SECTOR ASSESSMENT (SUMMARY): INDUSTRY AND TRADE

1. Sector Performance, Problems, and Opportunities

1. **Stable but moderate growth.** From a peak of 6.4% in 2010, the economic growth rate slowed to about 5.0% in 2013, where it remained until 2017.[1] This growth rate is significantly below the 7.0%–9.0% range targeted in Indonesia's National Medium-Term Development Plan (RPJMN), 2015–2019. In the early 2010s, falling global commodity prices, tighter macroeconomic conditions, and lower global demand all slowed growth from its peak in 2010. Towards 2015, the growth path reflected structural weaknesses in the economy, including lack of new growth sectors, inefficient investment allocation, and underinvestment in infrastructure. A medium-term perspective reveals a 5-year average investment growth rate of just 4.7% since 2013.[2] Leading up to 2017, robust private consumption helped compensate for low investment.[3] However, private consumption growth slowed in 2017 to 5%, posing risks to the medium-term growth picture.[4] In addition, decades of underinvestment in core infrastructure must also be reversed. Indonesia's stock of infrastructure lags the average of emerging market peers by about $1.5 trillion. In per capita terms, Indonesia's stock is just one-third of the average for emerging markets, or one-eighth of the average for advanced economies.[5] In addition, investment remains inefficient and expensive compared with the income it generates, especially relative to ASEAN partners. Indonesia's incremental capital output ratio is high at 7.1, meaning $7.1 of investment produces only $1.0 of income. The average incremental capital output ratio in neighboring countries is about 5.0.

2. **High-cost, inefficient business environment.** Despite recent improvements, the regulatory environment in Indonesia still imposes high costs on businesses because of the absence of a systematic analytical framework for good regulatory practice. Indonesia struggles with an overly burdensome regulatory framework. Until 2017, the government did not systematically apply good regulatory practice and lacked an analytical basis for regulatory change. This contributed to a significant increase in the average number of regulations issued by national and subnational governments, which increased from 453 per year during 1999–2003 to 1,789 per year during 2010–2014. The poor regulatory framework has been particularly acute for business licensing and permits. Starting a business in Indonesia requires an investor to obtain 11 approvals, and the total process takes 22 days, compared with 5 approvals and 4.5 days in Thailand. Outside of the capital of Jakarta, this increases to 12 approvals and 27 days. Business licensing remains complex, especially navigating approval processes for various levels of government (central, provincial, and regional and/or local).

3. **Improving trade performance.** While restrictions on investment remain, barriers to trade are slowly being eliminated. The government is gradually reducing most-favored nation tariff rates for a number of products. The government has also reduced nontariff barriers to imports by slashing the number of nontariff measures to 20.8% in order to reduce idle port time. However, a recent report on the implementation of this reform package finds the reduction in nontariff measures was achieved by shifting the barriers from border to post-border assessment (30% of products are now subject to post-border inspection). This shifted the responsibility of the risk assessment of nontariff barriers from customs to other institutions such as the Ministry of Home Affairs and the Ministry of Agriculture. Nevertheless, exports increased by 16.22% in 2017

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[1] CEIC. 2018. *Indonesia Real GDP Growth.* Accessed 27 April 2018.

[2] Investment is measured by gross fixed capital formation adjusted for price inflation.

[3] Private consumption grew at an average rate of 5.2% during 2013–2017.

[4] World Bank. 2017. *Indonesia Economic Quarterly: Closing the Gap*. October 2017. Jakarta.

[5] Ibid.

year-over-year, while imports increased by 15.66%.[6] However, restrictions on investments remain significant. According to the Organisation for Economic Co-Operation and Development, Indonesia has one of the highest levels of barriers to foreign investment among middle and high-income countries, with total foreign direct investment restrictiveness equal to 0.32.[7] Indonesia's negative investment list, which was issued in 2016, imposed restrictions on about 522 business fields across 16 economic sectors. Although the most recent updates to the negative investment list reduced the number of restricted fields and set higher foreign equity limits for several sectors (e.g., logistics, tourism, and health), foreign investment in some key sectors remains restricted (e.g., transport services, construction services, and agriculture).

