Fostering Competitiveness to Increase Investment, Trade And Good Jobs

Key Messages

1. Indonesia has made good progress in improving the investment climate and implementing trade reforms. Formal sector employment is once again expanding, poverty has been falling, and an incipient middle class is emerging.
2. Less affected than its neighbors by the global economic crisis, Indonesia has a unique opportunity during the recovery and post-recovery to increase both global market share and domestic sales.
3. To make this happen, the key is to push ahead with reforms designed to improve competitiveness, increase flexibility in the labor market, and avoid protectionism that stifles efficiency and innovation.

Key Action

1. Create the institutional structures needed to deliver consistent policy. Global evidence indicates that strong institutions drive regulatory reforms and improve coordination.
2. Accelerate administrative reforms designed to foster competitiveness. Reduce administrative burdens on businesses, improve the investment negative list (DNI or *Daftar Negatif Investasi*), lower non-tariff barriers, strengthen the national single window (NSW) and coordinate logistics policies.
3. Negotiate a 'Grand Bargain' in labor reform – lower severance rates in exchange for reliable unemployment benefits – this would improve private sector flexibility while increasing protection for employees.
4. Take advantage of high global commodity prices to push investment in mining, oil and gas by completing key mining regulations and clarifying uncertainties relating to oil and gas.
5. Promote the export of new products through public-private research and development partnerships, align fiscal incentives to develop downstream industries, and support the Export Import Financing Agency (LPEI or *Lembaga Pembiayaan Export Indonesia*).

Public Disclosure Authorized

Where Indonesia Stands Now

The success of the Indonesian economy over the past several years reflects a restoration of sound macroeconomic management, political stability, and up until recent times a favorable global context. Growth surpassed 6 percent for two consecutive years and exports more than doubled between 2003 and 2008 thanks in great part to the commodity price boom (see Fig 1). Formal sector employment is expanding again, investment has risen – particularly in the construction sector – and there have been some pleasant surprises in manufacturing exports like automobile parts. But there is room for improvement as overall manufacturing growth has been weak, the transition out of agriculture slow, and the mining and energy sectors have performed poorly.

The weak performance of the manufacturing, mining and energy sectors reflects the challenges in Indonesia's investment climate. Notwithstanding progress in several areas, foreign and domestic investors face regulatory uncertainty, cumbersome bureaucratic procedures, corruption, costly labor regulations and an overstretched infrastructure. The government has responded with a broad range of policies including new tax and investment

laws, trade facilitation initiatives, and economic policy reform packages. While progress has been made in tax administration and corruption eradication, additional restrictions have been imposed in key sectors such as mining, services and infrastructure. Indonesia remains one of the least favorable business environments for private sector investment in East Asia and Southeast Asia.

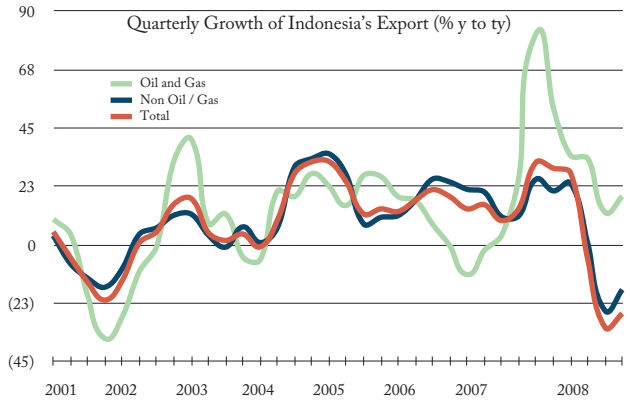
Firms face complex procedures to start a new business and costly and rigid labor regulations that affect their productivity and profitability. The present investment climate and trade regulatory environment inhibit investment and both domestic and international trade. Starting and operating a new business in Indonesia requires numerous approvals, registrations and licenses, a process that can take up to eight months. Indonesia's hiring and firing regulations are among the most rigid in East Asia and the world. International research indicates that developing countries with onerous labor regulations also experience lower rates of investment (particularly in manufacturing) and productivity. The Manpower Law (No. 13/2003) hurts firms' competitiveness by increasing severance rates, estimated to be the equivalent of a "hiring tax" of approximately one-third of a worker's annual wage. Despite the intended purpose of the law, the rigid severance system fails to protect the majority of workers adequately from the risk of unemployment. Regulations are largely irrelevant for 92 percent of the active labor force employed informally or working without a contract in the formal sector. High severance rates also restrict job creation and employment in the formal sector by discouraging entrepreneurs from creating new businesses and deterring potential investors. High minimum wages in the mid-1990s and early 2000s, combined with increasingly rigid labor regulations, caused Indonesia's labor-intensive export industries to become uncompetitive, leading to stagnant manufacturing production and low labor absorption in the formal sector.

