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Deep Crisis: Indonesia

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Making Trade Policy in a New Democracy after a Deep Crisis: Indonesia*

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Abstract

This paper examines the recent political economy of trade policy in Indonesia against the backdrop of two key events: the deep economic crisis of 1997-98, and the transition from three decades of rapid growth under an authoritarian regime to a weaker but democratic state. We investigate both international and domestic trade policy. The international trade policy regime has remained largely open, perhaps surprisingly in view of the unpopularity of liberal economic policies in the wake of the crisis and the forces advocating more protectionist policies. However, this openness is precarious, and lacks both institutional and community opinion support. In contrast, while remaining largely open at the international border, domestic barriers to trade have increased. This conjunction of economic crisis and weak, democratic states is a common phenomenon in the developing world, and the lessons for trade policy from the Indonesian experience over this decade are therefore relevant to many other countries.

Key Words: Trade Reform, Political Economy, Domestic Trade, Indonesia

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(1) Introduction

How do deep economic crises affect trade policy in developing countries? The conventional historical view is that economies turn inward, in an attempt to protect firms and employment, to restore trade balances, and in response to the perceived negative consequences of globalization. As a corollary, the conventional wisdom has been that governments find it easier to reform during 'good times', of strong economic growth and low unemployment.

However, over the past two decades, an alternative view has arisen, based on the observed behaviour of countries in crisis. This is what Little et al (1993) have termed the 'new liberalization'. That is: 'The balance of payments crisis creates the shock environment in which trade liberalization and other radical policy changes become possible.' (p. 271)

The political economy explanations for this changed behaviour are complex, and include both generic and country-specific factors. The purpose of this paper is to add to our understanding of the nexus between trade policy and crises with reference to a study of the Indonesian experience since the late 1990s. After three decades of mostly rapid economic growth, accompanied by liberalization in the late 1960s and mid 1980s, the country experienced a deep economic and political crisis in 1997-98. In 1998, the economy contracted by over 13%, the government signed on to a highly controversial IMF program, and the 32-year rule of President Soeharto came to an end. Authoritarian political structures gave way to a weakened state, a new and fragile democracy, and major changes in political and institutional structures.

Our main conclusion is that, perhaps unexpectedly, Indonesia remained largely open to the international economy over this period. However, in some instances, holding the line on trade reform has had more to do with the personalities involved in trade policy rather than the institutional processes for formulating that policy. Thus, openness is precarious, and not deeply embedded in either conducive institutionalized policy making structures or widespread popular support. Moreover, barriers to domestic trade have risen significantly and now pose a substantial threat to the country's economic integration. This latter issue has received relatively little attention in the literature on trade policy and crises, and yet it may now be the most serious challenge, especially in countries whose central governments have greatly weakened authority.

We are unaware of a substantial literature on this subject for other developing countries, addressing both international and domestic trade policy. But we conjecture that the Indonesian experience has wide general applicability. This is therefore an issue which other developing countries and international development agencies will need to address in post-crisis environments.

Our organization is as follows. Section 2 provides some context on Indonesia, including brief reviews of the evolution of trade policy and the severe economic crisis of 1997-98. Section 3, the major part of the paper, provides an overview of the changed institutional and policy making structures in the wake of the crisis, and then examines the international and domestic trade policy regimes. A final sub-section sketches the main, ill-fated attempt by the

bureaucracy to make new trade policy law in recent years. Section 4 sums up our arguments and draws attention to some broader implications.

(2) The Indonesian Context

2.1 Indonesian trade policy under Soeharto

It is sometimes observed that 'Indonesia was made by God for free trade'. This is a reference to its status as the world's largest archipelagic nation, its porous international borders, 17,000 islands, sometimes rampant smuggling, and proximity to free-trade Singapore and the major international sea lanes of the Malacca Straits. However, the official trade policy pendulum has swung over its six decades as a nation state from virtually complete commercial isolation to very open regimes.

There have been major changes in Indonesia's trade policy regime since the 1960s. By 1965, the country had disengaged from global trade and investment, and withdrawn from the United Nations, the IMF and the World Bank. The political turbulence of 1965-66 then ushered in a radical shift towards economic orthodoxy, including prompt and effective macroeconomic stabilization, and an open commercial policy. This period of liberalism was short-lived, however. By the early 1970s, there was a nationalist resurgence, prompted in 1973-74 by the sudden increase in international oil prices, and vigorous anti-Japanese protests. Tariffs were increased, but more importantly the government embarked on an ambitious program of heavy industrialization underpinned by increased resort to non-tariff barriers (NTBs). Such a strategy persisted for about a decade.

It was only in the early 1980s, and more decisively in the mid 1980s as oil prices continued to fall, that key economic policy-makers – the so-called 'technocrats' – were able to arrest the trend, and then embark on a series of major trade reforms. The second half of the 1980s constituted the high point of the reforms. This was a highly successful case of 'low politics' in the words of Soesastro (1989). The technocratic reformers largely eschewed 'high politics', in the sense of engaging in grand ideological debates. Rather, they developed a strategic reform program and, partly with the assistance of low-profile foreign advisors, persuaded the president that, in view of the falling international oil prices, the country faced a Mexico/Nigeria scenario (the two most commonly used international comparators) of debt crisis and IMF intervention if the liberalizations were not effected. Once Soeharto was convinced, reform was swift and effective. There was limited public debate. The reforms were not even referred to as 'liberalizations', but in deference to nationalist sentiment the politically milder term 'deregulation' was adopted.

The most thorough set of estimates of the trade policy regime in the late Soeharto regime are those computed by Fane and Condon (1996). Employing a consistent estimation methodology and data base, they concluded that the weighted average rate of effective protection for manufacturing (excluding the special case of oil and gas processing) declined from 59 per cent to 16 per cent over the period 1987-95, while the dispersion (standard deviation) fell from 102 to 39. The coverage of NTBs fell even faster: the percentage of non-

oil manufacturing value added affected by NTBs declined from 77 per cent to 17 per cent.

These estimates do not take account of the fact that most exporters of manufactures were effectively operating on a free-trade footing through various export zone and duty rebate provisions. The estimates are also unable to measure the proliferation of crony-related and firm-specific protection which began to spread in the 1990s. Nevertheless, the aggregate picture is unlikely to have been altered significantly by these interventions, especially as much of the 1990s cronyism was concentrated in non-tradable activities. Thus, at the time of the crisis Indonesia was a broadly open economy. Most sectors received quite low protection, except where politically influential lobby groups and individuals were able to resist the effective 1980s liberalization.

By international standards, Indonesia's reforms since 1980 have been incremental rather than 'big bang'. Rajapatirana (2001) accurately characterizes the country as a 'mild reformer' since the 1980s. According to the Sachs-Warner (1995) methodology, Indonesia was 'open' for a few years from the late 1960s and for most of the period since the late 1980s. Moreover, importantly, and borrowing Jagdish Bhagwati's (2002) terminology, the reforms were a case of 'genuine unilateral liberalization'. They were not part of an IMF/World Bank program, though these actors played a peripheral role. Nor were they conditional upon reciprocity, although shortly afterwards Indonesia was to enter into several regional trade agreements, principally involving the Association of Southeast Asian Nations.

2.2 The economic crisis of 1997-98

Indonesia experienced a deep economic crisis in 1997-98. Its economic contraction in 1998 was the sharpest decline among all four crisis-affected East Asian economies. This followed three decades of virtually uninterrupted, rapid economic growth, the first such occurrence in the country's history.

Triggered initially by the run on, and subsequent collapse of, the Thai Baht, Indonesia began to experience large-scale capital flight in the third quarter of 1997, resulting in a sharp depreciation of the Rupiah and financial distress.¹ At the peak of the crisis, the dollar exchange rate had fallen from Rp2,500 to Rp17,500, and credit in the modern financial sector had effectively dried up. In the first half of 1998, there was a loss of macroeconomic control, and inflation on an annualized basis exceeded 100%. The economy contracted sharply from late 1997, by over 13% in 1998. The industrial sector declined by a similar order of magnitude.

The economic crisis also precipitated a political crisis, culminating in May 1998 in the end of the 32-year authoritarian Soeharto regime. This created a

¹ For detailed analyses of the crisis, see the four-monthly 'Survey of Recent Developments' in the Bulletin of Indonesian Economic Studies. Hill (1999) documents the crisis and immediate post-crisis developments, while Temple (2003) offers an interpretation in the context of longer term growth dynamics and vulnerabilities.

political and institutional vacuum, heightened social and ethnic tension, and for a period threatened the country's territorial integrity.² Investment, both domestic and foreign, also collapsed. In the six years prior to the crisis, net annual FDI inflows averaged \$2.7 billion, whereas there were net annual outflows of \$1.4 billion for the five years after the crisis.

Reflecting its 'twin crises', both economic and political, Indonesia also recovered more slowly than its East Asian neighbours. Growth was negligible in 1999, but recovered to nearly 5% in 2000. For the period 2000-05, growth averaged 4.5%, in contrast to the 7.3% recorded in the pre-crisis period 1990-96. In the immediate post-crisis period, exports responded significantly to the exchange rate depreciation, with a lag. However, in spite of buoyant commodity prices in the early years of the 21st century, export growth since 1998 has been sluggish, compared to both neighbouring East Asian economies and the country's pre-crisis record (Athukorala, 2006b).