4. **Government has improved private sector participation in infrastructure.** The Coordinating Ministry for Economic Affairs set up a dedicated unit called the Committee for Acceleration of Priority Infrastructure Delivery. As of 19 December 2017, the committee had identified 245 national strategic projects and two programs valued at Rp4,417, of which 57% will be funded by the private sector through public–private partnerships (PPPs), Non-Government Budget Infrastructure Financing, and Limited Concession Schemes. However, an unclear regulatory framework for PPPs, along with the absence of long-term financing modalities, has limited private participation. Until 2017, the government did not have a dedicated unit or project development facility to help prepare project proposals or provide transaction advice. As a result, PPPs were viewed as higher risk and lower certainty. Functional responsibilities for the various dimensions of PPPs were fragmented across various central agencies, with poor coordination and limited information creating a confusing and burdensome landscape for investors. A lack of capacity on risk management and pricing has further biased line agencies away from PPPs, and a lack of capacity in engineering services has restricted the ability of spending agencies to design attractive and high-quality projects.

5. **Constraints to efficient investment and project execution.** The government has begun to strengthen public procurement, but inefficiencies and lack of transparency continue to pose constraints. Weak institutions and low human resource capacity, particularly at the subnational level, hinder disbursement and project execution. While the budget disbursement target of 96.8% was achieved in 2017, about 38% of project disbursement happens during the last 3 months of the year.[8] These delays also affect the physical realization of projects, which at the end of 2017 had reached just 81.5% of planned construction.

6. On the other hand, the value of procurement through the e-procurement system of the National Public Procurement Agency (LKPP) increased from Rp276 trillion in 2015 to Rp345 trillion in 2017. These transactions comprised e-tendering and e-purchasing.[9] However, some line agencies continue to demonstrate resistance to fully adopting e-procurement. An estimated 10% of procurement still occurs manually. Moreover, leakages and corruption continue to be major sources of concern for procurement of public goods and services. In 2016, the Indonesian Corruption Eradication Commission found about 75% of corruption complaints were related to public procurement.[10]

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[6] Government of Indonesia, Statistics Indonesia. 2018.

[7] Based on the Organisation for Economic Co-Operation and Development Foreign Direct Investment Regulatory Restrictiveness Index 2016. Indonesia was ranked fourth, after the Philippines (0.40), Saudi Arabia (0.36), Myanmar (0.36), and the People's Republic of China (0.33).

[8] Data are taken from the monitoring and evaluation system of the National Public Procurement Agency (LKPP).

[9] LKPP. e-Procurement Database.

[10] Government of Indonesia, Corruption Eradication Commission. 2016. *Annual Report 2016.* Jakarta.

7. **Other issues related to investment climate reform.** The government's investment climate reform efforts resulted in an increase in Indonesia's credit rating to investment grade from Standard & Poor's, Moody's Investors Service, and Fitch Ratings in 2017.

2. Government's Sector Strategy

8. **The National Medium-Term Economic Plan targets higher and more inclusive growth.** The RPJMN, 2015–2019 focuses on increasing growth while making it more inclusive and sustainable. It targets reducing the growing gap in consumption per capita between different income groups and reducing poverty from 11% in March 2014 to 7%–8% in 2019. By 2019, the government plans to address the structural reform agenda by creating more job opportunities in job-creating industries; improving the investment climate; and enhancing infrastructure quality to improve service delivery, particularly in the eastern part of Indonesia. Acceleration of investment is a key strategy identified in the RPJMN to achieve these objectives. The government has targeted a number of different reform areas to improve the efficiency, quality, and volume of investment, including making the business climate more transparent and attractive, strengthening the framework for private participation in infrastructure, and improving the transparency and efficiency of public procurement.

