important to continue to use these macroeconomic measures to maintain external and internal balance. Second, to benefit fully from the proposed trade reforms, complementary action in other areas, such as the domestic regulatory framework and the legal system, will be required. There is some feeling in the business community that reforms in the financial sector and to some extent import regulations have been implemented at a faster pace than in other areas. Particular concern has been expressed about the regulatory environment for investments outside of Jakarta. A concerted effort will be needed to maintain relative progress in deregulating both domestic and foreign trade regulations, including issues of implementation in the provinces.

#### **B. Non-Tariff Barriers to Imports**

5.07 As part of the overall strategy to move to a trade regime based on tariff rather than import license protection, GOI intends to eliminate all non-tariff barriers on imports except for a small group of products that are harmful to health, strategic to national defense or involve special economic and social considerations.<sup>2/</sup> The Government's commitment to attaining this objective has been demonstrated by the four trade deregulation packages that have been implemented since 1986. Nevertheless, over 900 items remain on the Restricted Goods List and, as discussed in Chapters 2 through 4, the resulting NTBs are the primary cause of important price distortions in manufacturing and agriculture. These price distortions have drawn resources into activities in which Indonesia does not have a comparative advantage (e.g., sugar or motor car production), increased costs for downstream industries, and lowered the rate of economic growth and employment creation at the economy-wide level.

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<sup>2/</sup> Government's "Statement on Economic Policy", Annex IV; Trade Policy Adjustment Loan II.

5.08 The reduction of NTBs can be approached in two ways. Either the NTB on a particular product can be removed or the restrictiveness of a license category can be reduced. The previous deregulation packages have used both approaches, with an emphasis, quite correctly, on the former. Removing items from the Restricted Goods List (i.e., classifying a good as IU) is administratively simple and, more importantly, it unambiguously opens access to all bona fide importers.<sup>3/</sup> An important objective of Indonesia's broader deregulation drive is to simplify and streamline administrative procedures so as to encourage private sector initiative and reduce the burden on Government departments. The reclassification of products under the General Importer (IU) license fulfills these objectives, and should remain the preferred option.

5.09 Where this has not been possible, or as an initial step towards deregulation, products have been moved from highly restrictive license categories (i.e., PI or IT) to less restrictive license categories (i.e., IP), and in some cases products have been classified under more than one license category (e.g., IP/IT). One extension of this approach would be to reduce the number of restrictive license categories. For example, the 348 products that are classified as IT (i.e., restricted to the six State Trading Corporations) could automatically be classified as IP items (i.e., open to all importer - producers). This would reduce the number of license types (by merging the IT license category with the IP license), and significantly increase competition by broadening access to all importer-producers. While such a move would be desirable, it does not completely remove the necessity to gain administrative approval to import a restricted commodity - i.e. one would still need an IP/IT license. Hence, the strong preference for reducing the number of goods on the Restricted Goods List by reclassifying goods under the IU license.

5.10 Partly because of the scope of the previous deregulation packages, the next phase of removing import license restrictions will entail focusing on difficult areas. The reduction of the coverage of NTBs below the current level of about a third of total domestic sales will involve: (i) the removal of all remaining NTBs in industries that have already been subject to deregulation (e.g., steel, textiles, chemicals, paper and pharmaceuticals); (ii) reducing the trading monopolies that BULOG and the STCs have on agricultural commodities and processed food and beverages;<sup>4/</sup> and (iii) dismantling the current mix of import license restrictions, import bans and domestic regulations that are used to protect the local mechanical and electronic goods industry, including heavy equipment and motor cars.

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<sup>3/</sup> For detailed definition of the various import license types see Chapter 2. Briefly, the IU license is non-restrictive, requiring only a business permit and a tax payers number. All other license categories (i.e., IP, AT, IT and PI) are restrictive to various degrees.

<sup>4/</sup> Where strategic or special economic/social conditions are paramount, these should be clearly specified together with the rationale for restricting international trade to one trader.

5.11 As discussed in Chapter 3, the remaining NTBs on steel, textiles, chemicals, paper and pharmaceuticals are on particular products where concerns for existing manufacturing plants have slowed the pace of reform. Failure to tackle these difficult areas will, however, retard the restructuring of these industries, and have broader detrimental effects through the negative price effects on downstream users. In most cases the process of restructuring these industries is already underway, and the move to an import tariff of 20% or 30% would not cause major dislocations.

5.12 In the case of steel, the domestic industry is competitive in basic steel products (slabs and billets) and hot rolled steel products. This part of the industry could be completely deregulated and placed on a tariff of less than 20%. Production of tin plate, cold rolled steel and the associated downstream products (e.g., tin cans or galvanized steel sheets) is less efficient. Both the tin plate factory and the Cold Rolling Mill are high cost producers, partly due to low volume throughput and/or high outstanding debt repayments. Given the sensitivity of the issues involved in exposing these plants to open competition, some form of direct measures to permit both these factories to sell close to world prices would be desirable. Containing the deviation from world prices at the plant level would at least reduce the detrimental price effects on potentially competitive downstream activities (e.g., processed food producers using tin cans) capital goods manufacturers and the construction industry.

5.13 The removal of the remaining NTBs in the textiles industry involves two distinct issues. First, there are a number of synthetic fibres and yarns that continue to be categorized under the IP license. While this does not appear to be hampering the current development of the industry, it has raised concerns in the minds of downstream fabric and garment manufacturers about the direction of future policy. Given the importance of the textile industry to non-oil export earnings and employment in the manufacturing sector, the competitiveness of the more labor-intensive downstream industry should not be compromised by increased protection of the capital-intensive upstream industry. The removal of the remaining NTBs on synthetic fibres and yarns would reaffirm the government's commitment to maintaining a competitive textiles industry. Second, there are about 250 split-tariff positions in the textiles sector which have been created to cover all batik fabrics and garments. These items have been restricted to the State Trading Companies (STCs), and placed under an informal ban. This reflects GOI's efforts to protect a part of the indigenous batik industry which is extremely labor intensive and is considered to warrant protection for economic and cultural reasons. The Restricted Goods List could be greatly simplified by removing these split-tariff positions and making the special provisions currently being made for the batik industry explicit. This could be achieved either through an above average tariff or a formal ban.

