Economic Diversification: The Case of Indonesia

Fauziah Zen*[1]

[1] Secretary of Economics Department, University of Indonesia. I am grateful for valuable assistance from Astrid Dita of the graduate program of economics at the University of Indonesia. Opinions expressed here are solely those of the writer and do not necessarily reflect the positions of the university's economics department or of Revenue Watch Institute.

Section 1. Introduction

The sectoral composition of Indonesia's economy has gone through a series of changes in the past decades. Indonesia's initial economic development depended on the extractive sector during the 1970s, and the country's industrialization started when the government adopted an import substitution policy. Windfall profits from the oil boom led the government to overlook the role of foreign investment; hence it focused on inward-looking policies. It was not until 1980s when oil prices plummeted that Indonesia started to embrace an export-oriented policy.

A series of liberalizations was launched to support exports and attract foreign investment. Although the manufacturing sectors grew significantly during this period, Indonesia actually relied heavily on the pseudo-comparative advantages of cheap labor and subsidized energy prices. The 1997 Asian economic crisis contributed to the fall of Gen. Suharto's authoritarian regime and also made the economy contract, forcing the state to radically reduce subsidies and removing protective laws, thus exposing the uncompetitive manufacturers and workers.

The underlying causes of Indonesia's lethargic industrialization can be categorized into three major issues. First, lack of infrastructure substantially hampers investment prospects. Second, accumulated resources in the manufacturing sector were not reflected in the competitiveness of its production factors. Third, unhealthy institutional settings also took part. In the past, bureaucracy was centrally managed; the subordinates were aligned, but no feedback mechanisms existed. Nowadays, even though bureaucracy failure can be disputed, the process would be inefficient and complicated, resulting in weak law enforcement and high-cost economy. Hence, Indonesia's efforts to substantially transform the economy into a modern industrial country by diversification and decreasing its dependence on the extractive sector have failed, despite the success the country has had in increasing the role of the manufacturing sector and non natural-resource exports.

1.1 Background

Indonesia is a vast maritime archipelago situated at the Equator, slightly above Australia. It consists of 17,000 islands has potential to be a source of several natural resources, i.e., geothermal reserves, liquid natural gas (LNG) reserves and minerals (bauxite, coal, copper, and gold). Although Indonesia had gained independence in 1945 from Japan, it was not until early 1970s when Gen. Suharto took power as president that it began to develop. His corrupt regime ruled the country for more than three decades (1965-1998) and eventually ended during a civil revolution triggered by the 1997 Asian economic crisis.

Economic development in the Suharto era, often called the New Order regime, was centrally planned. To minimize the political destabilizing effects on macroeconomic conditions, political dynamics were repressed. All commands were directed from the capital of Jakarta, without transparency or accountability. Local government officials in the regions acted more like clerks than local planners. The beginning of this era was marked by a high dependence on the mining and agricultural sectors.

We will analyze the structural transformation of the country once praised as a miracle of Asia during late 1980s. After the 1997 crisis hit the country severely, Indonesia revealed some of its hidden vulnerabilities and took longer to recover than its neighbors. The structures of its economy and policy instruments are among the key issues to investigate further. This paper describes the role the extractive sector plays in the Indonesian economy and analyzes the government's policies to diversify the economy and increase the manufacturing sector's role.

1.2 Country Economic Performance from the 1970s to2009

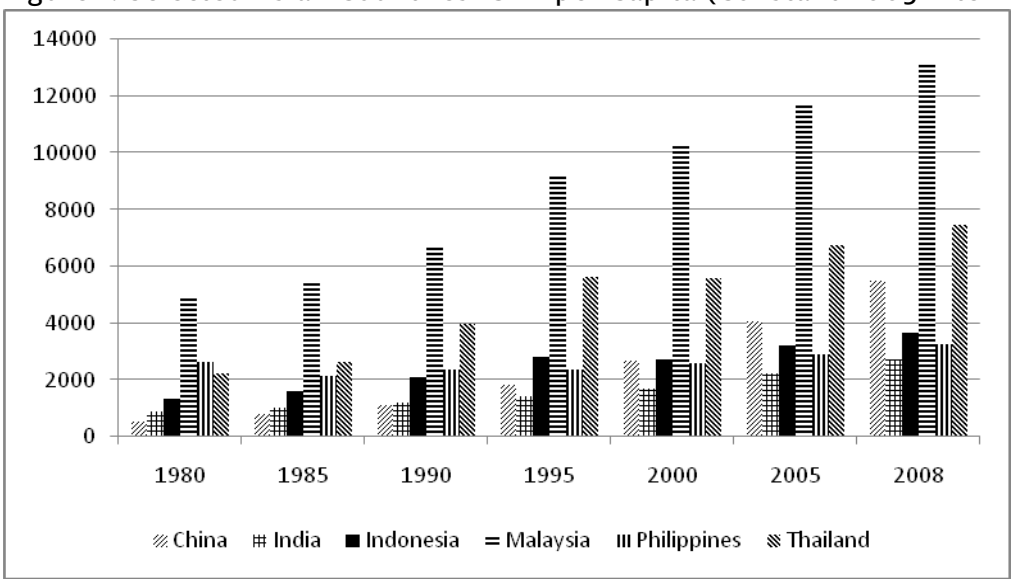
Indonesia recorded impressive economic growth from the mid 1970s to 1997. It was one of the top performers in Asia, along with China and Thailand, which booked high growth during the same period. However, when the 1997 Asian financial crisis occurred, Indonesia was the country hardest hit most severely (see Table 1 and Figure 1); the effects lingered for years afterward. In terms of GDP per capita (PPP), Indonesia is behind Malaysia, Thailand, and China, but ahead of India and the Philippines. This grouping shares a common characteristic, namely a decline in agriculture's share for top performers and a significant agriculture share for low performers.

Table 1: Selected Asian Countries' Average Growth (%)

Country	1970-1979	1980-1989	1990-1999	2000-2008	1970-2008
China	7.5	9.4	10.5	10.2	9.3
India	3.3	5.6	5.5	7.5	5.3
Indonesia	7.9	6.4	4.4	5.2	6.1
Malaysia	7.7	6.0	7.2	5.1	6.6
Philippines	5.7	1.8	3.1	4.8	3.9
Thailand	7.3	7.9	4.6	4.8	6.2

Source: World Bank, *World Development Report 2010*.