The country's poor logistics system makes many Indonesian products less competitive than foreign imports. For example, it costs roughly US$400 to send a forty-foot container from Padang to Jakarta, but only US$175 to send it to Singapore, which is further away. The high cost of transporting high quality products like shrimp from eastern Indonesia to processing centers in Java makes them too expensive to export. The high cost and uncertainty of domestic distribution channels also prevent Indonesia from being more integrated with just-in-time production networks of higher value-added products. Licensing and government-regulated pricing reduce incentives to invest in better services, and restrict competition between domestic sea and land freight companies. Restrictions on foreign investment in the logistics sector only worsen the situation by restricting access to new technology.

Despite progress, Indonesia needs to do more to raise port and customs efficiency to levels comparable to its neighbors. The average import container dwell time in the main container terminal is more than seven days compared to less than three days in major regional ports. Imports of empty containers clear in less than half the time needed for full containers, showing that most of the delay is caused by border control and inspection procedures rather than by inadequate infrastructure. Burdensome and unclear administrative procedures contribute to import delays and invite corruption, undermining the competitiveness of industries that use imported components.

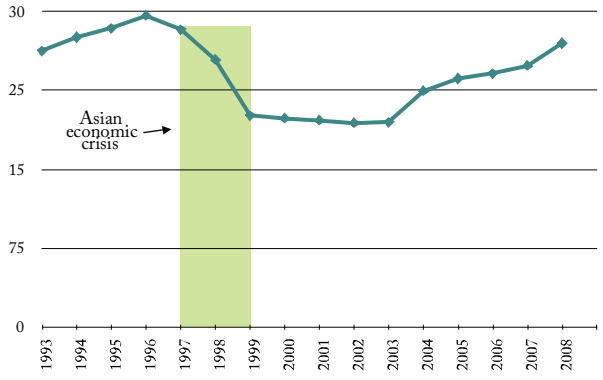
Firms identify Indonesia's overstretched infrastructure as one of the greatest obstacles to private investment.

Export Value Increased with Commodity Boom



Source: BPS, WB Staff calculation

Share of Investment in GDP 1993-2008 (%)



Source: BPS

Although government considers infrastructure a top priority, public infrastructure works have progressed slowly and very few large public-private projects have proceeded over the past five years. Of ten "model projects" offered at the second infrastructure summit in 2006, only two have made substantial progress. Continued weakness in the institutional and regulatory framework for public private partnerships (PPP) is hampering major advances. The government has also been slow to allocate sufficient funds for project preparation, provide public support to make PPP projects viable, and facilitate land purchase. Additional resources are needed for public infrastructure along with more efficient spending mechanisms.

Indonesia is a very open economy in terms of tariffs, but non-tariff barriers remain significant and there has been a worrying trend towards their recent increase. More than 40 percent of Indonesia's tariff lines currently require special import permits. Many of these permits exist for legitimate health and safety reasons, but they are implemented at the border in an unnecessary or excessively bureaucratic fashion. Meanwhile, nearly one-third of import containers are subject to physical inspection (red lane) compared to less than 10 percent under international good practice. Often goods that are already subject to mandatory pre-shipment inspection at the port of loading are still subject to on-arrival inspection.

In recent years Indonesia's export growth has been highly dependent on a small number of traditional products with limited value added and is vulnerable to the volatility in these markets. Four commodities alone, palm oil, nickel, copper and coal, accounted for almost half of total non-oil export growth in 2007. The low technological content of overall exports is reflected in the low share of medium and high tech manufactures in total exports. There has been limited progress in diversifying exports since 1997 revealed by the fact that a decade later, relatively few new products play any substantial role. As a result, Indonesia lags behind its neighbors in terms of the degree of processing of commodities, technological content of exports and the export of new products. This is in part because of the greater domestic tax applied to processed products, an unfavorable business climate, lack of incentives, and the high costs of discovery for private enterprises.