5.14 The NTBs on chemicals, pharmaceuticals and paper cover a wide range of products. With the exception of white newsprint paper, none of the restricted items account for a significant share of domestic output in these

industries. For the most part, further reform would involve a 'cleaning-up' exercise to remove the remaining anomalies within industries which have been largely deregulated. This would encourage further restructuring, reduce the profits of some traders, and yield important benefits to downstream users - including domestic consumers.

5.15 The extensive coverage of import license restrictions on processed food and beverages and agricultural commodities is discussed in Chapter 4. Most of the processed food and beverage items are restricted to the State Trading Companies (STCs), particularly Tjipta Niaga and Kerta Niaga. The recent growth in processed food exports and the declining share of the STC's business that is derived from this import/export trade, indicates that both STCs and domestic processed food producers are well positioned to adjust to a more competitive position under tariff protection. A recent survey of STCs indicated that over 70% of their business is derived from the domestic distribution of goods. Trading in imports accounts for less than 25% of their turnover and has been declining since 1986.<sup>5/</sup> Moreover, removing the monopoly trading rights of STCs will not necessarily result in a loss of business. Where STC do have a competitive edge, they should retain a major share of the import trade. With regard to the domestic processed food industry, it would appear that most firms could compete against imports with moderate to low import tariff protection. This is illustrated by the rapid growth in processed food exports (albeit from a small base) from firms that have access to inputs at world prices.<sup>6/</sup> Nevertheless, producers for the domestic market are disadvantaged by having to purchase some important inputs at prices higher than world prices - particularly packing materials (tin cans and tetrapak) and sugar. Consequently, the removal of NTBs on processed food and beverage products should be accompanied by the simultaneous removal of all NTBs on upstream inputs into the industry.

5.16 The NTBs on agricultural commodities restricted to BULOG (primarily rice, wheat, wheat flour, sugar, soybeans and soybean meal) cover a large share of agricultural value added and trade. With the possible exception of rice, the resulting price distortions have encouraged agricultural resources to be used in activities which yield low economic rates of return and have taxed Indonesian consumers (see Chapter 4). Given the important role that these crops play in the agricultural sector, changes in trade policy will have to be assessed in the context of GOI's overall agricultural strategy. Nevertheless, these crops are also important to the majority of Indonesian consumers. In the case of rice and wheat, some easing of BULOG's monopoly position may be warranted to increase competitive pressures on both traders and producers. As a first step, a quota allocation for each product could be auctioned off to private traders. This would reestablish a more direct link between domestic and world prices and provide a useful safety-value when domestic production falls below expectations (e.g., the rice crop in 1987/88). If successful, the quota could be gradually increased, until such a time as

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<sup>5/</sup> Exports account for the remaining 5%, primarily coffee and spices.

<sup>6/</sup> See Chapter 4, Case Study of Processed Food Producers.

moving to an import duty is considered appropriate. BULOG could still play its role in stabilizing domestic prices, by purchasing or selling these agricultural commodities to moderate the impact of private market transactions. The trade restrictions on sugar and soybean meal could be removed immediately and replaced with an average tariff.

5.17 Removing the NTBs on mechanical and electronic goods involves complex issues related to GOI's broad industrial sector strategy. As discussed in Chapter 2, trade barriers (bans, AT and IP licences) and the domestic content/deletion program are used to encourage the development of an indigenous engineering capacity. Currently, the engineering sector is encouraged to produce a wide range of mechanical, electrical and transport equipment. While Indonesia's competitiveness in this area is improving, there are a number of products which can only be produced at very high cost - in some instances at negative value added in terms of world prices. For example, recent price comparisons for AC generators (CBU), TV sets, and motor vehicles revealed Indonesian prices to be 92%, 27% and 42% above the respective world price. The resulting high cost of capital goods imposes additional costs on a wide range of domestic downstream industries - some of which are, or could be, competitive on world markets.

5.18 In recognition of this problem, the Government allows export-oriented firms to import some of their capital goods duty free, through either BKPM or BAPEKSTA. While this is a useful mechanism for exporters, it does not assist producers for the domestic market or small-scale exports, and approval to import duty-free is still subject to administrative discretion. In addition, efficient domestic producers of mechanical and electronic equipment can be disadvantaged by the current system. For example, if an investment project has BKPM/BAPEKSTA approval, domestic suppliers of engineering goods to this project have to compete against imported machinery which is exempt from import duty protection. This may disadvantage domestic producers where they have to purchase some of their inputs (e.g., steel or tin) at above world prices from domestic suppliers.

5.19 Moving away from the current complex administrative system for mechanical and electronic goods towards fairly uniform tariff protection would have several advantages. These include: (i) the engineering sector (defined in its broadest sense) would be encouraged to rationalize domestic production, focusing on those products which can be produced domestically with moderate tariff protection; (ii) the degree of administrative discretion involved in determining access to these goods at world prices would be removed, creating greater certainty for downstream users (especially for small and medium size enterprises); (iii) the differential access of export-oriented as oppose to import-substitution activities to capital goods would be removed; and (iv) the tariff structure would still permit slightly higher tariffs to be levied on those mechanical and electronic products where GOI decides it is important to encourage domestic production.

### C. Tariff Reform

5.20 It has been five years since the last major reform of Indonesia's tariff schedule. Since that time, the substantial progress made in reducing NTBs has, as intended, increased the relative importance of tariffs in the incentive regime. At the same time, partly in response to the removal of NTBs, ad hoc changes have been introduced in the tariff structure which have increased the level and dispersion of tariffs, particularly in the manufacturing sector. While the detrimental effect that the resulting import tariff schedule has had on exports has been partially offset by an efficient import duty exemption scheme (BAPEKSTA), this facility has been less successful in reaching small-scale or indirect exporters. Moreover, BAPEKSTA cannot assist disadvantaged producers for the domestic market or Indonesian consumers. Given the anticipated removal of more NTBs and the recent increase in private investment, it is opportune to consider a systematic reform of the current tariff schedule.