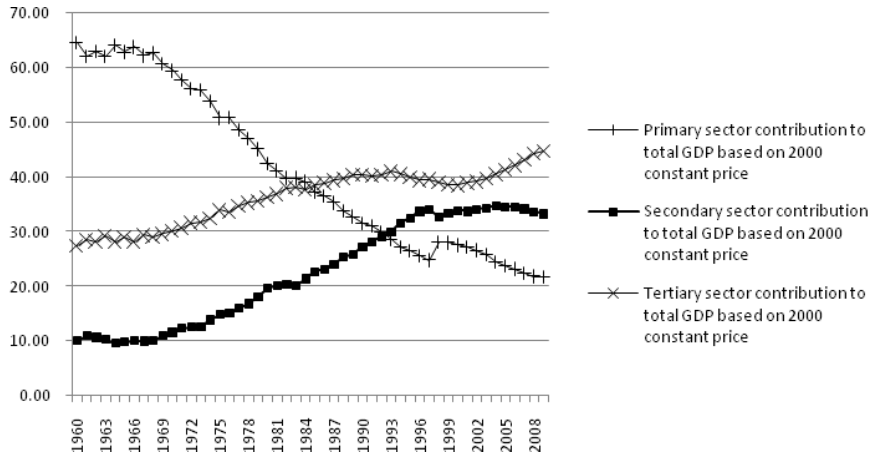
Figure 1: Selected Asian Countries' GDP per Capita (Constant 2005 International $)



Source: World Bank, *World Development Report 2010*.

From the time of Indonesia's early economic development until industrialization started to occur in 1980s, the main source of Indonesia's output was the primary sector (see Figure 2). Secondary and tertiary sectors significantly increased from the 1980s to 1996. Table 2 illustrates that while dependency on the primary sector has been steadily decreasing over time, growth was slower in the secondary sector and stagnant in the tertiary one during the past decade compared with those in previous ones. This is associated with the effect of the Asian crisis. The Indonesian manufacturing sector experienced decreasing growth rates despite the better rate of economic growth from 2001 to 2009, when compared with the previous decade. It is in line with the average growth pattern of total GDP until 2000.

Figure 2: Contributions of Sectoral Groups to Indonesia's Economy, 1960-2009



Source: Statistics Indonesia (2010), calculated by author.
Note: Primary sector = agriculture, mining and quarrying; secondary sector = manufacturing, utility and construction; and tertiary sector = all services.

Table 2: Average of Sectoral Contributions to Indonesian Output

Period	Primary	Secondary	Tertiary
1960-1967	63.06	10.21	28.49
1968-1978	54.91	13.37	32.05
1979-1997	34.22	25.71	39.03
1998-2009	25.16	34.00	40.86

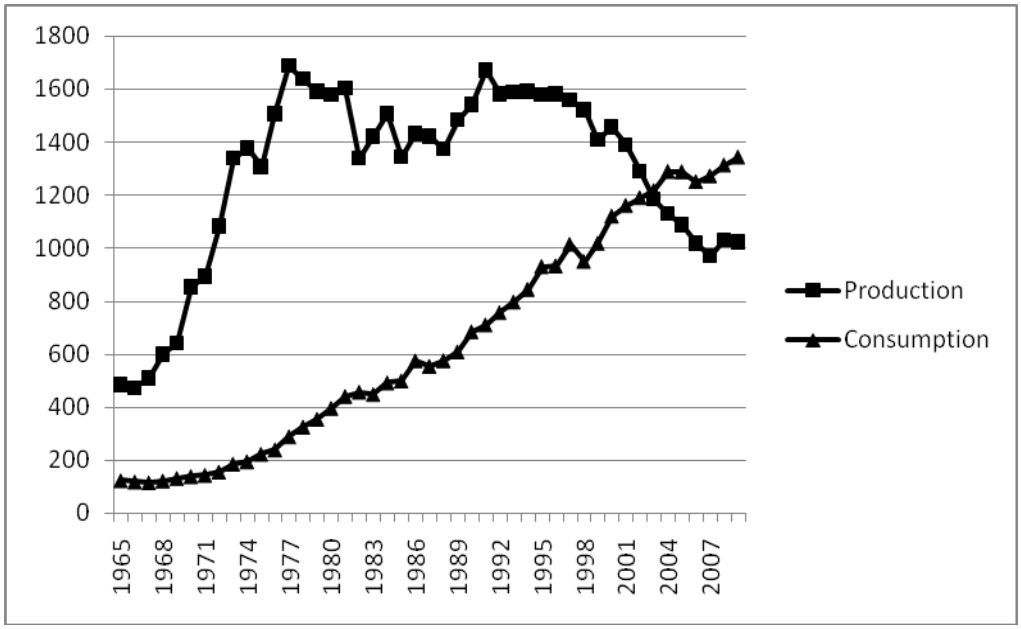
Source: Statistics Indonesia, 2010, calculated by author.

1.3 Role of Extractive Sectors in Indonesia's Economy

In the oil boom period (1972-1974), oil prices rocketed from $1 to $2 per barrel to around $10 to $13 per barrel. As an oil exporter, Indonesia gained large windfall profits. Hence, during the first decade of economic development, due to the government's perception that the country was highly self-sufficient and did not need much trade to support its economy, the industrial policy was inward-looking, focusing on an import-substitution approach. In this period, the government had a large number of investments in basic industries like steel, chemicals, cement and fertilizer and aimed to establish a self-supporting domestic economy. It also adopted a "cherry-picking" strategy for intermediate goods (Arnold and Javorcik 2005).

During this period, the only efforts the government made to develop the oil and gas processing industry was to build three refineries. As the result, Indonesia's refinery capacity grew very slowly compared with the increasing demand for fuel consumption. Furthermore, instead of investing in alternative energy, it shortsightedly gave generous fuel subsidies. Fuel prices were set below its economic price, triggering over-consumption; although on the positive side, the cheap energy attracted investments. The heavily subsidized fuel consistently increased oil consumption amid decreasing oil production. In 2004, Indonesia's position shifted from being a net oil exporter to being a net oil importer (see Figure 3).

Figure 3: Indonesia's Oil and Gas Production and Consumption (Thousand Barrels Daily)



Source: *BP Statistical Review of World Energy 2010.*

Despite the declining volume of oil and gas production, the extractive sector still plays an important role in the national budget. During the last decade, the total contribution from the oil and gas sector still accounted for an average of 30 percent of total national domestic revenue. However, this shows that the government's reliance on the non-extractive sector has not been significantly improving even after four decades.

The report is divided into five sections. The introduction provides a background, rationale and outlines. Section 2 discusses trends and dynamics of diversification in the Indonesian economy, followed by a discussion of existing policies and strategies in Section 3. Since it is important to look deeper into how the government policies would influence the results, Section 4 presents the analysis of the policy mix and determinants in light of the current policy debate. Section 5 presents the conclusion and recommendations.