(3) Post-crisis Policy Making in Indonesia

(3.1) New Institutional and Policy Making Structures

As a result of the crisis and regime collapse, Indonesia's political environment has changed radically.³ There has been a shift from a 'hard', authoritarian, corrupt but growth-oriented state delivering broad-based, rapidly improving living standards, to a 'messy', weakened, democratic, corrupt state, with the political leadership not yet able to provide a clear and unambiguous commitment to growth. The economic policy-making environment has changed, in some cases profoundly, in at least eight key respects. As we shall see below, these changes have major implications for how trade policy is formulated and implemented.

The first is a weakened presidency, a deliberate outcome of the anti-authoritarian sentiment in the wake of the Soeharto regime. Soeharto was characterized as being in 'supreme control' (in the words of Mackie and MacIntyre, 1994) for the second half of his presidency. Post-Soeharto political reforms have deliberately weakened the presidency, although the office was strengthened by the clean and effective direct election process in 2004.

The second changed parameter is significantly weaker cabinet unity. For most of the Soeharto period, the cabinet was essentially a mechanism for reporting to the president, and the economist members of cabinet operated as an effective de facto caucus within it. Post Soeharto, and especially under the three presidents between him and the current leader, cabinet unity was the exception rather than the norm, and cabinet members came to quickly represent particular constituencies, most commonly political parties. Public disagreements among the economist members of cabinet have been quite common.

² East Timor, which had been annexed by Indonesia in 1976, reverted to a UN trust territory in 1999 and subsequently became an independent state.

³ For reviews of post-Soeharto politics and political economy, see Liddle (2005) and the contributions to Bresnan (ed, 2005).

Third, the parliament (Dewan Perwakilan Rakyat, Peoples Representative Assembly) has been transformed from a moribund rubber stamp into a powerful, assertive, legitimate but unpredictable political force. The executive arm of government can no longer assume that bills introduced to the parliament – including the annual budget – will be approved. The proliferation of political parties, weak party discipline, the absence of coherent ideologies and policy platforms, and low levels of economic literacy have all resulted in a strong inclination towards populist politics, reflecting a general community reluctance to embrace liberal economic policies.

Fourth, and as a corollary, the newly liberated political parties face the imperative of campaign funding. Inevitably, this has spilled over to economic policies as votes are purchased in exchange for the allocation of rents, including in trade policy. The Indonesian media has reported several cases of alleged rent seeking trade policy measures introduced prior to the last national elections, of 2004.⁴

Fifth, the long suppressed civil society has suddenly become noisy and influential. 'Street politics' and 'rent a crowd' demonstrations are very frequent occurrences. Often little more than a sideshow, on occasion widespread public protests have been decisive, as for example in the overthrow of Soeharto in May 1998, and the opposition to the removal of the fuel subsidy in 2005. Almost invariably, these protests are 'populist' in nature and have little appreciation for economic literacy. A free press has also flourished. While diverse in its ownership and occasionally fearless in exposing government malfeasance, here to economic literacy has remained abysmally low, and liberal economic views are sidelined.⁵

A sixth parameter to have changed is the bureaucracy. Under Soeharto, it was a tool of, and subservient to, the all-powerful executive. In the process, it paid little attention to the parliament, the press and public opinion. There was also little attempt to build a professional, independent, non-political civil service. Promotion was based almost entirely on seniority, the career structure was premised on entry level admission and progression within a single department, middle and senior positions were not open to outside recruitment, there was little mobility between departments, there was little incentive to acquire relevant skills, lucrative (rent allocating) positions were routinely 'purchased', and an apparently highly compressed salary structure concealed a complex system of supplements at the senior level, quite apart from any illegal payments. There has been little attempt to reform the structure and organization of the civil service since the fall of Soeharto

⁴ For example, the then Minister of Industry and Trade facilitated counter-trade and barter deals with Russia and some other countries in a non-transparent manner, which were later picked up by the press. The Minister also attempted to impose a temporary surcharge on the importation of selected commodities three months prior to the presidential election of that year.

⁵ The two principal exceptions to this generalization are small circulation newspapers, the Jakarta Post and Bisnis Indonesia, read respectively by the elite foreign and business communities.

(McLeod, 2005). The bureaucracy remains a powerful force, but it is gradually being forced to face the accountability demands of both parliament and civil society. The fluidity of party politics and a weakened executive are also eroding its twin anchors of stability and power.

Seventh, the legal system is gradually evolving into a more powerful independent entity, affecting both political and commercial spheres. It too was largely irrelevant during (and prior to) the Soeharto era, except for minor cases where key political and business actors had no stake. Progress since 1998 has arguably been greater in political and constitutional matters than in commercial dispute resolution. In the case of the latter, the courts were placed in the virtually impossible position of suddenly being expected to resolve deeply complex cases at a time of unprecedented commercial distress, without the resources, skills, and case history precedents, and with a strong predisposition to favour debtors, especially where the creditors are foreign or government entities (Lindsey, 2004). Predictably, very little progress has been achieved. Business entities, especially those owned by foreign and politically unconnected domestic groups, therefore remain highly suspicious of the legal system, and avoid it wherever possible.

Finally, in an effort to preserve the nation's territorial integrity, a 'big bang' decentralization reform was hastily passed by the parliament in May 1999, and introduced in January 2001. This involved a significant devolution of power and resources from the central government to the second tier of regional governments, known as kabupaten and kotamadya (districts and cities). The weakened central government has been unable to prevent the rapid fragmentation of regional administrative units, and these second tier governments now number approximately 450. Centre-region relations are still in transition, with the national government attempting to regain some of its lost administrative and financial authority. We return to this issue in section 3.3 in our discussion of domestic trade issues.

These changes have far-reaching implications for trade policy. The national government is weakened, and there are many more policy actors. The framework for making economic policy has changed significantly. In particular, the 'low politics' strategy is no longer viable. That is, one which involves a unified team of economists with a shared policy outlook devising a reform program and convincing the president of the case for reform, aided by adverse external circumstances and low-profile foreign advisory inputs. The reformers now have to win over a constituency, in the parliament, the press and civil society, in generally unfavourable ideological circumstances and where money politics plays a larger role. Against this complex institutional and political backdrop, we now examine the making of international and domestic trade policy in the post-Soeharto era.

(3.2) International Trade Policy

At the outset of the crisis, as noted, Indonesia was a fairly open economy. As the country became ever more deeply engulfed in the economic crisis of 1997-98, the government signed on to a series of Letters of Intent (LOI's) with the International Monetary Fund. The increasingly acrimonious relationship

between the government of Indonesia and the IMF resulted in several rounds of renegotiation. While most of the conditions in these LOI's pertained to macroeconomic and financial policy, there were a number of trade related provisions. These provided for further trade liberalization, principally the removal of NTBs and domestic monopolies. Although the involvement of the IMF was highly unpopular, several of the trade provisions were broadly accepted by the community. Several involved the removal of special privileges granted in highly controversial circumstances to members of the Soeharto family. These included a clove monopoly (governing the marketing and distribution of this key input into the country's ubiquitous kretek cigarette industry) and a so-called national car program. Monopolies in the cement and forest industries, and in the distribution of several agricultural commodities (oranges, cashew nuts), were substantially dismantled.

In deference to nationalist sentiment, the government formally exited the IMF program in late 2004, although the Fund maintains a presence in the country. However, at the same time the government has announced its intention to proceed with continuing trade liberalization, including the tariffication of most remaining NTBs, and an in-principle commitment to unify tariffs and reduce them to around 5% by 2010. This in 2005 the government began what it called a 'tariff harmonization' program with the objective of adopting a uniform tariff rate (see Box 1 for further details). Team Tariff, an inter-ministerial team housed in the Ministry of Finance (MOF) was responsible for the program. It established criteria for setting tariff rates. These included lowering the average tariff rate, and reducing the number of tariff bands. The program was carried out in two stages. The first stage covered about 1,900 tariff lines, mainly agriculture commodities, and was implemented in early 2005. The second phase covering more than 9,000 tariff lines was completed in February 2006.

Box 1: The Tariff Harmonization Program: A Negotiated Outcome between Departments?

Indonesia has implemented a series of tariff reform packages since the mid-1980s, with the result that its average tariff rate of 8.5% is among the lowest in East Asia. In 2005 the government began what it called a 'tariff harmonization' program with the objective of moving tariffs towards a uniform rate. Team Tariff was responsible for the program, and it established criteria for setting tariff rates. These included: i) lowering the average tariff rate to 5%; and ii) reducing the tariff bands. The program was carried out in two phases. The first covered 1,900 tariff lines, mainly agriculture goods, for which implementation began in early 2005. The second phase, covering more than 9,000 tariff lines, was completed in February 2006. The tariff harmonization program specifies a tariff reduction schedule from 2005 to 2010. By 2010 about 94% of all tariff lines will have rates at or below 10%. The remaining 6% (the so-called 'sensitive sectors') would have their rates reduced by 2020.