5.21 There is a substantial amount of empirical evidence which suggests that the primary objective of tariff reform should be to move towards a tariff structure where both the absolute level and the variance between tariff rates is as low as possible.<sup>7/</sup> Such a structure reduces the range of protection provided to different economic activities, lowers the tax on domestic consumers, and removes the pressures to provide special treatment to powerful lobby groups. Moreover, the design of an optimum tariff structure requires detailed information on a wide range of constantly changing prices and production techniques, which policy-makers in any country are unlikely to have. While the theoretical conditions for ensuring that a low single uniform tariff structure is optimum will seldom be satisfied, the costs of deviating too widely from this bench-mark may be very high.

5.22 For these reasons, the tariff reform program discussed below has been designed to move towards a low and fairly uniform structure of statutory tariff rates. The proposed program has two basic components. The first involves a "tidying up" of the current schedule through the removal of split-tariff positions and the gradual elimination of surcharges.<sup>8/</sup> The second is a broad-based strategy involving the reduction of both average tariff rates and the degree of tariff dispersion. The broad-based reform is based on tariff reductions across the whole tariff structure as opposed to reductions in tariffs for particular industries. The industry-by-industry approach is not recommended because it can open the tariff reform process to protracted negotiations with affected groups, and it can result in a temporary worsening of price distortions due to complex inter-industry linkages. Reducing tariffs across the tariff structure is preferable because it appears even-handed, it

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<sup>7/</sup> See "Trade Liberalization: The Lessons of Experience", by Michaely, Choksi and Papageorgiou; and "Strengthening Trade Policy Reform", World Bank; and "Issues in the Design of Tariff Reform" by Prof. A.C. Harberger.

<sup>8/</sup> For definition of split-tariff positions, see Chapter 2.

removes the discretionary element in deciding which industries to focus on first, and it is administratively simple. Finally, establishing a lower more uniform import tariff would also relieve the administrative pressure currently placed on BAPEKSTA. As non-oil exports expand further, the burden on BAPEKSTA to efficiently process a greater number of applications will grow. Lower tariffs would reduce the incentives to use BAPEKSTA, freeing BAPEKSTA's staff resources to extend the scheme to capture small-scale and indirect exporters.

5.23 Split Tariffs. As discussed in Chapter 2, the subdivision of the tariff code by the use of splits complicates the tariff schedule in several ways. First, there is a loss in transparency when the split-tariff position is used to provide NTB protection, or differential tariff rates, to part of a standard 9-digit product description. As separate trade data are not collected for split items, policy makers cannot assess the implications of the increased protection. Second, the use of splits increases uncertainty because they can be created and changed more easily than the basic tariff code. Finally, they can be used to provide "made to measure" assistance for very specific products, which runs counter to the Government's objective of establishing a more uniform tariff structure.

5.24 The removal of splits should be accomplished by absorbing the split-tariff position back into the base-tariff position. The tariff and surcharge rates applied to the single item could then be set at either the rate that applied to the old split item or the rate that applied to the old base item. Given the general rationale of the reform effort there would be a strong case for selecting whatever import duty rate was lower.<sup>9/</sup> The removal of splits will result in a reduction of the dispersion of tariff rates, both overall and within commodity groups. It will also eliminate the unequal treatment given to particular commodities within commodity groups and hence the uncertainty this generates.<sup>10/</sup> Column one of Table 5.1 shows the effects of removing splits and applying the split tariff rate to the unified item.

5.25 Surcharges. The use of surcharges entails many of the same drawbacks associated with splits. They can be imposed more easily than the basic statutory tariff can be changed, and they can be used to target assistance to specific producers. It is proposed that all surcharges be removed in a phased, systematic manner. First, as there remains some uncertainty about the extent of surcharges - which surcharges have lapsed and so on - it would be

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<sup>9/</sup> As noted in Chapter 2, split tariff rates are on average lower than base tariff rates while split surcharge rates are on average higher. Thus, it may be appropriate to adopt the split tariff rates and the base surcharge rates when removing the splits. This is not a crucial point however as in aggregate, unweighted terms the difference is minimal.

<sup>10/</sup> If there are truly compelling reasons for separately identifying split items, then as a minimum these items should be given their own code within the Harmonized System. This is an inferior option to the removal of splits but will at least ensure that separate data are collected for the split item.

useful to issue a complete list of which surcharges are currently in effect. In compiling such a list, it may be appropriate to conduct a broad-based review, removing surcharges where they are no longer necessary. Second, as many surcharges were introduced to provide temporary protection following the removal of NTBs, it should be announced that all surcharges are to apply for a period of one year. After that year, extensions would be granted only to those activities which are restructuring to become more efficient and competitive. The remaining surcharge would have a maximum value of 50% of the original rate and would apply for one year. After the second year, all surcharges would automatically expire, with no exceptions.

5.26 If, after the initial publication of the full surcharge list it is deemed necessary to provide temporary surcharges for additional items,<sup>11/</sup> it should be clear that these surcharges are subject to the same "sun-set" clause. Thus, the additional surcharges would be reviewed after one year. Those that are not removed during the review period would be set at half the original rate and then revert to zero after one further year. Proceeding in this manner places a definite end-point to the use of surcharges and avoids any item receiving special, ad hoc treatment. The phasing of the removal of surcharges will allow those industries moved off NTB protection time to adjust. The impact of removing surcharges on Government tax revenue is minimal, estimated at less than 0.1% of total non-oil tax revenue.<sup>12/</sup>

5.27 As mentioned in Chapter 2, an additional reason for the introduction of surcharges has been a defense against dumping. Surcharges, however, do not constitute an appropriate anti-dumping device. Surcharges apply to particular commodities over a period of time whereas anti-dumping procedures constitute essentially legal actions by one party (for example, a firm) against another with respect to a particular shipment. Thus, the appropriate response to dumping is the imposition of specific penalties related to a particular supplier rather than measures which apply to a broad commodity group. If dumping is indeed a significant problem within certain industries, then the appropriate response is to establish anti-dumping procedure aligned with GATT rules.<sup>13/</sup> This would involve the clear demonstration that dumping has occurred and has in fact damaged particular firms. Clear procedures would eliminate the possibility of the benefits of the reform being reduced as has been evidenced in the past use of surcharges.