Section 2: Diversification Trends and Dynamics

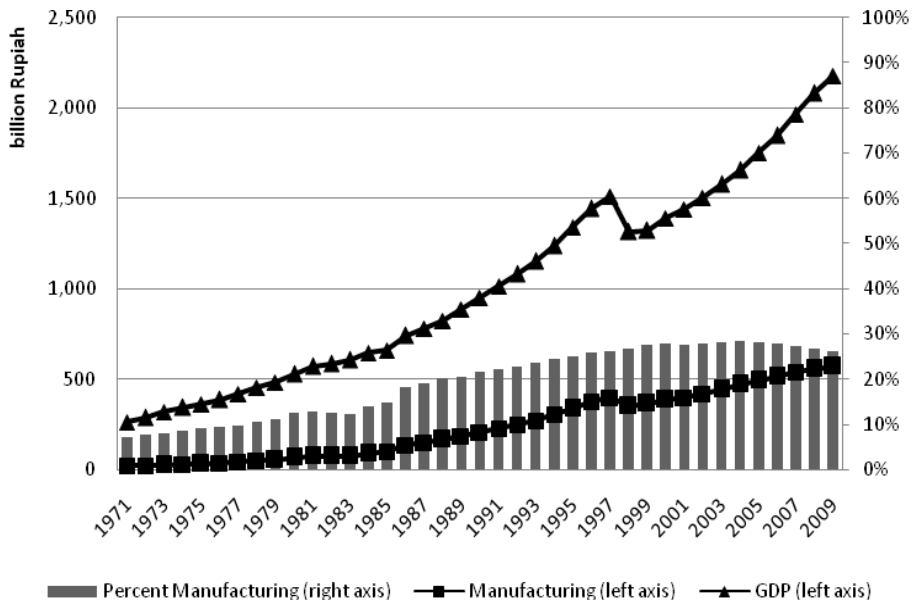
Indonesia's economic development can be divided into three periods. The first (1965-1975) began with the stabilization of the sociopolitical situation and openness to foreign capital. Stabilization was considered the primary requirement to carry out economic development as stated in the national Five-Year Development Plan (1969-1975). The foreign capital started to flow into the country with various restrictions and rigidity. As a result, incoming foreign direct investment (FDI) was very limited, despite its contribution to the growth acceleration.

In the second period (1975-1981), using the oil profits, the government built the economy in a few basic sectors: infrastructure, basic industries, agriculture and education. In the name of nationalism, the government adopted an import-substitution policy to decrease Indonesia's dependency on imported goods. The government's roles in the economy were dominant; it created several state-owned enterprises (SOEs), mostly in basic industries.

However, declines in demand for oil in 1982 drove prices down dramatically. State revenues fell, and the country faced an economic crisis. In 1983, the government had to respond by devaluating the currency, searching for foreign aid, reopening the door to foreign capital, and lifting protections on domestic industries. This was the beginning of the third period of economic development in Indonesia (1984 to present). Since then, when the government relaxed the restrictions and promoted export-oriented policies, FDI increased. It contributed to higher diversification in manufacturing industries in Indonesia.

Diversification was in fact also being supported by the relocation of factories from developed to developing countries. The 1985 Plaza Accord forced Japan to reevaluate the yen, which drove Japanese companies to relocate their factories to Asian countries with lower production costs. It gave Indonesia more opportunity to host more industries. Several textile-based companies from Taiwan, South Korea, Hong Kong and Singapore also relocated their labor-intensive plants to Indonesia, creating jobs for workers with few skills. The manufacturing sector's contribution to Indonesian output was significant enough from 1984 to 1996 that its higher growth pulled GDP growth (Figure 4). The average growth of the manufacturing sector was 17 percent from 1985 to 1993.

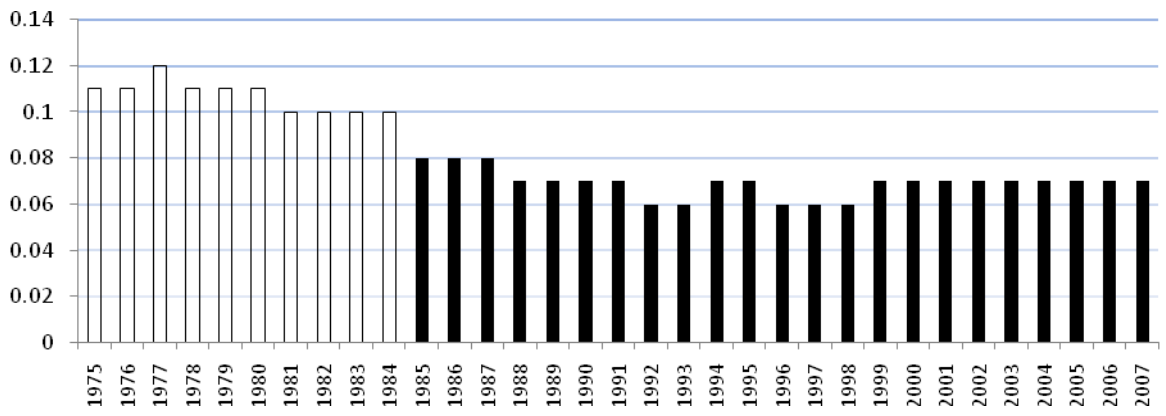
Figure 4: Manufacturing and Total GDP of Indonesia



Source: Statistics Indonesia, 2010.

Focusing on diversification in Indonesia's industry, figures 5 and 6 show the UN's third revised Industrial Standard Classification (ISIC 3) concentrations for both value added and employment.[2] The solid bars indicate unconcentrated industries, and the transparent ones are for moderate competitive sectors, even though the threshold is more arbitrary than absolute. By comparing these two figures, one can see that value-added and employment in the manufacturing sector have the same level of competitiveness. The level of variability also decreased over time even though it was still pretty high.

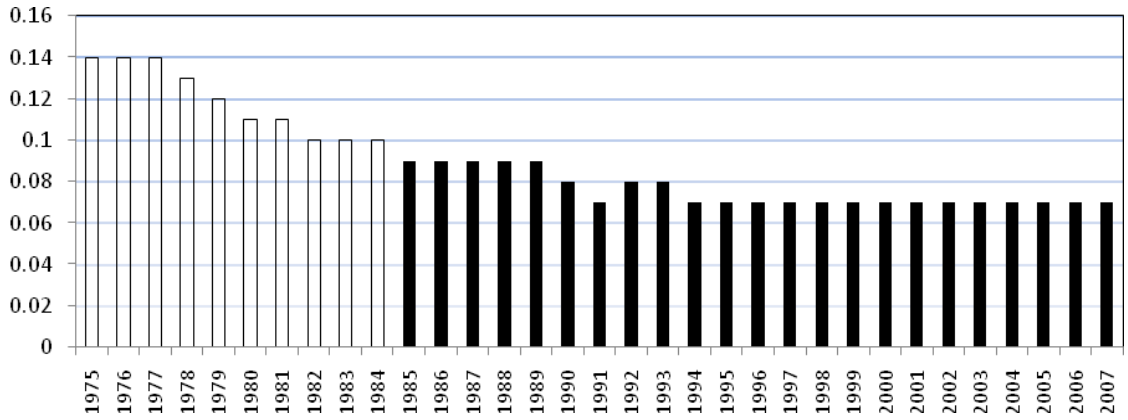
Figure 5: Herfindahl-Hirschmann Index for Sector Concentration of Value Added (ISIC3)[3]



Source: Statistics Indonesia, 2010.

[2] See http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17&Lg=1.
[3] According to Alan Deardorff's Glossary for International Economics (http://www-personal.umich.edu/~alandear/glossary/h.html), the index is defined as "a standard measure of industry concentration, defined as the sum of the squares of the market shares (in percentages) of the firms in the industry."