While Team Tariff had established basic guidelines for the committee members to follow when determining tariff reductions, in practice the final recommendations were essentially achieved through negotiations between the different line ministries represented in Team Tariff. No standard analytical tools were used during this exercise. For example, there were no simulated

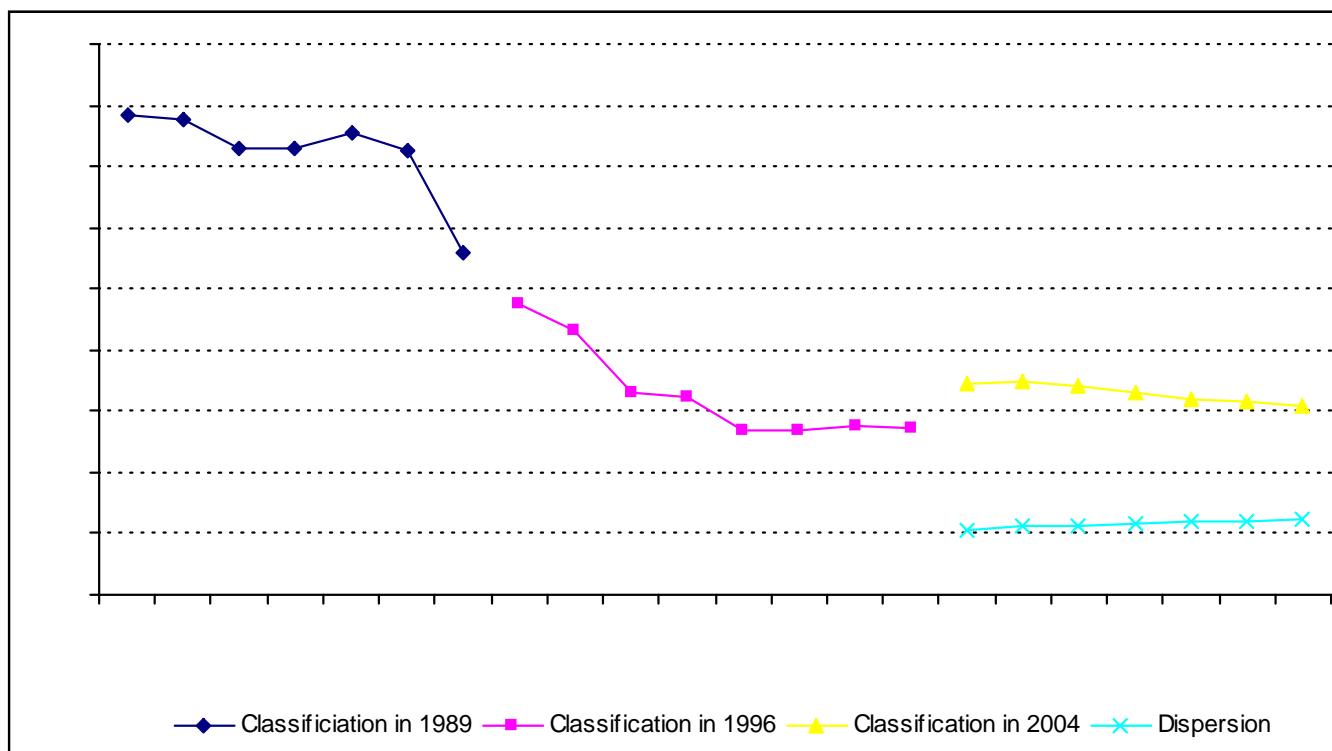
effective rates of protection to ascertain potential impact on resource misallocation. The negotiations are believed to have slowed the pace of reform in so-called sensitive sectors, in the process slowing progress towards the stated goal of a uniform tariff rate. While the average tariff rate is scheduled to decline from 8.5% in 2005 to 7.7% in 2010, the dispersion of rates actually increases (see Figure 1).

There are distinct differences in treatment between agriculture and non-agriculture goods. The simple average tariff rate for agriculture goods remains relatively high and with only a small decline from 14.9% in 2006 to 14.6% by 2010. Rice is subject to a specific tariff of Rp450/kg and sugar to Rp750/kg. Rice and sugar are subject to import quotas as well. Non-agriculture goods are subject to a lower average tariff and bigger declines over the schedule period: the simple average falls from 9.2% in 2006 to 8.1% in 2010. This differential treatment also reflects the various constituencies represented among the line ministries and also the broader political environment. The Department of Agriculture has been traditionally protectionist, but this predisposition has increased after the appointment of the new minister for agriculture in 2004. He is a senior member of the Justice and Prosperity Party, a small Islamist party and member of the ruling government coalition. The party's economic platform tends to be more inward-looking than the other parties in the coalition.

The new tariff harmonization program specifies a tariff reduction schedule from 2005 to 2020. By 2010, 94% of all tariff lines would have rates at or below 10%. The remaining 6% of tariff lines (the so-called 'sensitive sectors') would have their rates reduced to 10% by 2020. Team Tariff provided recommendations on the tariff harmonization program to the Minister of Finance, who then issued a decree implementing changes to the tariff schedule. While Team Tariff had established basic guidelines for the committee members to follow when determining tariff reductions, in practice the final recommendations were essentially achieved through negotiations between the different line ministries represented in Team Tariff. No standard analytical tools were employed during this exercise. For example, there were no simulated effective rates of protection to ascertain the potential impact on resource allocation. The negotiations are believed to have resulted in slowing tariff reform in so-called 'sensitive sectors'. In the process, this slowed progress towards the initially stated goal of a 'uniform' tariff rate.

In sum, the tariff harmonization effort resulted in the following seven outcomes. First, a reduction in the weighted average MFN tariff rate from 8.7% in 2004 to a likely 7.7% in 2010 (see Figure 1).

Figure 1: Median Tariff Rates, 1989-2010



Second, an increase in the actual number of tariff bands from 8 to 9 (the addition is the 8% band). However, by 2010 about 87% of all tariff lines are likely to fall into 2 bands – the 5% and 10% bands. The tariff harmonization program also resulted in fewer tariff lines subject to a zero import duty: the percentage of tariff lines subject to a zero duty falls from 22% in 2004 to 5.5% in 2010 (see Table 1).

Table 1
Distribution of MFN Tariff Rates under the Tariff Harmonization Program

Tariff Band	2004	2006	2008	2010
0%	2334 (21.9)	2454 (22.0)	2320 (22.8)	557 (5.5)
5%	4344 (39.0)	4134 (37.1)	3839 (37.2)	6008 (59.0)
8%	--	74 (0.7)	17 (0.2)	119 (1.2)
10%	1709 (15.3)	1703 (15.3)	1663 (16.3)	2835 (27.9)
13%	--	42 (0.4)	88 (0.9)	--
15%	1562 (14.0)	1562 (14.0)	1603 (15.7)	163 (1.6)
20%	305 (2.7)	590 (5.3)	122 (1.2)	21 (0.2)
25%	340 (3.1)	31 (0.3)	44 (0.4)	6 (0.1)
30%	11 (0.1)	43 (0.4)	13 (0.1)	14 (0.1)
35%	541 (4.9)	523 (4.7)	469 (4.6)	455 (4.5)
Weighted average tariff rate	8.6%	8.5%	8.0%	7.7%

Simple average tariff rate	11.0%	10.7%	10.3%	9.8%
Standard deviation of tariff rates	28.1	29.8	30.8	30.3

Calculated from tariff schedule.
Source: Ministry of Finance, RI

Third, the dispersion of tariff rates as measured by the standard deviation over the simple mean tariff rate is projected to increase from 2.6 in 2004 to 3.1 by 2010, indicating that the government's initial goal of a smaller dispersion in tariff rates will not be achieved.

Fourth, an exemption list of products subject to import duty of 35% or more accounts for about 6% of all tariff lines. These products will not be subject to reduced rates until 2020.

Fifth, the tariff harmonization program is in line with the long term trend in tariff reductions (see Figure 1), although it should be noted that the comparisons are not strictly accurate owing to the increased number of tariff lines in 2004.

Sixth, the effective tariff rate is much lower than the average MFN tariff rate. For example, customs data suggest that the average, effective tariff rate is in the range of 3-4% (i.e., customs duties divided by import value). This arises for two reasons. One is that Indonesia's commitments to the ASEAN Free Trade Agreement (AFTA) mean that most common effective preferential tariff (CEPT) lines have rates ranging between 0 and 5%. The other is that a substantial proportion of imported intermediate goods are duty-exempt under Indonesia's various export facilitation programs.⁶

Seventh, the economic efficiency effects of the harmonization program are not clear, as the dispersion of tariff rates will slightly increase by 2010. Moreover, the program still exhibits a cascading tariff structure, which would be consistent with a positive, average effective rate of protection for final goods.⁷

So much for tariff policy. The picture is much less clear-cut in the case of non-tariff barriers (NTBs), and this illustrates the precarious nature of Indonesia's trade openness. During the last decade of the Soeharto era, Indonesian trade policy was broadly consistent and unilateralist, both across sectors and with reference to trade policy instruments. In particular, both the average tariff and the number of NTBs declined. However, since 2001 trade policy has become inconsistent. This is indicated by the trends in various trade policy measures.⁸