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<sup>11/</sup> For example, following the removal of NTB protection.

<sup>12/</sup> The revenue implications of both the removal of surcharges and the reduction in base tariff rates is discussed in more detail in paras 5.37 to 5.40 below.

<sup>13/</sup> GATT principles require that duties only be imposed to the extent of any dumping margin and that they only be imposed once it has been established that: (a) dumping has occurred; (b) injury has been caused or threatened to a domestic industry; and (c) there is a causal link between dumping and injury.

**Table 5.1: EFFECTS OF PROPOSED REFORM PROGRAM ON UNWEIGHTED AVERAGE TARIFFS**

Sector	Removal of Splits	Reduction in Tariff Ceiling		
		50	30	20
<b><u>Economy-wide</u></b>	<b>26</b>	<b>28</b>	<b>18</b>	<b>14</b>
Agriculture	16	16	16	12
Mining	5	5	5	5
Manufacturing	27	24	18	14
<b><u>Manufacturing sector</u></b>				
Food Manufacturing	27	26	28	17
Beverages	41	41	27	19
Tobacco	52	25	25	17
Food, Beverages and Tobacco	28	27	24	17
Textiles	44	39	28	18
Wearing apparel	56	48	29	20
Leather products	24	24	17	13
Footwear	70	48	30	20
Textiles, leather and footwear	46	40	28	19
Wood, cork and products	25	25	25	18
Wood furniture	47	47	30	20
Wood, cork and products	29	29	26	18
Paper products	21	21	21	15
Printing and publishing	18	18	16	11
Paper and printing	21	21	20	14
Industrial chemicals	8	8	8	7
Other chemicals	16	16	15	12
Petroleum refining	5	5	5	5
Petrol and coal products	6	6	6	6
Rubber products	42	25	18	14
Plastic products nec	37	37	27	19
Chemical, petrol and coal	14	13	12	9
Ceramic products	52	44	27	18
Glass and glass products	37	34	22	15
Other non-metal products	29	27	20	15
Non-metallic industries	35	32	22	16
Iron and steel basic metal products	10	10	10	8
Non-ferrous basic metal products	10	10	10	9
Basic metal products	10	10	10	8
Metal products nec.	25	24	22	17
Non-electric machinery	14	14	13	11
Electric machinery	23	22	18	13
Transport equipment	37	28	16	11
Scientific equipment	15	14	14	12
Metal products and machinery	21	19	16	13
Other manufacturing	36	36	26	18
Dispersion	89	77	64	55

Source: World Bank staff estimates.

5.28 Broad-Based Reform. The above proposals essentially set the stage for a much broader-based reform of the tariff schedule. The proposal here is to reduced the highest allowed tariff rates to a common ceiling, and then to lower the ceiling tariff over time. This 'tops down' approach results in a reduction in the level and variance of protection at each step. The exact ceiling rates and the phases should be carefully chosen and clearly announced at the outset of the reform program. Such preannouncement sends a clear signal to the business community concerning the direction of future policy change which reduces investor uncertainty and enables more informed investment decisions to be made.

5.29 The proposal explored in this report is to move to a 50% ceiling in year one, 30% in year two and 20% in year three. To establish the credibility of the program, the plan to introduce a phased reduction in maximum tariffs could be announced at the same time as the 50% ceiling is imposed and measures are taken to deal with splits and surcharges. In addition, it may be worthwhile considering rationalizing the tariff structure further by imposing more uniform rates within commodity groups. This would result in some low rates (zero or 5% import duties) being raised. Finally, it would also be desirable to eliminate some of the exemptions to import duty, replacing them, where appropriate, with less distortionary corporate or investment tax credits.

5.30 The overall approach has the practical advantage of being simple, easy to administer, and would involve a minimum of uncertainty. The timetable would be announced in advance and details of all the items affected at each step of the reform could be provided. Thus firms would know the pace at which protection for their products will diminish which should reduce the costs of adjustment. There is also flexibility in the detailed design of the reform program -- the timetable, the tariff rates that are chosen, etc. Nevertheless, given the likely resistance to change from powerful vested interests, there is a strong argument to implement the reform in a relatively short period - particularly if this can coincide with a period of macroeconomic stability and robust growth. In addition, the recent significant jump in actual and planned private investment, underlines the necessity of creating an incentive framework which channels new resources into competitive activities.

5.31 Step 1: Tops down to 50 per cent: There are some 1500 items with tariff rates above 50 per cent in the Indonesian schedule. Those with the highest rates are motor vehicles and tires. Tires are protected by specific-import duties, the ad valorem equivalent of which are very high in many cases. Reforming these items will involve changing the tariff from a specific to ad valorem and adopting a maximum import duty rate in line with other tires (20% to 40%).

5.32 The effect on average tariffs of tops down to 50 per cent is presented in Table 5.1. Clearly, the greatest pressure will be felt in transport equipment and rubber products and indeed there may be considerable

resistance to a reduction of these tariff rates. It should be ensured that this does not prevent reductions in other tariffs from taking place. If necessary, the tariffs (and in some cases bans) on motor vehicles can be maintained as a special case. However, there would need to be very clearly defined reasons for this. Further, it is likely that the objectives behind the use of the tariff on motor vehicles could be achieved more efficiently through other policy instruments, such as an excise or general luxury tax. If it is decided to maintain the tariff, the community should be aware of the costs of doing so.