Despite abundant mineral wealth, investment in mining has stagnated. The contribution of mining, oil and gas to GDP growth declined from 7 percent during 1986-1996 to just 1 percent between 2000 and 2008 despite a boom in commodity prices. Global mining companies rank Indonesia among the top ten countries in the world in geological potential but tenth from the bottom (out of 64 countries/regions) in mining policies. The biggest problems identified by investors in the oil and gas sector are (i) uncertainty over cost recovery and the State Audit Agency or BPKP audits; (ii) sanctity of contracts; (iii) interference from other government agencies; (iv) tax issues such as "ring fencing;" and (v) the security of assets, people and ownership rights. Slow progress towards resolving these issues is causing Indonesia to miss out on a global wave of new oil, gas and mining investments sparked by the surge in global commodity prices up to mid-2008.

Policy Priorities in a Rising Indonesia

Looking to the future, an Indonesia that takes dynamic and innovative steps, can position itself at the forefront of regional economies. An aggressive push on investment and trade reform designed to achieve higher growth would increase employment opportunities in high-value industries, while increasing domestic and international trade. Introducing a social protection system (pension, health and unemployment benefits) while reducing termination costs would increase jobs in the formal sector (where workers get greater pay and are better protected) while improving the competitive position of producers in domestic and international markets.

Present reform efforts are moving in the correct direction but will require a greater push to yield results. A number of ongoing reform efforts are designed to streamline and simplify investment and trade related procedures and practices, but will require a greater push to yield results. The recent creation of a single window for trade that will replace manual paper processing with an online system that eliminates face-to-face contact between traders and officials is a major initiative to reduce the time and expense of exporting and importing. While progress has been made by establishing electronic links among government agencies that issue import permits, traders are still required to visit each agency individually. Electronic systems have been added on top of existing manual systems resulting in double submissions and double checking. The creation of one-stop shops in local governments is an important step towards simplifying business start-ups. Although this can help reduce waiting time, one-stop shops will not cut through the complex web of business regulations issued by central government agencies. A cohesive regulatory reform program is necessary to streamline and simplify investment and trade procedures.

The key challenge is to create the institutional change needed to deliver the required reforms in regulatory and administrative procedures. Reform efforts have suffered from a lack of coordination between ministries and from a regulatory process that pays little attention to the costs imposed on businesses. For instance, regulators tend to design rules for their own narrow scope of authority with little thought to those imposed by other regulators, resulting in overlapping requirements by different ministries. Impact assessments of draft regulations to ensure that benefits outweigh costs are not normally performed. There is also a worrying tendency to write restrictions directly into new laws rather than in regulations, thereby tying the government's hands.

The second challenge is the removal of administrative burdens, uncertainty and other domestic barriers to investment, jobs and trade to convert the large domestic market into a single market. This will permit firms to reduce costs, increase investment, reap economies of scale, and make the best use of labor and resources. Allowing greater competition among domestic producers and a better use of labor and resources will make the country more dynamic and help improve technological sophistication.

Early and decisive action by the new administration is needed to improve investor perceptions and address key constraints rather than attempting to tackle all problems at once. High priority actions are:

1. Implement the institutional change needed to deliver reforms.

- Create a Regulatory Reform Commission. International experience shows that a coordinated top-down approach based on a strong legal foundation is often the only way to overcome bureaucratic resistance to reform. The National Team to Enhance Exports and Investment (PEPI) could be considered as an early start to forming such a Regulatory Reform Commission. This Regulatory Reform Commission is to be composed of teams devoted to different topics, like the existing Tariff Team and a possible future logistics council.
- Improve regulatory procedures by sending a draft regulatory reform law to parliament incorporating the need for Regulatory Impact Assessments, a regulatory guillotine, and a 60-day public disclosure, discussion and feedback period prior to enactment of new regulations.