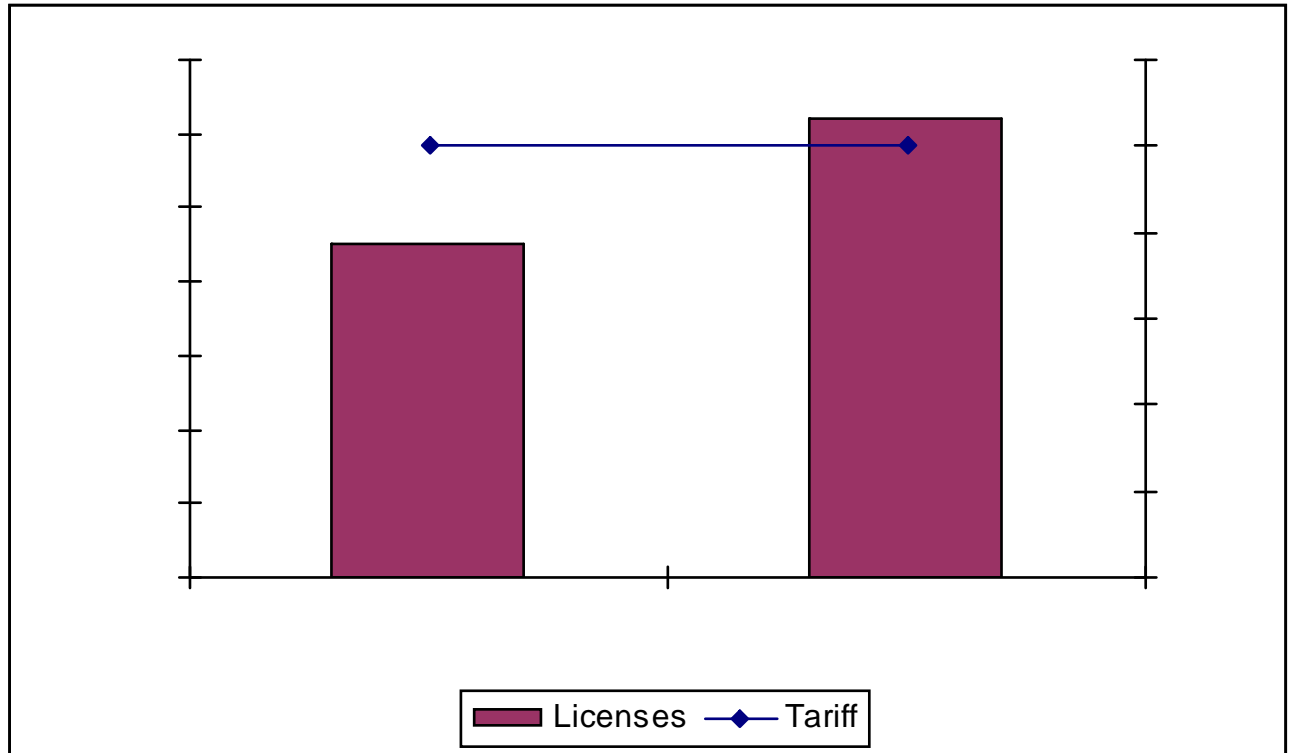
⁶ Recent data are not available on the value of imported goods exempted from duties, but this could be as much as \$10 billion per year, or about one quarter of non-oil and gas imports.

⁷ The program aims to set tariffs in 2010 at 5% for raw materials, between 5% and 10% for intermediate inputs and 10% for final goods.

⁸ The Ministry of Trade generally issues three types of importer licences. An importer-producer (IP) licence (applied for example to the sugar industry) means that only the producer of that commodity can also import it. The

Figure 2 shows that tariff rates—under the control of the MOF—remained relatively low at a median tariff rate of around 5% between 2002 and 2004. However, import licence requirements, which are under the control of the sectoral ministries, have proliferated.

Figure 2: Non-Tariff Barriers and Median Tariff Rate



This the crux of Indonesia's trade policy challenge: no minister or agency has control over the full array of trade policy instruments, and is able to adopt an economy-wide public interest viewpoint. The MOF controls tariffs, while sectoral ministries are able to introduce specific NTBs. Thus, as noted, tariff rates have remained relatively low since 2002. On the other hand, import licensing restrictions under the control of the sectoral ministries have proliferated. Basri and Soesastro (2005, pp. 10-12) provide illustrations of what they refer to as 'creeping protectionism' since 2001. Rice, sugar, wheat

restricted import licence (or IT) imposes quantitative restrictions on the importation of the commodity. These are mainly used for commodities deemed to damage the environment, alcoholic beverages, public health etc. The third type is the importers' registration (NKIP) licence, which requires the importer of a listed commodity to register with the MOT. In principle, this does not involve any restriction on who can register or how much they can import, apart from the inevitable costs of dealing with the bureaucracy. In addition, the MOT occasionally issues inter-island trade registration licences as part of its anti-smuggling drive, and reflecting the fact that certain coastal regions of Indonesia in effect control the trade regime in their ports.

flour, and cloves are some of the agricultural products affected by these new measures. Anti-dumping has come to be used as an active protectionist instrument. (See Boxes 2 and 3 for trade and regulatory policy case studies.)

Box 2: Managing Trade Policy Disputes within the Government: The Case of Wheat Flour

In 2002, a public dispute erupted between the Ministry of Finance (MOF) and the Ministry of Industry and Trade (MOIT) over the former's refusal to raise import tariffs on wheat flour. The wheat flour producers threatened to sue the Minister of Finance. In 1998, the wheat flour industry was deregulated under the IMF structural adjustment program. The monopoly of the National Food Logistics Agency (BULOG) over the importation of wheat flour and the distribution of flour within the domestic market was removed, and the import tariff rate set to zero. The dominant producer, PT Bogasari, was then subject to unrestricted import competition for the first time. Subsequently, its market share fell from around 90% in 1998 to 65% by 2001. In 2001 the company requested the Indonesia Safeguards Committee, located in MOIT, to impose a tariff of 20% on imports, on the grounds that the surge in imports was damaging the wheat flour industry and could potentially cause job losses (the company employed about 2,000 workers). The Safeguards Committee ruled in favour of Bogasari, and the Minister of Industry and Trade signed an approval letter to raise the tariff to 20%. The Minister of Finance refused to implement the decision, based on advice from Team Tariff. The MOF argued that it has sole authority to set import tariffs by virtue of the Customs Law, which overrides the Minister of Industry and Trade's authority under a Presidential Decree establishing the Safeguards Committee. An eventual compromise between the two resulted in an increase in the import tariff rate to 6%. Not satisfied with the outcome, the MOIT used its regulatory authority to introduce a non-tariff barrier measure in the form of a standards regulation for wheat flour imports, as well as establishing one laboratory to test wheat flour at the major seaport in Jakarta. Importers of wheat flour would have to wait for certification from the laboratory that the imported flour met the specified standards. This measure reportedly resulted in delays in releasing consignments from the port. It also increased uncertainty for importers, as standards were not clearly defined. This conflicting policy outcome reflected weaknesses in institutional processes in coordinating trade policy, as well as regulatory rivalry between two key economic policy departments.

Box 3: Making Trade Policy in the Public Interest

It is difficult to argue with the central proposition that policy should be tested against some sort of notion of the public interest. In the context of trade policy, this typically involves consideration of both the benefits and the costs of a particular policy, that is, the full economy-wide effects. The mechanisms for ensuring that a public interest test is applied to proposed policy change vary from country to country. In some countries, an impact assessment is a mandatory requirement for any policy and regulatory change.

Formalizing a public interest test through a mandatory impact assessment procedure is a useful way of helping the public, the government and parliament think through all the issues. It should thereby raise the quality of both analysis and regulation. However, in Indonesia impact assessments are not produced for public information. Line ministries will undertake analysis when formulating new policy, but the quality varies across agencies, with the National Planning Development Agency (BAPPENAS), the MOF and the Central Bank (Bank Indonesia) generally producing better quality analysis than the 'line' ministries. In many instances, trade policy is formulated without adequate information and data on the benefits and costs, as well as the winners and losers. Very rarely is stakeholder analysis carried out, or public discussion encouraged by policy makers. Instead policy makers generally go public with what they call 'socialization' of the policy, explaining the policy after it has been made. Consequently, parliament and the public are not always convinced about the merits of the policy change. Several examples of policy formulation at the Ministry of Trade (MOT, formerly MOIT) illustrate these institutional weaknesses. Here we discuss two cases: i) the Ministry's review of trade licences, and ii) the proposed export tax on cocoa beans.

Trade licence review: In 2005, the MOT announced a review of many of the import licences and other regulations on foreign and domestic trade. The Ministry initially designated 77 licences for review with the purpose of either reforming or eliminating them. For this purpose a "Team 7" was established comprising seven directors from the Ministry. The Team was to make recommendations to the Minister for reform of the licences. The Ministry hired a local research institute to carry out a review of the licences. During the review process the Ministry narrowed down the number of licences to be reviewed to about 40. Eighteen months later only eight licences were revised, of which one is under review again. The disappointing pace of reform of the 40 licences arises from several administrative weaknesses in the Ministry's regulatory review.

First, the review process did not establish guidelines or principles for carrying out the review, or criteria for determining which licences should be abolished, reformed, or left alone. For example, there was no consideration that regulations should be tested against 'public interest', or a compliance cost assessment. Nor was there a requirement that licences be consistent with the government's overall investment strategy. Therefore, regulators had no guidance on how to review the licences. This affected the quality of the review and it is reflected in the revisions of the six licences.

A second weakness is that the Ministry had not kept historical records of the original purpose of the regulation, and for some licences the source of its legal basis was unknown, hence making it difficult to carry out a disciplined review of licences.