5.33 Step 2: Tops down to 30 per cent: From the tariff structure established in step 1, reduce all tariffs above 30 per cent to 30 per cent. Table 5.1 summarizes the effects of this. In terms of average tariff reductions, the greatest changes occur within textiles, leather and footwear and within non-metallic industries. In particular, wearing apparel, footwear and ceramic products experience large reductions in average tariffs. This is unlikely to cause major problems as most of these industries are now primarily geared to the export market and could compete on the domestic market with significantly lower import duties.

5.34 Step 3: Tops down to 20: From the tariff structure established in step 2, reduce all tariffs above 20 per cent to 20 per cent. Table 5.1 summarizes the effects of this step.

5.35 Rationalizing Tariff Rates: The above changes will result in a reduction of average tariff rates as well as a substantial reduction in dispersion. As noted above, the tariff schedule can be further rationalized by ensuring that broad commodity groups, at the 4-digit level for example, receive uniform tariff rates and by removing some tariff exemptions. Actual import tariff collections are less than half the current average statutory tariff rate, reflecting the effect of numerous tariff exemptions. In the case of BAPEKSTA, the import duty exemption is justified. However, the need for import duty exemptions for general investment should be reconsidered, as should exemptions for the oil and gas industry, imported inputs for specific traders (e.g., edible oil), and foreign aided projects. In some instances, this will involve the raising of tariff rates. This will ensure a more uniform treatment for particular products, and will raise additional revenue.

5.36 Other Components of Reform: As mentioned above, it is important that the reform be announced in advance with a clear timetable and that this timetable is adhered to. This will increase the creditability of the reform program and considerably aid adjustment to the new tariff regime. It is also important that the government be informed as to how the reform is proceeding and monitor its effects. This is a fairly data intensive, complex task, which would be best undertaken by a unit specifically equipped (both in terms of hardware and expertise) to analyze and examine tariff reform in an economy-wide context. Such a unit would provide quantitative information and analysis to the government concerning the effects of reform and deal with the inevitable lobbying for exceptions.

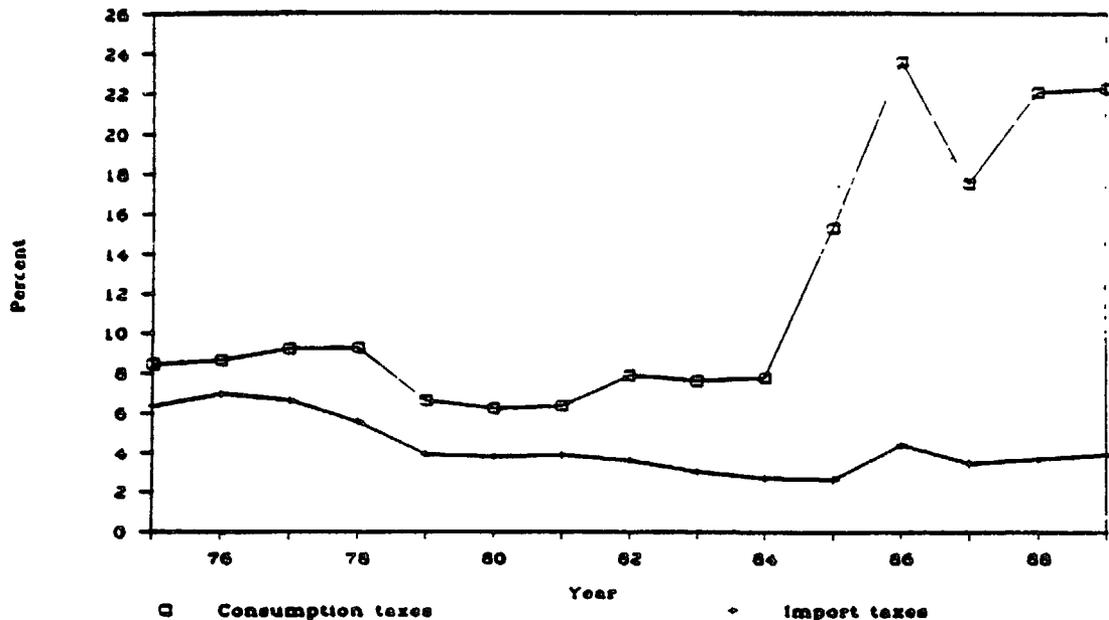
5.37 As tariff policy is only one element of a country's overall economic strategy, it is important to ensure that tariff reform proceeds in a manner consistent with general economic policy. For example, there are close links between tariff policy and domestic taxation policy as well as between tariff policy and investment policy. The analytical unit suggested in the preceding paragraph should also have the capability to assess the interaction between these policies.

5.38 Revenue Effects of Proposed Reforms. In many countries, tariffs form a large share of government revenue. Thus, the revenue effects of tariff reform are of major concern. In Indonesia, the share of import duties in total government revenue has declined since the late 1970s, and is now at around 4 per cent. At the same time, broad tax reform has increased the importance of other forms of revenue, such as consumption taxes (Graph 5.1). Even without further tariff reform, import duties are taking a lower profile. Indeed, Indonesia appears to have considerable scope for replacing any lost tariff revenue with revenue from less distortionary taxes. In examining the revenue effects of tariff reform, it is important to consider all forms of government revenue. As will be argued below, what revenue is lost as tariffs are reduced is likely to be more than regained as the benefits of reform, in terms of increased imports and a higher rate of economic growth, are felt. It is also important to note that the estimates provided here make no allowance for the additional import duty revenue that could be generated from either removing most of the remaining NTBs or reducing the number of import duty exemption schemes.

5.39 Surcharges account for around 4 per cent of total revenue from import duties or less than 0.1% of total non-oil government tax revenue. Thus, with no increase in imports following the removal of surcharges, tariff revenue would decline by around 4 per cent. Accounting for the change in demand for imports, tariff revenue is estimated to decline by 3 per cent - assuming that imports are fairly unresponsive to price changes. As tariff revenue is around 4 per cent of total government revenue, this amounts to a reduction in total revenue of around 0.1 per cent.