Figure 6: Herfindahl-Hirschmann Index for Sector Concentration of Employment (ISIC3)

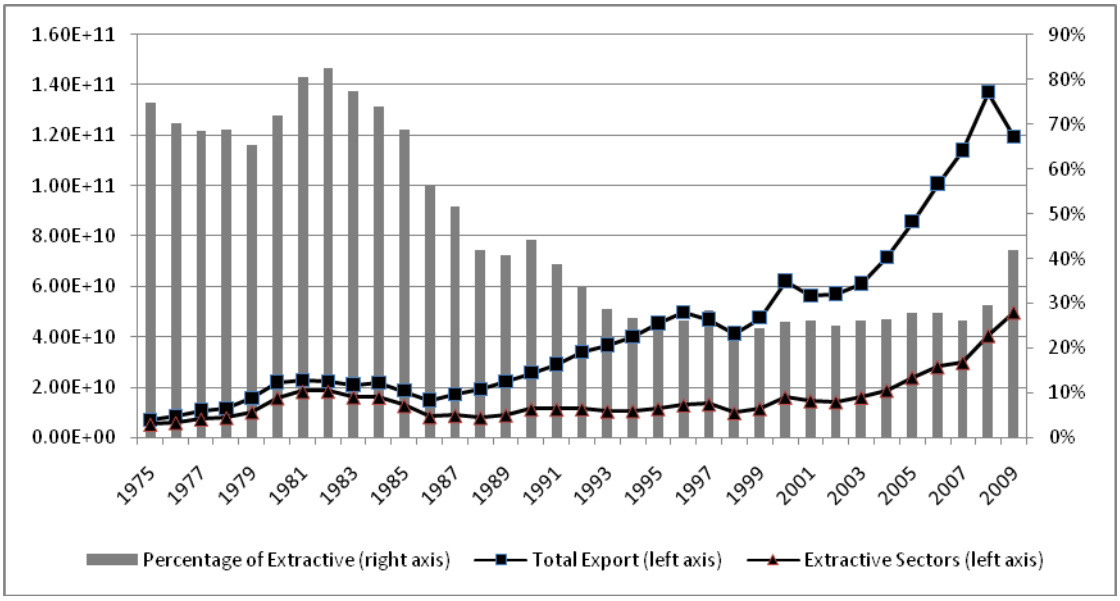


Source: Statistics Indonesia, 2010.

2.1 Export Performance

In line with the restricted policies on openness, export performance was undersized before 1985 and was dominated by the extractive sector. The export value of the nonextractive sector had been increasing since then (see Figure 7), but tends to be stagnant since the 1997 crisis. Meanwhile, the extractive sector (primary commodity) continues to play a significant role in Indonesia's economic growth.

Figure 7: Export Value (US$) of Indonesia to the World

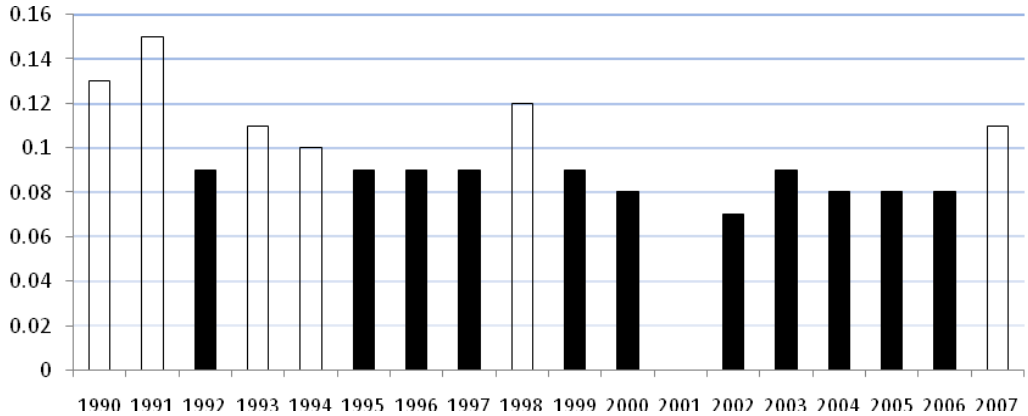


Source: Statistics Indonesia, 2010.

The shifting of industrial policies from inward- to outward-looking was accomplished by introducing incentives for export-oriented industries in the 1980s, accompanied by growing numbers of export processing zones (EPZ) established in several locations. The EPZs were created to provide jobs, increase exports and gain technology transfers. Imported and

exported goods to and from EPZs are exempted from tax and duty. During the past two decades, export concentration has moved in between unconcentrated and moderate concentration indexes (Figure 8) with higher variations compared with those of value added and employment (figures 5 and 6). However, it depends on regional and global demand for exported products.

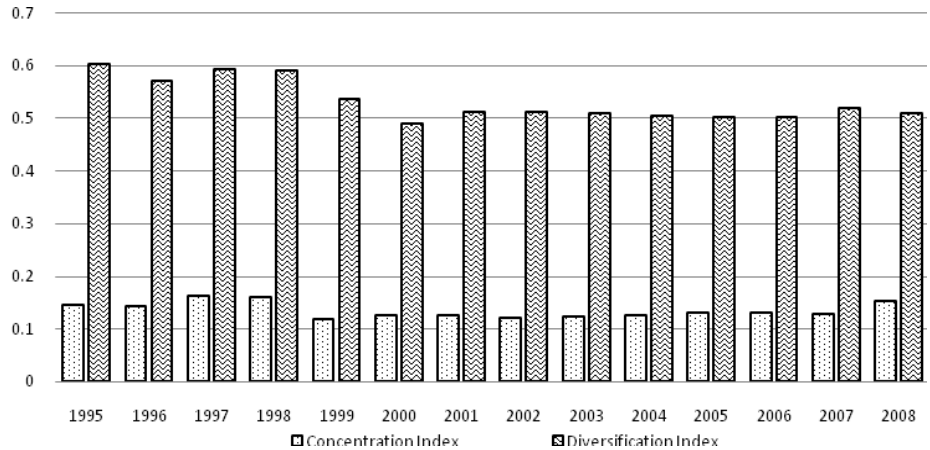
Figure 8: Herfindahl-Hirschmann Index for Indonesia's Export (ISIC 3)



Source: Statistics Indonesia, 2010, , calculated by author (mean of samples: 17,619 firms).

The UN Conference in Trade and Development (UNCTAD) provides data on Indonesia's exports and its concentration index by using a sample of 232 to 257 products, as presented in Figure 9. It shows a moderate level of concentration between 1995 and 2008. While the export products have a moderate concentration index, they consist of quite diverse products. In comparison, Malaysia has a concentration index at 0.15 and a diversification index at 0.43, meaning that it has similar concentrated exporting products and slightly less exporting product diversification than Indonesia.

Figure 9: Concentration Index and Diversification Index of Indonesia's Exports



Source: UNCTAD, 2010.