Finally, there did not appear to be established procedures that were time-bound. Consequently the review has been a slow process, demonstrated by the fact that only 8 licences had been reviewed after more than 18 months from the start of the process.

The proposed export tax on cocoa beans: Export taxes are frequently employed policy instruments which create both winners and losers. The following example provides approximations of these wins and losses. An identification of the losers also highlights the welfare of people who would otherwise be ignored in the decision-making process.

In 2005, the Indonesian cocoa processors association proposed to the government measures to develop the downstream cocoa processing sector, as part of a strategy for developing so-called higher value added industries. Among the measures suggested was an export tax of up to 10% on unfermented cocoa beans; unfermented beans accounted for almost 100% of Indonesia's cocoa bean exports. The association argued that the export tax would serve two purposes. First, it would help secure supplies of the raw material for the local processing industry, so it could further develop. Second, the funds raised from the tax could be ploughed back to farmers through financing extension services to improve quality of cocoa beans. The quality of Indonesian cocoa beans has suffered in recent years as a result of endemic pod borer infections and poor farming practices, leading to increased discounts on the international market.

Whether the proposed tax is good for Indonesia could be assessed by testing it against the public interest. However, no internal assessments were carried out by the Ministry on the welfare effects of the proposal. The producer association provided industry data supporting the proposed measures, and helped arrange meetings between government officials and industry players, including selected farmers who supported the export tax. In mid-2005 the research department of the Ministry commissioned an independent report on the proposal.

The assessment of the benefits and costs of the proposal found the following. On the benefit side, it argued that an export tax of 10% could reduce domestic prices of cocoa by as much as 10% and raise gross profit margins of processors. In 2005, the industry employed about 3,000 workers, mainly in Jakarta (with an average of about 250 workers per factory — the downstream industry is relatively capital intensive). Industry proponents of the tax reportedly suggested that the higher profit margins and plant expansions could increase employment by about 20%, equivalent to about 600 workers.

On the cost side, the benefit to processors is a direct tax on growers of cocoa beans. About 85% of bean production comes from 300,000 small holders mainly located on the island of Sulawesi. Several studies showed that farmers received almost 80% of the fob export price. Thus, an export tax of 10% would reduce farm gate prices by about 13%. For an average cocoa farm household in Sulawesi, the potential loss in income from growing cocoa beans could amount to Rp1 million (or about US\$105) per year. Based on simulations, this tax would cet. par. increase the poverty rate within the cocoa growing region from 16% to 19% of the local population.

It was also argued that some of the tax revenue collected from farmers, which could amount to US\$35 million based on 2004 export values, would be ploughed back to farmers through extension services to raise quality. But such redistributions always involve costs – costs of collecting from some and

costs of distributing to others. In this case the suggestion was not viewed as credible by stakeholders. The South Sulawesi government already levied a charge of US 5 cents per kg on exported beans, of which some portion is supposed to go back to farmers in extension services. Apparently no services have ever been provided. Moreover, the lower farm gate prices arising from the tax would be likely to act as a disincentive for farmers to grow cocoa beans in the medium term, even with improved extension services.

Overall, the public interest test suggested that the export tax would not be good for the welfare of Indonesians. A few would benefit, while many would lose from the tax. The report helped persuade some Ministry officials to reject the proposal, although the industry association continued to lobby the MOT and parliament for support for their proposal.

Moreover, many of the NTBs introduced between 2001 and 2004 were non-transparent. For example, in late October 2001 the then Ministry of Industry and Trade⁹ established an importer-producer licensing scheme for imports of 26 categories of textile fabric, with the stated objective of preventing illegal smuggling of textile fabrics. The scheme appears to have succeeded on paper as official import statistics recorded a drop in fabric imports between 2001 and 2004. However, these data do not account for imports into bonded zones, where most clothing exporters operate. Export statistics from major foreign suppliers of fabric reflect these unrecorded imports. Furthermore, in 2003 the MOIT introduced importer's registration licences for selected commodities. More than 500 tariff lines at the 9-digit level were subject to this scheme. Its stated purpose was to clamp down on alleged smuggling by keeping a registry of importers of commodities considered 'vulnerable' to smuggling. While the importer's registration licence is generally merely a nuisance, and does not restrict the importation of a commodity, there are cases where the registration licence has been used in a restrictive manner. For example, the MOIT 'refused' to register importers of cloves, effectively creating a ban on imports. No rigorous assessment of the effectiveness of NKIP licences, or whether the various import licence schemes are in the 'public interest', was undertaken.

Other non-tariff restrictions include a ban on farmed shrimp imports, imposed in 2004 following allegations of transshipment of shrimp of Chinese origin. The ban was extended in June 2006. Sugar imports were also restricted by an MOIT decree issued in 2002 stipulating that licensed importers, defined as just five state entities, were permitted to import sugar. This replaced the estimated 800 private importers in operation before the decree was issued. This licence was accompanied by a specific tariff per kilogram, of Rp550/kg for cane and Rp700/kg for industrial grade and white refined sugar. The ad valorem tariff equivalent of these specific tariffs varies with the prevailing international prices of cane and refined sugar, but were estimated to be 30% and 35% respectively. The decree in effect created a cartel as the importers with licences accounted for over 90% of white sugar produced on Java and

⁹ Henceforth referred to as MOIT. From late 2004 its name was changed to the Ministry of Trade, MOT.

over 60% in the country as a whole.¹⁰ The proliferation of NTBs partly arose because, as noted, the current institutional arrangements for setting NTBs do not require overall trade policy coordination, and they do not deliver transparency, consultation and economy-wide analysis to produce consistent policy outcomes.

This conclusion, that the trade regime remained broadly open, requires both explanation and qualification.

First, there have been many pressures to erect substantial barriers to trade. The deep crisis reinforced suspicion of the global economy, and triggered calls for 'temporary' protection for displaced works and ailing firms. This was especially the case since the IMF intervention was highly unpopular, and was seen in many quarters as a 'Washington' orchestrated program of interference. Underpinning this opposition was a general mistrust of market forces and liberalism, borne out of the country's anti-colonial struggle, which spawned a state ideology favouring some sort of vague 'middle road' between capitalism and socialism.¹¹ An additional factor, noted above, was that the advent of democracy introduced an imperative to raise campaign funding, and with it the pressure to buy votes through trade protection. These developments also occurred against a backdrop of the international trade policy architecture drifting away from a firm embrace of multilateralism and towards a set of 'hub and spoke' preferential trading arrangements. Domestic opponents of trade liberalization were able to exploit these trends for their own purposes. A final factor was that economic conditions were increasing the pressure to resort to greater protection. Exports were no longer seen as the engine of growth, as they had been for about 15 years from the mid 1980s, owing to intensified competition from China and slowing policy reform.

Why have these pressures for protection on the whole been resisted, at least so far? The political economy reasons are complex and inter-related, but the following are central to the analysis.¹² One was that, in the immediate post-crisis period, and for all its unpopularity. The IMF LOI played a role in at least checking protectionist pressures. Moreover, as noted, some of the blatantly political protection which was dismantled was popular. A second factor was the very large depreciation of the Rupiah in 1997-98, which provided some exchange rate protection for tradables. Related to this, economic recovery in the immediate post-crisis period was crucially dependent on the growth of the

¹⁰ For details of these estimates, and discussion of the institutional arrangements and protectionist measures in the industry, see Stapleton (2006).

¹¹ In the words of the most prominent public intellectual among Soeharto's group of technocrats, Moh. Sadli: 'One of the economic doctrines of [Soeharto's] New Order is that it is against "free fight competition", because the latter is too much identified with "capitalism", which even the New Order cannot embrace.' (Sadli et al, 1988, p. 364)

¹² See Basri and Soesastro (2005) and Basri and Hill (2004) for discussion of this issue.

export sector, which was thereby politically empowered, and of course opposed to protection.¹³

A third explanation is that finance ministries are typically central to the resolution of a crisis, and these now more powerful agencies are generally more likely to favour lower protection. In Indonesia, this ministry had been the key driving force for trade liberalization in the 1980s. Most ministers since then have been economists with a strong commitment to reform. Thus the resistance to protectionist pressures has been as much to do with personalities as institutions.

Fourth, this liberalization was still a recent memory at the time of the crisis, it had built up a constituency of support and thus an unwinding of successful reforms was likely to be resisted. Fifth, notwithstanding the faltering WTO negotiations, the global trend towards liberalization at this time had strong intellectual appeal, particularly with the example of the increasingly open Asian giants, China and India, and in contrast to the appeal in the 1970s and 1980s of Northeast Asian-style guided, export-oriented, industry policy. Finally, at the margin, Indonesia was a signatory to various regional trade agreements – AFTA in particular – which provided a mild barrier to increased protectionism.

Thus the reformers were broadly able to nullify the incipient protectionist pressures. But as noted this achievement has been precarious, is not deeply embedded in the Indonesia polity, and is subject to frequent attempts to secure exemptions.