5.40 Adopting the tops down tariff reforms will also lead to a reduction in tariff revenue. Going tops down to 50 per cent could lead to a tariff revenue reduction of 6 per cent - that is, a reduction in total revenue of 0.2 per cent. Proceeding with the next step - from the new import base - could lead to further tariff revenue reductions of around 10 per cent - or 0.4 per cent of total revenue. The entire tops down process, from beginning to end, could lead to a reduction in tariff revenue of around 30 per cent. This is equivalent to a reduction in total revenue of around 1.2 per cent. This figure should be treated with some caution, however. It is calculated by assuming that tariff revenue is only influenced by changes in tariffs and changes in import volumes induced by import price changes. In reality, as tariff reform proceeds, the level of imports will be determined by a number of other factors, such as changes in incomes. As incomes increase, so will imports and, therefore, tariff revenue collections.

**Graph 5.1:** Share of consumption and import taxes in total government revenue



Source : World Bank staff estimates.

5.41 Introducing tariff reform will be beneficial to the economy, leading to increased GDP and increased incomes. Such increases will lead to higher revenue collections from sources such as income and commodity taxes. Indonesia's past experience indicates that collections from these sources are proportional to GDP, so every percentage in GDP will lead to a similar percentage increase in revenue collections. Thus, an increase in GDP of around 2 per cent over the three year period of tariff reform would more than offset the reductions in total revenue occurring as a result of lost tariff revenue.

#### D. The Export Regime

5.42 Indonesia's export regime is comprised of two types of policy interventions, export regulations (bans, quotas, taxes and approved exporter arrangements), and export assistance measures (the import duty exemption scheme and the subsidized export credit program). The significance of both

these policy interventions has increased since 1986. As discussed in Chapter 2, the trend towards increased export regulations is worrisome - particularly where the policy instruments create artificial barriers to entry and are non-transparent. These regulations may not be in Indonesia's own best interests and even in those limited instances where there is a case for intervention, the current policy instruments may not be appropriate. The recent expansion in the use of BAPEKSTA and the export credit program reflects the growing importance of non-oil exports to Indonesia's economy. While the BAPEKSTA scheme does provide a useful mechanism by which to circumvent import barriers, more direct measures to reduce NTBs and import tariffs are warranted. Moreover, the provision of subsidized credit is not an appropriate method by which to assist exporters.

### Export Regulations

5.43 While the Government's desire to increase domestic processing is understandable, care needs to be taken in deciding on the appropriate policy instruments through which to achieve this objective. In general, the regulations of exports can be justified on economic grounds only under very specific (and rather uncommon) conditions. Factors such as the share of the world market, the price elasticity of demand, the availability of substitute products and the supply conditions in the export country, all need to be taken into account. Experience in other countries which have imposed export barriers, provides strong evidence that the dynamic effects of these interventions are often negative (see Box 3, Chapter 4). A thorough economic analysis should, therefore, be done for each regulated product, with the burden of proof lying on the need for regulation. In addition, such an analysis would have to be repeated periodically as global demand and supply conditions change. Aside from whether a product should be regulated, a second but no less important issue, concerns how a product is regulated. The economic effects of different policy instruments (e.g., a tax as opposed to a ban) vary significantly in terms of efficiency and the distribution of benefits and losses.

5.44 The products which are subject to export regulations in Indonesia can usefully be divided into three categories:

- o those products which are subject to externally-imposed trade barriers (i.e., textiles, tapioca, and until recently, coffee);
- o those products where Indonesia has a large enough market share to influence world prices (i.e., logs, plywood, rattan, nutmeg and rubber); and
- o those products where Indonesia is largely a price taker.

5.45 Where external barriers exist, the key requirement is to create an efficient and equitable quota allocation mechanism. Taking the example of textiles there are two basic options. First, the Government could try to

improve the current system. This would involve steps to improve the transparency and efficiency of the Government's quota allocation mechanism and the operation of the quota exchange market. As a minimum the Ministry of Trade should publish information on quota holders (by detailed commodity groups and market), the export performance of quota holders and production capacity. If past performance is the sole criteria, any quota expansion should be awarded on a pro-rata basis to exporters to non-MFA markets for the most recent period. If other criteria are used, and a non-price allocative system is employed, these criteria should be defined as clearly as possible to reduce administrative discretion (i.e., 'newcomer' or 'weak economic group' are difficult to put into operational terms).

5.46 A second option would be to move to an open auction system. This would have several benefits including; quick and relatively straightforward administration of the quota allocations; ensuring that quotas are allocated to exporters who have an incentive to maximize returns on quotas through full utilization of high value export items; discouraging 'rent-seeking; and ensuring that the quota rents are appropriated by the Government and can be monitored. Finally, whatever method is used to allocate quotas, the existing administrative capacity to monitor quota utilization for each market and product should be strengthened. These records should be consistent with the importing nations data to avoid the risk (as has happened in the past) of violating quota agreements, and should be in the public domain. The quota monitoring body should also be used to negotiate international quota arrangements and lobby GATT for the removal of the MFA.

5.47 Whether the first or second option is adopted, it will be important to create an open secondary market where quotas can be freely traded. The current penalties imposed on those quota holders that use the quota exchange encourages trading to occur in an informal market which may not operate efficiently. The removal of penalties for trading the quota will focus attention on the rationale underlying the initial quota allocation. The benefits of an open quota auction will be a more efficient allocation and use of Indonesia's quota as well as a clearer indication of the value of different quotas - including who are the quota rent recipients.