2.2 The Role of International Trade

International trade, to some extent, has been carried out by Indonesia since the beginning of the New Order in 1970s. It was then intensified after the 1982 oil boom, characterized by

new policies on foreign direct investment, trade, policy and aid (Thee 2001). Indonesia's initial participation in international trade cooperation was marked by joining trade forums at regional and international levels: ASEAN Free Trade Agreement (AFTA), Asia-Pacific Economic Cooperation (APEC) and the World Trade Organization (WTO). Consecutively, Indonesia's economic integration with the world starts with AFTA (2003), WTO (2005) and APEC (2020).

2.3 Impact of Indonesia's Membership in International Trade Forums on Industry and Export

Indonesia's participation in international trade agreements at the global (WTO) and regional (AFTA and APEC) level was supposed to enhance the national and global economic growth. However, after the formation of AFTA, Indonesia did not benefit much from an increase in exports to ASEAN countries (Chowdury 2007). This is in line with the findings of Hartono et al. (2007), and Feridhanusetyawan and Pangestu (2003), which used Computablel General Equilibrium (CGE) models to find that Indonesia's real GDP and welfare may increase by 0.13 percent and 0.61 percent from AFTA, respectively, and increase by 1.31 percent and 2.64 percent from global international trade, respectively. Hence, Indonesia has a stronger link to global liberalization than to regional ones.

Section 3. Policies and Strategies

Indonesia became open to foreign funds in 1967 by issuing Law No. 1 on Foreign Direct Investment. The law, however, provided a closed list for FDI.[4] The government also gave tax incentives including up to five years of tax holidays for business profits, and an additional five-years of tax holidays for reinvesting net profits and dividends, as well as free import duty and excise for capital goods.[52] More importantly, the government agreed to respect foreign investors' ownership rights by promising not to seize the foreign companies—a process often called "nationalization." (If this ever happened, it should be implemented constitutionally for the sake of national interest, plus the government would pay compensation according to international rules.)

In 1968, Indonesia issued Law No. 6 on Domestic Investment. As in Law No. 1, national private companies got generous tax incentives. Yet, these two important laws in investment said nothing about export incentives. Government policies were indeed still inward-oriented, and production was directed to fulfill the domestic market. The problem was that the generous tax incentives were framed within a highly protective regime, described by a closed list of investments, that favored joint ventures and aimed to increase domestic portions in them. This policy was set up when import substitution policies were adopted throughout the world. International trade was not viewed much as a growth engine then; instead many countries expected to benefit by replacing imported goods with domestic goods. In the early 1970s, Arab-Israeli conflicts in the Middle East led to OPEC's embargo of world oil production. Soon, fuel prices rocketed, which benefited oil-exporting countries like Indonesia. Receiving windfall profits from oil exports made the Indonesian government treat foreign investment only as a supplementary source of capital.

This continued until oil prices plummeted in 1979 and finally hit bottom in 1982. It forced Indonesia to undertake significant deregulation and liberalization policies. From 1985 to 1987, a series of regulations to support investment were issued. Some of the more significant ones were deregulation packages for the following industries: automotive, machinery and electrical equipment (issued in January 1987); and mining, agriculture, and health (issued in June 1987). The government also discounted import duties for selected commodities, including textiles and steel. To accelerate exports, it created Bonded Zone through Government Regulation No. 22 in 1986. Companies operating within such a zone got various tax and duty incentives to support their exporting activities. This showed that Indonesia was changing its import-substitution policy for an export-oriented one.[6]

The government's support for an export-oriented policy was also reflected by a series of deregulations that included continued improvements in customs and goods clearance, relaxation of restrictions on foreign investment ownership linked to export orientation, and a general program to reduce some of protected sectors. Competition was introduced vis-à-vis divestment of government shares in some large SOEs including PT Telkom (Telecommunication SOE), PT Indosat (Satellite Operator SOE), a few government banks, a

---

5

The Law No. 11/1970 further revised some of articles in Law No. 1/1967 and granted additional tax incentives.

6

number of cement producers, a television company and gas company. Indonesia also opened its market for private investment and ended what had long been a monopolistic market for SOEs in these industries.[7]

Pangestu (1997) explained that the process of Indonesian foreign investment deregulation "occurred more gradually, culminating in a substantial deregulation in June 1994." The process covered the period between 1985 and 1986 when the restrictions on foreign ownership and requirements on divestment were lifted for export-oriented investments and those located in bonded zones. In 1992, investments worth more than $50 million or those located in eastern Indonesia and in bonded zones were allowed to be owned entirely by foreigners, with less stringent divestment requirements. In 1993, this was extended to investments with a minimum capital of $2 million in the supplier industry, to encourage small and medium-sized foreign investments in components and parts in the electronics industry. In the same year, Entry-Port for Exported Production (*Entrepot Produksi Tujuan Ekspor* or EPTE) was introduced as a new form of a stand-alone export-processing zone. Finally, in June 1994, 100 percent foreign ownership, with few restrictions, was allowed; the divestment requirements were virtually eliminated; and nine public goods sectors, such as power generation and telecommunications, were opened to foreign participation. Since then, the rules on EPTE management have been improved through better regulation, resulting in both significant growth in exports and export-oriented foreign investments.

The series of deregulation packages has affected the flow of FDI despite its limitation in terms of amount. Its limited contribution was on gross fixed capital formation in Indonesia (about 6 percent between 1987 and 1997) and employment (less than 1 percent of the labor force).[8] FDI contributed to generating net export revenue (20 percent of total manufactured exports), developing supplier and support industries, transferring technology and generating tax revenues in the 1990s.

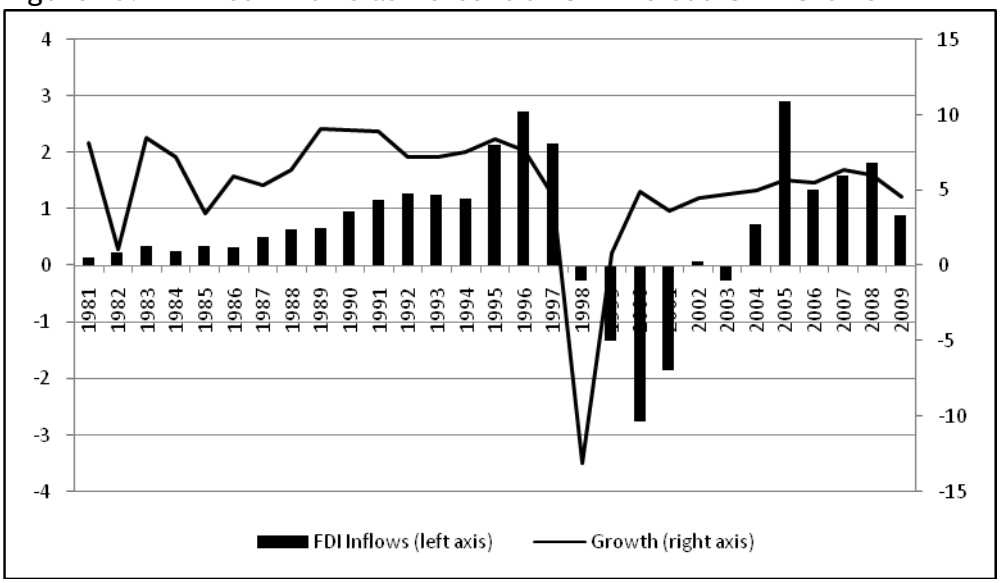
The openness to international capital accompanied by macroeconomic stabilization had attracted both foreign capital as well as domestic investment and eventually diversified the outputs. On the other hand, it decreased the portion of the extractive sector. Note that the extractive sector was not in the restricted investment list; therefore there were several foreign companies operating in this sector. As higher FDI influences a country's performance, it also works in the opposite way: high-performing countries attract high capital inflows. Of course investors want to secure their funds. Figure 10 illustrates that the period of high economic growth was followed by high FDI inflows, while during the economic crisis, there were massive capital outflows and the effects lingered for a while.