Although we lack precise quantitative measurement, there has been a pronounced swing from protection of manufactures to agriculture. Most of the NTBs granted since 2000 have been in agriculture. Three factors appear to explain this trend, in Indonesia and elsewhere. One is that most of the past intellectual endeavour has focused on manufacturing, which was the most heavily protected sector. Consequently, with a few exceptions, manufacturing protection in Indonesia is quite low, and firms have adjusted their operations to this low protection environment. The spread of globally integrated international production networks in East Asia, which are predicated upon the unhindered movement of goods across international boundaries, has reinforced this trend (Athukorala, 2006a). Another predisposing factor has been that, with democracy, rural votes matter, and politicians are able to exploit this factor along with appeal to sentimental notions of food self-sufficiency. Finally, it is now easier to introduce protection for agriculture than manufactures owing to various loopholes (quarantine, etc) and to the fact that the OECD north has been extremely slow to liberalize its own agricultural protection.

The reformers have also had limited success in managing trade facilitation measures. That is, liberalization is a necessary but not sufficient condition for successful internationally-oriented growth. In particular, there are at least three key pre-requisites for countries to participate in the growth of these

¹³ This argument applies mainly to the immediate post-crisis period, 1999-2000. As we note above, export performance has been indifferent since 2000.

MNE-dominated global production networks: high quality logistics infrastructure, speedy import-export procedures, and an open FDI environment. In all three respects, the Indonesian environment is deficient. Since the crisis, public debt has risen sharply and the uncertain business environment has deterred private infrastructure investors. The country's infrastructure investment (as a proportion of GDP) is about half the East Asian average. Export/import procedures have also slowed significantly, and are now among the longest in East Asia.¹⁴ In the wake of the twin economic and political crises of the late 1990s, FDI has also been negative in most years since 1998. In consequence, Indonesia has been a relatively minor participant in the rapidly expanding East Asian production networks, particularly in industries such as electronics, where vertically integrated MNEs dominate.¹⁵

Indonesia's disappointing export performance since the crisis, notwithstanding the sharp exchange rate depreciation in 1997-98, has triggered pressure for a range of second-best 'stop gap' measures. One is the growing popularity of export zones, which offer simpler administrative procedures and (sometimes) freer trade. Additional investment incentives are also foreshadowed. These zones are a key feature of the government's new measures to promote investment, announced as part of a major initiative in February 2006. Their proliferation should be interpreted as reflecting the inability of policy makers to achieve further first-best, economy-wide liberalization.

There has also been increased resort to preferential trade arrangements. Until very recently, Indonesia was staunchly multilateralist in its approach to trade negotiations (Basri and Soesastro, 2005). The principal exception has been the special case of the ASEAN Free Trade Agreement (AFTA), in recognition of overriding geo-strategic considerations in a region formerly characterized by much tension. In any case, however, AFTA's discriminatory effects have been mild, since its rules of origin provisions are less restrictive than most preferential agreements, and most of its concessions have been multilateralized. However, commencing in 2003, Indonesia embarked on negotiations towards its first bilateral trade agreement, with Japan. This was eventually signed in late 2006. Inevitably, most sensitive trade issues were exempted from the agreement. Several additional bilateral agreements are under discussion, and some essentially political agreements have been signed.¹⁶

Thus in sum there is an uneasy stalemate on trade and industry policy. Elite opinion in Indonesia has always been uneasy about notions of liberalism. The country's perceived heavy handling by the IMF and donors in 1997-98 further encouraged these sentiments. Liberally inclined economics commentators

¹⁴ At a general level, these bureaucratic complexities are illustrated by the 2007 World Bank Doing Business Survey, which ranks Indonesia 135th out of 175 countries in terms of ease of doing business.

¹⁵ For comparative assessments, see Athukorala 2006a; Athukorala 2006b; and Kimura, 2006.

¹⁶ These include for example a recently signed agreement with Pakistan, which apparently originated from military interests close to the latter's government who control that country's citrus industry, and who seek to promote its exports through discriminatory trade agreements.

find it difficult to have a voice in the media today, including the 'quality press'. Conversely, Indonesia has an unhappy experience with industry policy. The government has rarely had success in 'picking winners'. In fact, most industries which have received assistance have been dominated by politically influential individuals, and the industries have tended to under-perform by the usual benchmarks (Basri, 2001). Policy makers in the economics ministries have in the main been able to successfully resist protectionist pressures since the crisis of 1997-98. But it has been a constant battle, pressure for exemptions persists, the policy environment lacks an institutionalized voice for economic literacy, and there is always a danger that the disappointing trade performance will increase the attractiveness of ad hoc and misdirected policy responses.

(3.3) Domestic Trade Policy

Discussions of trade policy focus primarily on barriers at the international boundary. Yet Krugman's (1991) fusion of trade and geography reminds us of the importance of national economic integration and the range of natural and policy barriers to it. There is a large literature on domestic infrastructure issues in developing countries, and the resultant 'incomplete markets'. But there is much less discussion of policy barriers to national integration, especially in the context of spatially diverse weak states in which the centre is unable to impose nationally consistent economic policies in the wake of deep economic and political crises. This may be compounded by post-crisis related reforms which are deliberately intended to weaken the centre through a systematic program of decentralization, as has occurred in Indonesia, The Philippines, Russia and elsewhere.

The implications for patterns of trade are potentially far-reaching. In the case of a huge archipelagic state such as Indonesia, for example, some regions – especially those proximate to the highly open economies of Singapore and Malaysia – could become more integrated with the global economy than with other Indonesian regions.

A wide array of domestic trade and trade-related laws are currently in existence in Indonesia, and they provide the basis for government policies and practices in this field. The following are the major laws in existence:

1932: BRO, licensing law

1961: Law on goods

1962: Law on trade in goods in special areas

1965: Law on warehouses,

1981: Law on measurement

1982: Registration law

1997: Law on commodity futures

1999: Law on consumer protection

1999: Law concerning the prohibition of monopolistic practices and unfair business competition

Warehouse receipts law (under discussion in parliament).

The first of these dates back to the colonial era and is in the Dutch language. Three date from the socialist 'Guided Economy' period of the early 1960s, and reflect the priorities of that era, namely centralized authority, together with a

state-dominated, closed economy. Much of their focus was to clamp down on 'speculation', 'smuggling' and other attempts to evade a highly distorted economy experiencing hyper inflation by the mid 1960s. Another two were introduced in the immediate aftermath of the 1997-98 economic crisis, and aimed at addressing public concerns with monopolistic practices and consumer protection.

Indonesia's Constitution (UUD) and its amendments contain little reference to domestic trade issues. However, the following broad principles appear to be widely accepted, if not actively enforced.

First, that there be free internal movement of goods, services, and labour. The strongest statement is contained in the 1999 Laws on decentralization, to the effect that local/regional regulations¹⁷ cannot be inconsistent with national policy, or harm public welfare. As we shall see shortly, this principle is now widely flouted.

Second, as a corollary, Indonesia should be regarded as a single national customs zone, in which international trade policy is the sole prerogative of the national government, and sub-national tiers of government cannot interfere with the flow of goods and services across international boundaries. This principle is also flouted. Especially in more remote regions in proximity to other countries, some regional authorities have in effect sanctioned smuggling as a revenue-raising measure for public or private gain.¹⁸

Third, there is general agreement that public interest principles be enshrined in all legislation and regulations, although practice lags considerably behind this principle. Ideally, this would entail the regulator producing an impact statement of proposed regulations, according to clearly enunciated public interest objectives. The impact statement should include an assessment of the compliance costs of any regulation. These costs would include the official cost of any licence/permit, together with a realistic estimate of the likely administrative costs (resources and time) spent by businesses in complying with the regulation. In addition, the onus for departures from this proposition should be on those proposing any exceptions. This principle was enshrined in the establishment in 1999 of the Commission for the Supervision of Business Competition,¹⁹ a body which has been more effective in promoting competitive business structures than was anticipated at the time of its establishment (Thee, 2006). The Commission has begun to address the issue of ensuring that all regulations are at least competitively neutral, or address clearly defined market failures. This applies to all tiers of government, and to inter-jurisdictional issues.

¹⁷ These are referred to in Indonesia as 'perdas', or peraturan daerah.

¹⁸ The adoption of this principle would not preclude the establishment of special customs arrangements (export zones, bonded warehouses, etc) approved by the central government, and which contain provisions for zone-specific duty-free trade.

¹⁹ Known in Indonesia by its acronym KPPU, Komisi Pengawas Persaingan Usaha.

Fourth, as an increasingly decentralized but formally unitary state, with all three major tiers of government having some responsibility for economic policy and the business environment, there is supposed to be a clear demarcation of powers and responsibilities among governments.

As noted, there have been two major changes with implications for domestic trade issues. The first are at the national level, and affect relations between the executive and the legislature, especially the emergence of an increasingly powerful and assertive parliament, and a gradually more independent judiciary. The second has been the devolution of administrative authority and financial resources from the centre, which we now examine briefly.

As noted, Indonesia is a unitary state, and for the first fifty years of Independence power was increasingly centralized in Jakarta and in the office of the President. It then suddenly embarked on a 'big bang' decentralization program.²⁰ President Habibie introduced and the parliament quickly passed Laws number 22/1999 and 25/1999. The former provides the basis for political and administrative decentralization, while the latter is concerned with fiscal arrangements. The new system became operational on January 1, 2001, 18 months after the laws had been passed. Authority was devolved to the second tier of local government, the kabupaten and kotas (cities), thus largely bypassing the provinces. At the same time, the number of second-level governments has risen sharply, from a little over 200 during most of the Soeharto era, to approximately 450. The number of provinces has risen more slowly, from 27 during most of the Soeharto period to 34 currently, that is a net increase of eight.²¹

This was a 'big bang' decentralization, motivated at a time of widespread inter-communal and ethnic violence, by a fear of territorial disintegration and occurring when the central government was at its weakest. They were also driven by a strong push towards democratization at both the central and regional governments. Owing to the scale and rapidity of change, centre-region relations are in state of transition, and are regularly being modified by new laws and regulations. A new modus operandi, widely accepted by all parties, is in the process of being established. Coordination and supervision procedures are thus being refined, especially as the central government is clearly unable to supervise almost 500 sub-national government units.