5.48 Where Indonesia can influence the world market price, a theoretical case for an optimal export tax exists. The primary issue here is to set the tax at a level which maximizes the economy's gains over the medium-term. In practice, these taxes are difficult to estimate and, as discussed in Chapter 4, while part of the costs of the tax will be passed on to foreign consumers via higher prices, part of the benefits are also passed on to foreign producers. Other producers of the same product (or a close substitute) receive the higher world prices that the tax creates, without incurring the costs of the tax. This will encourage producers in other countries to increase their output at the same time as production in Indonesia is discouraged. As a result, the benefits derived by the country imposing the tax may be short-lived - except where the costs of entry by foreign competitors are high. In addition, world demand will decline as a result of the more efficient use of the taxed commodity and a switch in consumption to substitute goods.

5.49 In the final analysis, the use of export restrictions is an empirical issue which should be analyzed at the commodity level. If it is decided to impose an export restriction, there are strong reasons for choosing an export tax rather than imposing a quota or ban.<sup>14/</sup> As discussed in Chapter 2, quotas and bans can create incentives to engage in wasteful 'rent-seeking' behavior and be used to restrict domestic competition. This in turn lowers the incentive for innovation and improvements in efficiency which would work against Indonesia's long-run competitiveness. Channeling exports through domestic cartels--as is occurring for a number of agricultural commodities--may be particularly harmful to domestic producers who supply "approved exporters", as well as running counter to GATT rules.

5.50 As a first step towards reform the Government should review the current mix of export regulations and where possible replace quotas and bans with an export tax. This approach would mirror the reform program adopted by the Government with respect to import restrictions, where NTBs are being replaced by import tariffs. In addition, the analytical capacity of Government needs to be strengthened, to determine what type of export restriction is optimum (i.e., the level of export tax). This will require an objective government body to monitor developments in international and domestic markets, and development of a capacity to use this information to demonstrate the benefits or costs associated with the proposed trade restriction. If possible, decisions to restrict or tax exports should be discussed by all affected parties in a public forum. One example of such an institution is the Australian Industries Assistance Commission (IAC) which may provide some useful institutional lessons.

5.51 Where Indonesia cannot influence the world price, the case for any type of export restriction is weak. As discussed in Chapters 2 and 4, export restrictions on commodities in which Indonesia is a "price taker" are unlikely to be in the country's own best interests. The result is to lower returns in activities in which Indonesia is competitive (e.g., crude palm oil, crude coconut oil and copra) in order to provide a subsidy to inefficient downstream processors (e.g., edible oil producers). This will lower investment/technical change, and hence growth, in the taxed activity, as well as fostering the development of an uncompetitive downstream industry. A clear case where this has occurred is in the domestic leather industry, which has been taxed in order to provide cheap inputs into that (small) part of Indonesia's footwear industry which sells solely on the domestic market.<sup>15/</sup>

5.52 In line with the recommendations made in the Bank's recent Tree Crops report, all export restrictions on commodities in this category should be removed. This should include the removal of market allocations, export or inter-island taxes, and controlled domestic prices.

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<sup>14/</sup> An example of the type of economic analysis required to determine if an export tax is appropriate is provided in the World Bank's recent report on the Indonesian Tree Crops Sector - No. 7697-IND.

<sup>15/</sup> See Chapter 3, footwear case-study.

### Export Assistance

5.53 BAPEKSTA. The duty exemption facility operated by BAPEKSTA operates efficiently and has provided essential support to Indonesia's expanding non-oil exports. Firm level interviews in both the industrial and agricultural sectors confirm how important BAPEKSTA has been in providing direct access to imported inputs at world prices and as a mechanism to increase the competitive pressures on domestic suppliers.<sup>16/</sup> However, the rapid growth of utilizations of BAPEKSTA's services (currently over 20% of non-oil exports) has placed a strain on staff resources. In addition, the duty drawback mechanism has not been widely used (see Chapter 2), largely because of the requirement that suppliers furnish information to the exporter on their import costs and duties.

5.54 In the near term, to ensure that the efficiency of the exemption mechanism is maintained, the best additional staff resources and some technical assistance should be considered. This should be coupled with continued efforts to improve the transparency and efficiency of BAPEKSTA's overall operation. An important component of improving BAPEKSTA's operations will be to simplify application procedures in an effort to encourage more small-scale or new exporters to apply. BAPEKSTA's operations could also be improved by modifying the system for granting duty drawback to encourage greater participation by indirect exporters. One option would be to use the domestic L/C system introduced by Bank Indonesia in October 1988 as an administrative mechanism. Under this option the master export L/C, the domestic L/C and the L/C opened by the commercial bank on behalf of the indirect exporter to import foreign inputs should together constitute the proof needed by P4BM to grant prior exemption for duty free imports for the indirect exporter. To ensure that imported inputs resulted in exports, P4BM can apply the same procedures as it currently applies for the direct exporter.

5.55 While every effort should be made to increase the efficiency of BAPEKSTA, this should not be viewed as a substitute for continued action to reduce import policy distortions directly. The removal of NTBs and reduction and rationalization of import tariffs, discussed earlier in this Chapter, will reduce the incentive to use BAPEKSTA, thereby freeing valuable staff resources to focus on broadening access to the scheme to cover small-scale and indirect exporters.

5.56 Export Credit, Guarantee and Insurance. The existing export financing, loan guarantee and credit insurance schemes have supported the rapid growth in Indonesia's non-oil/LNG exports in the last few years. However, as discussed in Chapter 2, the existing schemes appear to have had only limited impact on broadening the export base or facilitating backward linkages, due to a number of drawbacks: (i) the preferential interest rates charged to the exporter have encouraged misuse of the export loan, whereby funds have been diverted by the borrower for purposes other than exports; (ii) rationing of credit has restricted its use principally to large, established exporters; (iii) the low intermediation margins on export loans as compared to other commercial loans have discouraged commercial banks from

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<sup>16/</sup> See Chapters 2, 3 and 4.