7

The Indonesian industrial structure was marked by large SOEs dominating strategic industries—producing cement, fertilizers and steel—funded by oil revenues; meanwhile the foreign and domestic companies carried out import-substitution activities in various manufactured products like textiles, clothing, consumer electronics, chemicals and automobiles. Around the mid-1980s, plywood, textiles and garments became the main exports of manufactured products. Plywood enjoyed the benefit of subsidized loans and regulations banning timber exports, while textiles and garments soared from the comparative advantage of low labor costs, as well as export subsidies that comprised subsidized export credits and the implicit subsidy inherent in the duty-exemption scheme operating between 1978 and 1985.

8

Figure 10: FDI Net Inflows as Percent of GDP versus GDP Growth



Source: World Bank Development Indicators, 2010.

Further, Table 3 illustrates that the extractive sector's role in Indonesia's economy has declined over time and was significantly decreasing during the period of industrialization. The Asian crisis hit import-based manufacturers the most since they could not contain the sharp depreciation of the rupiah currency, and that made Indonesia rely on the extractive sector again (see Figure 7 for the role the extractive sector plays in export value).

Table 3: The Role of Extractive Sector in Indonesian Economy

Year	Period of	Extractive Sector	
		Average Ratio to GDP	Growth (%)
1960-1967	Closed Economy	14.97	1.01
1968-1978	Open up to FDI	25.24	37.58
1979-1997	Industrialization	15.19	-55.00
1998-2009	Post-crisis	10.29	-32.75

Source: Statistics Indonesia, 2010, calculated by author.

Section 4. Policy Mix and Its Determinants

As discussed in earlier sections, Indonesian industrial policies began with an import-substitution policy in 1970s while the country enjoyed high revenue from oil exploitation. The government was inward-looking and did not consider foreign investment as a growth engine. Most capital spending during this period was prioritized on transportation infrastructures (especially on Java) and agriculture. Yet, infrastructures for electricity and mass transportation were pretty much abandoned.

The large investment in agriculture and basic infrastructure paid off as the country remarkably improved its Human Development Index (HDI). Additionally, apart from increasing the welfare of people, it also provided and abundant supply of labor, sufficient amounts of food and inputs for other products. This condition also supported the country's preparedness for industrialization.

Beginning in the 1980s, the manufacturing sector and exports grew significantly. This shifting from crops to industry reduced the share of the extractive sector to Indonesian GDP from about 50 percent to 25 percent. However, the growth was mainly pulled by labor-intensive industries that have only a little effect on innovation and technology transfer. With only a little investment on innovative technology during the previous decade—despite high income from exporting oil—the country had a relatively unskilled workforce and had deprived itself of vital infrastructures. Reliance on labor-intensive manufacturing indeed supports jobs creation and reduces the poverty level, but is not sufficient to lift the industrial sectors up to the next level of competitiveness.

Export-oriented policies were effective and immediately became growth engines. There were debates over which policies should be undertaken when Indonesia started to develop, but at that time, outward orientation was not popularly adopted. With narrow foreign markets on input and output, and especially for the country that just started economic development after two decades of political turbulence, one can expect that import-substitution was the eloquent choice available. In most countries that are now known as open economies, applying an import substitution policy usually started the process of industrialization.

The main failures did not lie on choosing inward-looking policies during the oil boom, but rather on trivial spending to prepare the economy for the next stage of industrialization. Furthermore, the administration did not anticipate challenges in the future if energy becomes scarce, thus its opportunity cost becomes higher; and the economy cannot rely on exporting raw natural resources products forever, because of their scarcity and limited endowment. These views were not envisaged in Indonesian policies even until the 1997 crisis.

Windfall profits from high oil prices were not invested in resource-based or capital-intensive manufacturing. Following the conventional path of labor-intensive manufacturing and trying to transform it into a capital-intensive form without fulfilling its prerequisites (e.g. skilled labor, adequate infrastructure, mastering the technology, institutionalized capital markets, etc.) is a formidable task. One can see that even until today Indonesian industries have not brought themselves into high-tech and capital-intensive industries; instead it recently has a

declining trend, making the role of the extractive sector seem to increase once more (Figure 7). Bonaglia and Fukasaku (2003) argued that resource-rich, low-income countries should diversify into resource-based manufacturing or processing of primary commodities instead of following the conventional path of low-skill manufacturing.

Another thing to consider is that international demand for manufactured products was restricted by transportation costs and diversification. During the 1970s, intra-Asian trades were limited. South Korea and Japan have captured demand from North America, thanks to their advanced level of technology. There were not so many sectoral choices for the least developed countries during 1970s. Unfortunately, in the 1980s, while Indonesia was enjoying export growth from manufacturing, it did not place a clear path for its future industrialization. After being severely hit by the Asian crisis, Indonesia had lost too many opportunities to grow again. The reversal condition during the crisis had revealed weaknesses in policy instruments and institutions, especially in managing the competition.

In a competitive market, the government must assure and provide several preconditions managed by a set of fair, clear regulations. Several institutions that work on and enforce regulations must exist and work well, and they could be financial, capital and equity markets, market regulators, antitrust institutions and business courts, etc. The collapse of the banking system in 1997-'98 resulted in the loss of confidence in all sectors and also the relationships with international trade partners. Indonesian manufacturing relied much on comparative advantages, including inexpensive labor and land, subsidized energy prices, and simple environmental standards; all these aspects eventually must be improved to comply with development progress and fiscal discipline. Emerging neighbor countries will in the near-term defeat Indonesia's temporary low costs of labor and land. The government could no longer give generous subsidies for energy since it became more costly and scarce. A recent simulation by the Indonesian Ministry of Finance shows that every dollar increase in crude oil prices could have increased revenue by as much as approximately $290 million, but at the same time it pushed up energy price subsidies as much as $380 million, leaving the national budget with an additional deficit of $90 million or 0.7 percent of estimated 2011 GDP.[9] This simulation indicates that subsidy policies impose potential high risks to Indonesian macroeconomic stability.