This reform has had two major implications for the business environment and domestic trade. The first is that there are new and powerful policy actors in Indonesia located outside the capital. Whereas in the past all significant administrative decisions were taken in Jakarta, licensing authority, a range of business-support facilities, and legal sanctions now reside with the regional governments. Given Indonesia's great diversity, and as centre-region relations become more settled, regional governments can be expected to compete for footloose labour and capital through the provision of clean, efficient, business-

²⁰ See Rasyid (2004) and Brodjonegoro (2004) for details of these changes, and an early evaluation of their impacts.

²¹ As noted, the former province of East Timor seceded from Indonesia in 1999.

friendly environments.²² The second implication is that ambiguity in centre-region relations, combined with the political vacuum at the centre (especially in the immediate post-Soeharto period), has created a significantly more unpredictable business environment. As Brodjonegoro (2004, p. 139) observes, 'decentralization has increased uncertainty in doing business at the local level', principally owing to the emergence of many formal and quasi-legal business charges, with little commensurate improvement in public service provision.

As would be expected after the hasty introduction of a major law, various refinements and modifications have since been promulgated. Law 32/2004 replaced the original decentralization Law 22/1999. It introduced provisions that local government decrees cannot conflict with those issued by the central government, and that they cannot disturb 'general welfare'. The latter provision has been interpreted to imply that local governments cannot interfere with commerce among regions. Law 34/2006 sets out the taxes and charges which may be levied by local governments. The objective is to remove the discretionary authority of these governments by creating a 'positive list' of allowable taxes, together with prescribed ranges. Thus, anything not included in the list is automatically regarded as illegal.

Meanwhile, there has been a proliferation of regional charges and taxes issued by local governments. Some of these include barriers to inter-regional commerce, mainly in the form of taxes on the movement of goods. Some of these regulations have a legal basis, in the sense that they are based on laws passed by properly constituted local authorities, with accompanying and published implementing regulations. Others are short-term, opportunistic, illegal exactions, in which members of the military and police feature prominently.

Some very approximate indication of the incidence and magnitude of these regional taxes and charges can be obtained from two sources. The first is records maintained by central government agencies which are responsible for the monitoring and examination of these regional regulations. The second is based on various surveys and anecdotal information concerning the incidence of quasi-legal charges, especially related to goods in transit.

On the officially monitored regulations, according to unpublished Ministry of Finance data²³ over the period 2001 to January 2006 provinces issued 570 regulations relating to taxes and charges and kabupaten/kota 12,950, a total of 13,520 issued by the two tiers. Of this total, 71% (9,573) of the regulations had been formally received by the Ministry (all regulations are supposed to be immediately sent to the central government). Of those received, 61% (5,794)

²² This is obviously a long term process, which will work only if the 'rules of the game' are transparent, durable and equitable. For example, in the Philippines, a country which decentralized a decade before Indonesia, and with greater prior preparation, such effects are still only weakly evident, if at all (Balisacan and Hill, eds, 2007).

²³ As reported in a document 'Monitoring Peraturan Daerah: Pajak Daerah, Retribusi Daerah' ('Monitoring Regional Regulations: Regional Taxes, Regional Charges').

had been examined. And of these, 11% (611) had been recommended to be abolished (475) or revised (136). There is no indication as to whether the regional authorities responded to these recommendations.²⁴

There has yet to be a systematic examination of the nature, incidence and effect of these regulations, but a number of field surveys provide a reasonably comprehensive picture. Lewis (2003) investigated the incidence of regional regulations in 2001, the first year of operation under decentralization. He concluded that most of the 1,000 levies were imposed unilaterally, and with very limited central government supervision and monitoring. Indeed, he worried (p. 188) that, given the central government's reluctance to employ its authority over regional governments, 'the pendulum would appear to have swung too far' [... from] 'excessive regional control' [... to] 'laissez faire treatment of regional governments ...'.

Simanjuntak and Lewis (2005) observed that, beginning in 2001, regional governments have issued at least 1,000 regulations each year, with the central government recommending cancellation or revision of about 100 per year. The largest number of cancellations/revisions has occurred in the agriculture and livestock sector. Consistent with the observations above, the most frequent complaint in business and consumer surveys was that the regional governments had not provided a clear justification for the levies. The authors also note that there is considerable regional variation in business licensing procedures, with regard to the payments involved and the complexity of regulatory compliance.

Notwithstanding the data limitations, several observations are warranted.

The first is the complexity and magnitude of the monitoring and examination tasks. Not only do central government officials have to obtain copies of thousands of (frequently incomplete or unclear) regulations, but they also have to examine them against the existing body of rapidly evolving law and regulations across several departments and jurisdictions.

Second, the array of taxes and levies is extremely wide. They include practically every imaginable impost, from the common trade taxes to the employment of workers from outside the local area.

Third, central government officials acknowledge that there are many regulations which are unreported, in the sense that they are illegal or the regional government has not formally sought permission for them. There are no reliable estimates of the extent of non-reporting.

²⁴ The Ministry of Home Affairs undertakes a similar monitoring activity but maintains less complete data. Over a similar period (that is, commencing 2001 with the decentralization reform), it reports to having received 5,012 regulations from regional governments, of which 79% (3,943) were assessed as acceptable. The remainder were either to be cancelled (923, 18%) or revised (146, 3%). Here too no information is provided on the response of local governments.

Fourth, there are numerous cases of ambiguities, where it is not clear whether a levy is justifiable. A frequent example concerns road levies: in principle, these may reflect user pays principles, in effect a toll road. But they are more commonly regarded as an easy opportunity to impose transit levies. This ambiguity arises in part because the relevant central government departments (principally Finance and Home Affairs) have yet to issue clear, joint guidelines as to what constitutes 'public welfare', and which therefore provide the basis for official revenue raising.

Fifth, although these levies are imposed at the regional level, the instigating party is frequently a powerful central government agency, notably the armed forces and the police, with or without the collusion of the relevant local authorities.

Sixth, there is considerable regional variation in the incidence of these levies. Although there has yet to be a detailed study of the patterns, they are thought to be more widespread in more remote regions (which are more difficult to monitor), in poorer regions, where additional revenue-raising is a high priority; and in resource-rich regions, on 'ease of taxation' grounds.

As would be expected, there are no widely collected statistics on the incidence of illegal levies. Thus anecdotal information and snapshot surveys, for all their limitations, are the only source. Various pieces of field research indicate that they are widespread. For example, Pantjar Simatupang (2005) cites the case of an 8-ton consignment of oranges from Karo (North Sumatra) to Jakarta having to pay levies totalling Rp190,000 at 45 collection points. These levies were equivalent to Rp24/kg, in addition to much time lost and inconvenience (see Simatupang 2005, table 3). A recent unpublished World Bank survey in Aceh found that goods in transit encountered barriers at each kabupaten boundary; in some cases they were also at kecamatan boundaries. Most the barriers were erected by the police and army. One consignment which was systematically monitored observed 12 check points on a cross-province trip in Aceh (northern Sumatra), and estimated that the levies were equivalent to 11% of the value of the goods.²⁵

These cases may not be typical: the general impression is that these levies on transit trade are more in the nature of 'nuisance taxes', involving relatively trivial amounts levied on a variable and opportunistic basis. But it is clear that there has been a breakdown of central government authority and a rapid increase in barriers to domestic trade. Precise quantification of the incidence and magnitude of these barriers is not possible. Nor is there an accurate set of regional price data available to monitor these impacts.²⁶ While in aggregate these levies may not be large, they increase the sense of unpredictability in the commercial environment. Moreover, they have occurred in an overall environment of declining infrastructure investment, resulting particularly in a

²⁵ See also Montgomery et al (2002) and SMERU (2004) for detailed field reports on the incidence of inter-regional trade barriers.

²⁶ It is worth noting that a similar set of circumstances in the Philippines – weakened central authority, declining infrastructure investment and rising barriers to regional commerce – appears to have resulted in increased regional price differentials since 1986 (Balisacan and Hill, eds, 2007).

deteriorating road infrastructure network, thus further raising the costs of domestic transportation.

(3.4) The Official Response: A Draft Trade Law

In 2001 the MOIT (now the MOT) embarked on drafting a new trade law, primarily in reaction to the proliferation of local government domestic trade restraints following the implementation of regional autonomy in 2001. The proposed bill was initially intended to guarantee the free movement of goods and services within the national market. However, the resulting draft law simply bundled together modern laws with old trade laws without reforming them. In this sense, the draft trade bill reflected the weaknesses of trade policy formulation in Indonesia, and of how the bureaucracy was not entirely 'bought' into the economic reforms of the 1980s and 1990s. As noted above, a wide array of trade and trade-related laws are currently in existence in Indonesia, and they provide the basis for the MOT's policies and practices.