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5.54 In the near term, to ensure that the efficiency of the exemption mechanism is maintained, modest additional staff resources and some technical assistance should be considered. This should be coupled with continued efforts to improve the transparency and efficiency of BAPEKSTA's overall operation. An important component of improving BAPEKSTA's operations will be to simplify application procedures in an effort to encourage more small-scale or new exporters to apply. BAPEKSTA's operations could also be improved by modifying the system for granting duty drawback to encourage greater participation by indirect exporters. One option would be to use the domestic L/C system introduced by Bank Indonesia in October 1988 as an administrative mechanism. Under this option the master export L/C, the domestic L/C and the L/C opened by the commercial bank on behalf of the indirect exporter to import foreign inputs should together constitute the proof needed by P4BM to grant prior exemption for duty free imports for the indirect exporter. To ensure that imported inputs resulted in exports, P4BM can apply the same procedures as it currently applies for the direct exporter.

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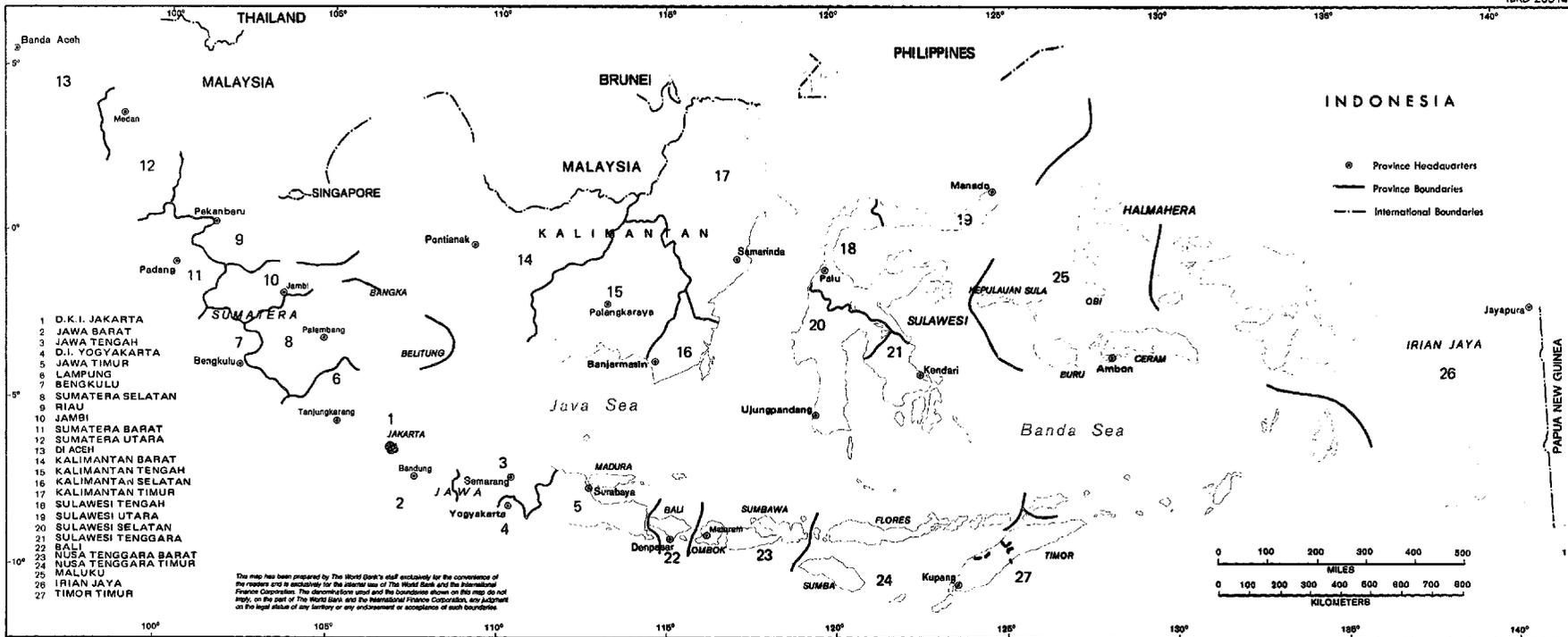
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<sup>16/</sup> See Chapters 2, 3 and 4.

willful noncompliance in which case the claim should be totally rejected. To check the appropriateness of the premium it may be necessary to review the experience with the PEFG portfolio, to analyze the main causes of default and to find ways to minimize the exporters' non-performance risk. An in-depth analysis of claims would clearly distinguish the legitimate claims associated with exporters' non-performance from those associated with exporters' deliberate default and misuse.

5.61 The efficiency of administering PEFG requires: (i) close coordination between pre-shipment export finance guarantee (i.e., PT. ASEI) and the pre-shipment export loan disbursement mechanism (i.e., Bank Indonesia); (ii) PEFG beneficiaries paying the actual cost through appropriate premium rates; and (iii) operational effectiveness in the information-gathering and risk-pooling functions. Over time and after the institution building phase is substantially completed, the PEFG agency can also play an important role in the risk-reduction by channeling technical assistance, either directly through in-house activities or indirectly through other specialized agencies.

5.62 Finally, with respect to the Export Credit Insurance/Guarantee program, the most important step that can be taken to encourage its use is to familiarize the banks and exporters with its availability and advantages through an active, targeted marketing campaign. In addition, new insurance policies would need to be designed to cover specific medium-term transactions, sales of services, unconditional guarantee to banks, etc. Unconditional insurance coverage for banks is offered in many countries to facilitate financing of exporters' sales on usance terms. While non-oil/LNG exports are on sight L/C terms, in many cases where banks rely upon the L/C as security for advances, they obtain confirmation of the L/Cs from offshore banks. Insurance to banks covering L/Cs would be an alternative to seeking confirmation offshore. Insurance for L/Cs is presently available for exporters, but not for banks except under an insurance policy assignment. It should, however, be borne in mind that at the present stage of Indonesia's development, PEFG is more important as an effective instrument of export expansion than ECI/G. This is because a very large proportion of total non-oil/LNG exports are destined for markets -- USA, Japan and EEC -- with little political as well as transfer risks.



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