2. Push ahead with regulatory reforms.

- Complete and update the Investment Negative List (DNI). A further revision of the DNI, maintaining the positive improvements in the 2007 revision while relaxing restrictions in key sectors, will boost investment levels in infrastructure and critical services.[1]
- Push ahead on the National Single Window agenda (NSW). Eliminate the requirement to submit paper copies of trade documents and create a functioning NSW as agreed with ASEAN, using a single administrative document, single submission, single and synchronous processing, and single approval. To allow the single window to reach its full potential, strong leadership is needed to push the core agencies to change their back-office procedures and to cooperate in simplifying trade systems.
- Use the proposed regulatory review process to review and remove unnecessary non-tariff measures on goods trade and obstacles to trade in services that constrain growth. Retain only necessary import permits and streamline the import licensing regime to secure and strengthen past gains from tariff reforms.
- Negotiate a "Grand Bargain" with labor leaders that lowers severance rates in exchange for unemployment benefits to improve flexibility for firms while increasing protection for employees. Adjust severance rates downward so that they fall in line with regional standards to improve labor market flexibility and global competitiveness. At the same time, introduce a complementary unemployment benefit system to improve the level of protection for terminated employees. Introduce a "pay-as-you-go" system to improve the predictability of firms' costs without impinging on their firing decisions, and increase compliance. Unemployment benefits are one component of an effective social insurance system that is needed to increase the level of protection for workers and stimulate job creation by improving labor flexibility.
- Issue implementing regulations for the 2008 mining law that provide the same security for investors as is found in the Contract of Work system. Limit costs associated with the new domestic processing requirement and clarify transition provisions. Issue clear rules on cost recovery and remove "ring fencing" on Production Sharing Contracts. Implement the Extractive Industries Transparency Initiative (EITI) to improve public accountability in the use of Indonesia's mineral wealth.
- Finalize and implement the blueprint for logistics reform and establish a national logistics council. This council will need to be strongly empowered to implement national logistics reform. Among the

1 Improving the investment climate will require restoring the degree of openness embraced in 1994, when Government Regulation number 20 was issued allowing 95% foreign ownership in key sectors such as telecommunications, ports, healthcare, construction services, insurance, pharmaceuticals, and logistics.

changes envisaged are modifications to the regulations that restrict competition leading to high transport costs and delays, and improvements in infrastructure. Some quick wins include extending the railway-to-the ports network and providing 24/7 custom services in key ports.

3. Promote innovation and export diversification. Promote public-private R&D partnerships for new product development and align fiscal incentives for the private sector to move into downstream processes. Other practical actions are to support the efforts of the LPEI and related agencies to develop financing and guarantee instruments to support exports of new products or exports to new markets.

How The World Bank Can Help

Current Support

The World Bank Group (World Bank and IFC) is working closely with the Coordinating Ministry for Economic Affairs (CMEA), Ministry of Finance, Ministry of Trade, Ministry of Home Affairs and State Ministry for Public Administration (MenPAN) among others, to improve the trade and investment climate in Indonesia. The World Bank Group is supporting the National Team to Enhance Exports and Investment (Timnas PEPI) to improve the policy formulation process, and assisting the CMEA with its regulatory reform initiatives including streamlining business licensing at the national level. With financing from Multi-donor Trust Funds, it is also supporting trade facilitation measures like the Indonesia National Single Window and the development of a blueprint for the reform of the national logistic system. A series of cross-cutting Development Policy Loans also include policy and institutional reform measures to address some of the constraints to private sector development in Indonesia.

Future Directions

The World Bank Group's Investment Climate and Trade Teams can provide wide-ranging support to the Government of Indonesia in the form of capacity building and the facilitation of public private dialogues. Its advisory work on trade and investment climate could include issues like:

- Advising on best practice institutional set up and processes to implement regulatory reform in the areas of investment climate and trade facilitation.
- Training in risk management for government agencies participating in the Indonesia National Single Window.
- Monitoring implementation of policy reforms by supporting Indonesian institutions to carry out investment climate surveys.
- Supporting the development of the Ministry of Trade's roadmap for bureaucratic reform.
- Enhancing the capacity of key trade finance institutions to support export diversification.
- Assisting the assessment of different reform options for delivering unemployment benefits.
- Helping to advance the social insurance agenda by exploring options to support the government institutions responsible for designing and implementing a social insurance system.

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