An ideal political revolution (from authoritarianism to democracy) should be able to change the mindset of the nation. Therefore the nation can utilize the advantages of revolution, including the freedom to innovate and openly exchange knowledge. Unfortunately this was not the case for the Indonesian political revolution of 1998. Changes of the political regime provide people with freedom to criticize everything without adequate and proper instruments for facilitating them such as regulations, rules, arbitration institutions and court systems. Low-skilled workers now demand wage increases every year, people challenge the government in land ownership disputes, and in some regions there are clashes between communities and the armed forces. Decentralization gives more authority to local governments via multi-interpreting laws, and conflicts often occur between the levels of government in managing investment and business. New investment procedures are lengthy, costly and confusing. Most of this mess was caused by poor regulation and weak enforcement. Corruption is still the main unsolved problem in Indonesia, as one can see in

9

the 2010 Transparency International's Report. The situation is certainly bad marketing for investors. This part leads to the discussion on institutional setting.

President Suharto was a central figure who kept full authority in all aspects, including the armed forces, Parliament, subnational governments, economic development and the legal system. To manage economic operation, his cabinet maintained three coordinating ministries: Economic Affairs, Politics and National Security, and Welfare. All others were grouped into one of the three coordinating ministries. In terms of policy implementation, the system was somehow quite efficient because the command lines were clear; disputes could be solved by the highest command (the president). The system had low transaction costs because of the effective internalization of the externalities that may occur.

Certainly, this institutional setting had a number of weaknesses; a one-man show depends heavily on a single judgment that may be right or wrong. It is also closed to wider participation and innovation, as well as adverse selection; the good people and ideas may be driven out.

The nation has witnessed several failed plans during the New Order regime. The1,000,000 Hectares Peatland Conversion project, in which the government wanted to create productive land by converting peatland in Kalimantan, resulted in total failure, and an aircraft mega project went bankrupt after spending billions of U.S. dollars. After the regime's fall, the system swung to becoming a decentralized and democratic one. This increased participation from all stakeholders, but also increased transaction costs and conflicts across institutions. This is mainly because the nation is still in its initial point of the democratization learning curve.

During the crisis and afterward, there were capital flights, and industries left Indonesia to go to more competitive countries such as Vietnam, China and Thailand. Indonesia also relied too much on a small number of importers, including the United States and Japan. Since it had only little in the way of capital goods industries, Indonesia's position was weaker than the competing countries. Because it lacked infrastructure and had a high-cost economy, Indonesia lost its competitiveness during the aftermath of the Asian economic crisis. The World Bank *Index of Doing Business* for 2011 reported that in terms of competitiveness, Indonesia is 121 out of 183 countries, down from 115 in 2010. The major reasons for this are problems in "starting a business" (ranked 155), "enforcing contract" (149), "closing a business" (142), "paying taxes" (130), and "getting credit" (116). These show that streamlined procedures and policies that support investment are not in place.

Relaxing rigidity and restrictions in investment regulations can increase economic diversification. Low entry barriers induce more players to come in and bring the industry into a more competitive market. The new Commission for Supervision of Business Competition (*Komite Pengawas Persaingan Usaha* or KPPU), established in June 2000, is an advance to supporting diversification.[10] The commission has cracked down on some monopolized industries and acts of collusion done by big players. In spite of this institutional progress, there are still a number of tasks that the government has not addressed, including clarifying and simplifying business procedures, law enforcement,

10

creating the right business incentives, reducing misallocated subsidies, and improving labor competencies.

Section 5: Conclusion and Policy Recommendations

From the previous discussion in this paper, we could see that Indonesia's decision to move to industrialization began with the adoption of import substitution policies to achieve a self-supporting economy. Even though there were a lot of arguments that a country cannot produce all goods and services at an efficient point due to variation in comparative and competitive advantages, Indonesia had benefited from the subsequent industrialization. As the government provided more options for investors and the economy attracted more investment, the structural transformation began. This was a strategy adopted by the New Order during the initial period of economic development. Massive international funds then flew to Asia during 1980s and offered diversification options in host countries.

The degree to which an industrial policy succeeds can be determined by some key features; among them are macroeconomic and political conditions, provision of infrastructure, as well as institutional setting. Dhanani (2000) identified three key elements of macroeconomic stability, namely stable and competitive exchange, interest and tax rates. The government maintained the stability of local currency by adopting a managed floating exchange rate regime (and later a floating exchange rate regime since the Asian crisis) and controlled inflation by subsidizing major commodities. Tax rates had been kept low—resulting in a preferable situation for investors, but at the cost of low tax revenues for the budget.

Policies adopted in industrialization were facing various tradeoffs. Political stability is the basic requirement for development, and it was conducted at the cost of human rights violations as well as through a undemocratic governmental system. Macroeconomic stabilization was achieved through strict state control and heavy intervention in the market; the economy was centrally planned and, as a result, the regions had almost no role in economic development. Basic infrastructure was built and centered in Java—and Sumatra to some extent—basic education improved, and agricultural productions were regulated and subsidized.

Low tax rates to some degree supported investment levels—and job creation—but the subsequent low revenues reduced the opportunities to provide adequate infrastructures. Adoption of inward-looking industrial policies also reduced the country's exposure to international competition, which in turn hindered capacity building compared with Indonesia's international counterparts. When the government eventually adopted the policies to promote exports, it was not very competitive despite abundant cheap labor, land and supplies. In the period of high growth in manufacturing and export, Indonesia benefited from employment, foreign exchange reserves and international trade advantages such as technology advances and enhanced efficiency.

Catching up with a lack of infrastructure is time-consuming and expensive. Therefore Indonesia opted for providing pseudo-competitive advantages by giving generous subsidies for production factors (energy, land and labor costs). This strategy worked as long as the country could maintain it and failed when it was no longer reasonable to keep the subsidized prices. The democratic government elected in 1998 could not repress workers and confiscate land for the sake of industrial policy goals. Meanwhile, energy prices have been very volatile in the past decade, contributing to the bleeding of the state budget for

the tremendous amount of subsidies. In the future, Indonesia will have no choice but to reduce the subsidies.

During the New Order regime, the institutional setting was complex, but managed by the president through three coordinating ministries; this was considered efficient, yet lacking in terms of participation and innovations. Subnational governments or provinces were ruled by governors who were controlled by the Ministry of Home Affairs (all governors were army generals appointed by Suharto). While the government ran things with low transaction costs, this came with a heavy price tag in terms of human rights violations and corruption. This was replaced by a democratic and decentralized system in 2001, which had the advantages of openness and participation but also the disadvantages of potential conflicts and higher transaction costs.

The effects of the Asian economic crisis lingered in Indonesia. While the nation is now more ready and prepared for external shocks, it suffered from stagnation of productive sectors because it lacked infrastructure and complex institutional arrangements. Nowadays, the rise of the extractive sector's role may be attributed to global demand and the decreasing role of the manufacturing sector. Indonesia should take appropriate actions to bolster the situation of its manufacturing sector.