While the initial objective may have been to set rules to counter the proliferation of local government trade regulations, the MOT expanded the draft to include foreign and domestic trade, with the intention of 'modernizing' the body of trade laws. Eventually the Ministry found this to be too difficult, and so it opted for an 'umbrella' law on trade, in an attempt to reform and consolidate the existing body of law into one, as well as adding new laws.

In principle, economic legislation is introduced for a number of reasons. These include, for example, the modernization of the existing body of law to reflect contemporary challenges and issues; addressing a significant market or government failure; and addressing equity concerns in the community. However, the 'umbrella' approach of this draft did not appear to accomplish any of these purposes in a substantial way. The draft law did explicitly repeal three old laws/regulations. But it selected key provisions from these repealed laws and wrote them into the new draft law. Consequently the draft law bundled modern laws with several outdated economic laws. Many of them were introduced at a time when there was extensive state control over the economy, proliferation of licensing, import controls and extensive price controls. Many of these laws are no longer relevant in an open, modern economy. For example, the law on warehouses (1962) regulates inventory of so-called 'important' or 'basic' necessities so as to enforce their price controls and control the hyperinflation of the period (early 1960s). In an open trade regime and with existing safeguards on competition (that is, the competition law), such a law on warehouses is no longer relevant.

The draft law was also overly prescriptive in content. It prescribed both practices that are and are not permissible, rather than simply prescribing practices deemed illegal, as is generally the approach in modern codes. For example, one provision states that foreign-owned business must distribute their goods through an intermediary. Consequently, the draft law signaled a continuation of a 'bureaucratic control' mentality, which is pervasive in many old economic and social laws in Indonesia. Recent international trends in legislative drafting have shifted from an overly prescriptive approach to a

more descriptive one, whereby laws focus on processes and guidelines. For example, mandating the 'public interest' test would be a 'descriptive' approach to legislation.

Some provisions in the draft law signal potential 'backtracking' on previous reforms, and are perhaps indicative of the fact that the drafting team in the MOT had not really endorsed the reforms over the past two decades. One example was a proposed provision that foreign-owned producers must distribute their products through an intermediary. Apparently this was inserted without wide consultations with stakeholders since these restrictions were removed in 1998 as part of measures to improve efficiency in the distribution system.

The draft law did not deal with economic governance or strengthening trade institutions. In particular, there were at least three broad areas not dealt with in the draft law. First, there is very little mention of processes for making trade policy, including guidelines, tests for policy makers (that is, the public interest) to follow when setting policy, and rules on transparency (for example, electronic publication of regulations and impact statements). Second, the draft law adopted a sectoral approach to trade policy. For example, it assumed that the Minister of Trade sets tariff policy. However, good trade policy requires a 'whole of government' approach that takes an economy-wide perspective on trade policy. In this regard, there is no mention of current institutional arrangements, such as the role of the MOF and Team Tariff in overseeing tariff policy. Perhaps these were to have been regulated through a future 'implementing regulation'. But the draft law could at least have enunciated the principles for setting policy and provided guidelines for reforming institutions. The third striking gap in the draft law is that it is silent on clarifying the respective roles of and relationships between the national and sub-national governments in the area of trade policy. For example, there could have been an explicit provision stating that sub-national governments could not introduce regulations affecting imports and exports.

The drafting of the bill was also indicative of the policy formulation process that worked well under the authoritarian Soeharto regime, but are less relevant and effective under a newly emerging democracy. The drafters did not consult widely with stakeholders on the draft bill. There were no public hearings, submissions were not requested. Nor did the MOT carry out or solicit rigorous analytical work prior to drafting the law. Usually, Indonesian practice is to carry out an 'academic' paper to build a case for the legislation, but apparently this was not available for this law. Moreover, little attempt was made to draw on international experience and lessons. As it happened, the parliament, independent of the Ministry's efforts, was also drafting a similar law on domestic trade, primarily to restrict foreign investment in the retail sector as a means of protecting traditional retailers.

In the event, in spite of a large bureaucratic commitment within the MOT over several years, the draft trade law was never made public and was never formally submitted to the parliament. It is beyond the scope of the paper to discuss the reasons for this; essentially both the Minister and senior bureaucrats regarded it as impractical. But the key point to emphasize is that, while Indonesia remains a largely open economy, there is still a strong

bureaucratic propensity for intervention, both for ideological and rent-seeking reasons, and this predilection attracts widespread community support.

(4) Summing Up

Several key points emerge from this examination of Indonesian trade policy since the economic and political crisis of 1997-98 and the transition from authoritarian to democratic government. These conclusions are grounded in the Indonesian experience, but they are also of general relevance for other developing countries in similar post-crisis circumstances.

First, Indonesian has remained a largely open economy, notwithstanding a deep economic crisis and a highly unpopular IMF program. This may appear surprising, but there is a plausible political economy explanation for why there has been no significant retreat into protectionism.

Second, however, this openness is precarious and not deeply embedded in either institutions or public opinion. Moreover, owing to major changes in Indonesia's political architecture since the crisis, the earlier basis for reforms, of 'low politics' in which technocrats convinced an all-powerful president of the case for change, is unlikely to sustain the future reform agenda. In addition, the international commercial policy architecture cannot be relied upon to be supportive of continuing unilateral reform.

Indonesian trade policy making broadly occurs in an institutional vacuum. The ad hoc inter-departmental Team Tariff sets tariffs on an informal basis, without reference to clear objectives and rigorous analytical research, and in a largely non-transparent manner. It has no control over other trade barriers, principally non-tariff barriers, and here as noted the more protectionist line ministries seek to by-pass the Team. Such a policy making structure worked well in the 1980s when the technocrats were in control, the main game was to persuade the all-powerful president, and the strategy of Soesastro's (1989) 'low politics' guided policy reform. But it is much less well suited to an era of assertive legislatures and noisy civil society, where vocal elements of both are predisposed to protectionism, and where a constituency has to be won over by argument.

To maintain the reform momentum, and ensure that past achievements are not over-turned, three would appear to be at least three requirements. One is that, to the extent possible, a 'cordon sanitaire' be established around key areas of economic policy. This process is already under way in Indonesia, with the establishment of an independent central bank, legislated rules governing fiscal deficits and public debt, and (as a second best option for economy-wide reforms) the establishment of export zones in which firms operate on a free-trade footing and a less complicated regulatory environment.

Another parameter is that, in a newly democratic era, the case for reform has to be advanced and won in the public domain. This requires a major change in the role and activities of the Indonesian economics profession. No longer do the debates have to be won only in the presidential office or around the cabinet table. Members of parliament have to be convinced, as does the

general public. Economists have to win constituencies in the media and public forums.

These two approaches will be more effective if there are institutionalized means of establishing high quality yet accessible analytical capacity guiding public policy. This may include, for example, the establishment of an independent agency which reports on the benefits and costs of any measure intended to provide assistance to a particular industry or firm. Ideally, this process would involve public hearings in which the proponents of such assistance – whether from the private sector or the bureaucracy – would be expected to make their case in public, and to have it scrutinized by independent technical staff. Such an agency would need to be adequately resourced, and to have the legislative capacity to initiate hearings, as well as to receive referrals from cabinet and the parliament.

Moreover, trade policy reform ‘works’ when it delivers results and thereby wins over a constituency for further reform. This in turn requires competent macroeconomic management (to ensure that the exchange rate does not overshoot), institutions such as a customs service which ensure the speedy and unhindered movement of goods across international borders, and labour markets which translate economic growth into growing employment opportunities. Since the crisis, Indonesian economic policy has been just adequate with respect to the first variable, weak on the second, and notably deficient on the third.²⁷ Consequently, it is possible for opponents of the continued maintenance of open borders to mount a critique of it on the basis of the country’s indifferent export performance (noted above), even though the root causes lie elsewhere.

A third general conclusion is that trade reform is about much more than barriers to commerce at international boundaries. Perhaps unexpectedly, this is where major problems arose in Indonesia after the crisis. That is, a weakened central government has been able to maintain broadly open international boundaries, but it has been powerless to prevent the proliferation of a range of quasi-legal and blatantly extortionist exactions on domestic trade. Combined with a far-reaching decentralization program and under-investment in infrastructure – both common features of post-crisis countries – Indonesia risks fragmenting into a series of poorly connected regional economies, some of which may be more integrated with neighbouring states than with the rest of the country,

It is an open question whether these principles ought to be enshrined in and supported by a formal set of laws. Very few countries have an over-arching ‘trade law’, preferring instead to legislate on specific issues, such as

²⁷ There has been a marked shift in labour market policies and outcomes from the Soeharto era of low regulation, trade union suppression, but high productivity and wage growth to the current situation of free labour association but in other respects (rapidly increased minimum wages and restrictive labour regulations) an unfriendly employment environment. In consequence, employment in the modern (‘formal’) sector has declined, while informal sector employment, typically lower paid and less secure, has been rising. See Manning and Roesad (2006) for a recent survey.

competition policy and consumer protection. As noted, Indonesia has inherited a hugely complex set of trade laws, much of it contradictory and rarely enforced. The principle task for reformers will be to overhaul these laws, discarding those (the vast majority) which are no longer relevant. There may also be a case for passing a specific law explicitly embodying the principle of free movement of goods, services and people throughout the archipelago.

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