The policy recommendations could be divided into short- and long-term ones. Because investment is one of the keys to accelerating growth and diversifying the economy, policy should be directed in the short-term to attract more investments from domestic and foreign sources. To increase Indonesia's competitiveness, investors should receive benefits that are comparable to those offered by other countries. According to Feldmann (2009), the quality of the legal system has a positive relationship with increasing employment.[11] This is in line with a 2010 World Bank report that found that among the variables of investment decisions, Indonesia had a bad record in enforcing contracts. The government should seriously enforce the law to provide a fair, healthy investment atmosphere. The process of business should be made efficient and inexpensive, and this should actively involve subnational governments.

Labor law should be revised to be less rigid in places where the government provides social security for temporarily unemployed workers. Indonesia records high costs in hiring and firing workers (World Bank 2009). This means that new entrants in the workforce face very narrow opportunities, and in turn this reduces competitiveness because of less open competition.

The government should enhance the competitiveness of production factors by building capacity and smoothing the path for business. While Indonesia is largely supported by domestic demand, it is also opening its market to imported goods; so it is important to put these two factors in a competitive way of thinking. Indonesia should treat the imported products as an invitation for competition, therefore making quality improvement and cost efficiency inevitable. Support for export activity should be continued through increasing capacity for small and medium enterprises, facilitating domestic products to access foreign markets, and becoming a supportive government for international relations.

11

One of the main problems Indonesia faces is a lack of infrastructure, especially in energy and transportation. To address this problem, promoting and implementing public-private partnerships (PPP) would be favorable options. Since a president decree on this was recently issued, the government should immediately act in order to make the implementation work. It should also issue supporting regulations necessary to carry out PPPs, actively encourage subnational governments to use the scheme to develop infrastructure in the regions, educate related parties on financial market regulation, and establish institutions and manage the coordination required for the implementation.

Apart from these, the central government must provide basic infrastructure needed for investment, particularly energy and transportation. There is no need to subsidize the price of energy or transportation costs, but making them available adequately is most important. Subsidies for energy prices are not only threats to the environment but also to macroeconomic stability.

Overall, to achieve the above recommendations, Indonesia has to solve its internal problems, especially bureaucratic red tape and inter-departmental coordination. These problems have been delaying many solutions suggested before in many papers by many institutions and scholars. Timing is one crucial factor that can determine a policy's success.[12]

In the long run, Indonesia has three major challenges to address. First, it should clearly target a well-connected interregional network across the country. It is a basic requirement to induce distribution of development centers and to reduce transportation costs. Several growth centers outside Java should be equipped with adequate infrastructures, and these should be interconnected with each other and also with Java.

Second, the government needs to estimate energy needs for the future and formulate the strategy to fulfill them. If in the short run it must fulfill the minimum energy need, in the long run it must be able to not only anticipate the needs but also to make energy supply one of growth engines. This program should be performed within the context of a conserving environment.

The first and second challenges are related to the third challenge: the government must have a workable strategy to utilize its potential resources, such as alternative energy sources, human capital and the large number of abandoned islands. Aside from the benefit of increased output, an energy-mix policy can preserve nonrenewable resources. Meanwhile, redistributing development centers across the country can reduce inequalities and provide jobs for the poor. This is also the efficient way to utilize diversities in Indonesia, since regions may have different competitive sectors.

[12] One example is when the government agreed to promote PPP as a backbone scheme to support growth that has been announced since 2005 in an infrastructure summit; the government did not follow up with appropriate actions. The 91 projects offered were not well prepared, and the required policy and regulatory framework was not ready. The same thing happened again after 2006 Infrastructure Summit.

References

Arnold, J. M., and B. S. Javorcik. 2005. Gifted Kids or Pushy Parents? Foreign Acquisitions and Plant Productivity in Indonesia. World Bank Policy Research Working Paper No. 3597.

Bonaglia, F., and Kiichiro Fukasaku. 2003. Export Diversification in Low-Income Countries: An International Challenge after Doha. Working Paper No. 209, Organisation of Economic Co-operation and Development.

Chowdury, A. 2007. Indonesia's Hesitance with AFTA and AFTA Plus: A Political Economy Explanation. Paper for FTA, Regional Integration and Development Conference, Pusan National University, South Korea.

Department of Information, Republic of Indonesia. 1969. *The First Five-Year Development Plan, 1969/70-1973/74.* http://books.google.com/books?id=mtTsAAAAMAAJ

Dhanani, S. 2000. *Indonesia: Strategy for Manufacturing Competitiveness*, vol. II (Jakarta: UNIDO).

Feldmann, Horst. 2009. The Quality of Industrial Relations and Unemployment in Developing Countries. *Review of Development Economics*, 13: 56-69.

Feridhanusetyawan, T., and M. Pangestu. 2003. Indonesian Trade Liberalisation: Estimating the Gains. *Bulletin of Indonesian Economic Studies,* 39:: 51-74.

Firdausi, C.M. 2005. *Productivity Performance in Developing Countries: Case Study: Indonesia* (Jakarta: UNIDO).

Hartono, D., D. S. Priyasono, and T. D. Nguyen. 2007. Regional Economic Integration and Its Impacts on Growth, Poverty, and Income Distribution: The Case of Indonesia. *RURDS,* 19: 138-53.

Law No. 1/1967 on Foreign Direct Investment, http://www.bi.go.id/NR/rdonlyres/EDE6E4B2-F069-481C-A4BE-1A6647222F64/13987/UUN011967concerningforeignInvestment.pdf.

Law No. 6/1968 on Domestic Investment, http://www.bi.go.id/NR/rdonlyres/4957098A-E36F-4CB4-BC42-56AE9A49330B/9650/UU12th70concerningDomesticInvestment.pdf.

Nazekh, E.K.M. 2005. *Study on Indonesia Industrial Sectors Contribution to Sustainable Development* (Jakarta: UNIDO).

Pangestu, M. 1997. Indonesia: Trade and Foreign Investment Linkages, in *Multinationals and East Asian Integration,* eds. W. Dobson and C. S. Yue (Singapore: Institute of Southeast Asian Studies).

Thee, K. W. 2001. The Role of Foreign Direct Investment in Indonesia's Industrial Technology Development. *International Journal of Technology Management*, 22: 583-98

IBRD. 2010. *Doing Business 2011 Indonesia: Making a Difference for Entrepreneurs* (Washington, DC: World Bank).

Transparency International. 2010. *Global Corruption Barometer 2010*. (Berlin: Transparency International).

Related Links:

Central Bank of Indonesia: www.bi.go.id/

Commission for the Supervision of Business Competition (KPPU): http://eng.kppu.go.id/

Coordinating Ministry for Economic Affairs: http://www.ekon.go.id/

Ministry of Finance: http://www.depkeu.go.id/Ind/

Ministry of Industry: www.kemenperin.go.id/

Ministry of Trade: www.kemendag.go.id/
Statistics Indonesia: http://dds.bps.go.id/eng/