9. **Introducing good regulatory practice and improving business conditions.** The government issued Presidential Regulation 91/2017 in September 2017 (Acceleration of Doing Business), which mandates a number of reforms including (i) a national review of business licensing processes, (ii) the establishment of task forces to oversee business license applications, and (iii) establishment of an online single submission web portal that integrates license issuance across different agencies and levels of government. Presidential Regulation 91/2017 is currently being piloted in Batam municipality and special economic zone, the city of Purwakarta (West Java), and the city of Palu (South Sulawesi). A nationwide rollout was initiated in April 2018. The government also issued Presidential Instruction 7/2017 to institutionalize regulatory good practice. This regulation (i) established the Coordinating Ministry for Economic Affairs as the oversight body for any new regulations that have national strategic importance or cross-sector impacts, and (ii) requires line ministries to apply regulatory impact assessments for the development of all new regulations.

10. **Business climate and competitiveness reform efforts.** These efforts have been coordinated under a series of 16 economic policy packages issued by the President starting in 2015, which are beginning to show results. These packages cover a range of issues such as simplifying business and trade regulations, improving trade logistics, reducing barriers to investment, and liberalizing foreign ownership restrictions in key sectors. The packages have been particularly effective in addressing fragmentation of responsibilities and poor coordination across government agencies by unifying efforts under a shared set of results, answerable to the President's office. Because of these efforts, Indonesia's rank in the World Bank's Doing Business report improved from 114 in 2015 to 72 in 2018.[11] Indonesia's rank in the World Economic Forum's Global Competitiveness Report also improved from 54 to 36 since 2010.[12]

11. **Reforms to the public–private partnership framework.** These reforms have focused on improving coordination, addressing binding constraints, and expanding investment modalities. Recognizing the fragmented network of agencies, each with some share of PPP responsibilities, the government improved coordination by establishing a Joint PPP Office of Indonesia. The office

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[11] World Bank. 2014. *Doing Business 2015: Going Beyond Efficiency*. Washington, DC; and World Bank. 2018. *Doing Business 2018: Reforming to Create Jobs.* Washington, DC.

[12] World Economic Forum. 2018. *The Global Competitiveness Report, 2017–2018.* Geneva.

comprises Indonesia's Investment Coordinating Board, National Development Planning Agency, Ministry of Finance, Ministry of Home Affairs, LKPP, and the Indonesia Infrastructure Guarantee Fund. The government has also begun to clarify and issue guidance on PPP modalities such as unsolicited proposals and availability-based schemes. The government has also targeted land acquisition constraints and expanded the scope and coverage of support mechanisms like the project development facility and the viability gap funding modality.

12. **Public procurement continues to improve.** The government continues to target improvements in public procurement at the central and subnational levels. A coordinated program of reform focuses on three dimensions: (i) continued introduction and utilization of e-procurement tools at all levels of government to promote efficiency, transparency, and fairness; (ii) the development of new tools and policies that strengthen the monitoring and evaluation role of the LKPP to provide management at all levels with accurate, timely information on procurement performance; and (iii) the strengthening of capacity for government officials at all levels to understand and comply with procurement rules and practices.

3. ADB Sector Experience and Assistance Program

13. **Development partner support.** Development partners are assisting the government in the reform of investment and trade policies, PPP implementation, and public procurement. The Government of Australia is supporting Indonesia through its Indonesia Infrastructure Initiative Facility, as well as through its Multilateral Development Bank Infrastructure Assistance Program.[13] The Government of Australia also supports PPP reform through its Sustainable Infrastructure Assistance Program, which is administered by ADB.[14] The World Bank has a number of policy lending operations, including the Economic Resilience, Investment, and Social Assistance Program, and has been managing a multi-donor trust fund to support reform of the investment climate and PPP.[15] The World Bank also supports capacity development for regulatory good practice, as does the Organisation for Economic Co-operation and Development. The Government of the United States is supporting procurement reform through the Millennium Challenge Corporation's Procurement Modernization Project.

14. **ADB support of investment climate reform.** Given the cross-sector nature of investment climate reform, ADB has been using an integrated sector approach. The proposed subprogram aims to strengthen the institutional part of the reform. Other reforms, such as financial inclusion,[16] fiscal policy, and energy sector reforms, look at access to finance, government spending on core social sectors, and energy. ADB is also conducting an engineering services project that aims to improve the quality and timeliness of public infrastructure projects.[17]

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[13] Indonesia Australia Infrastructure Partnership.

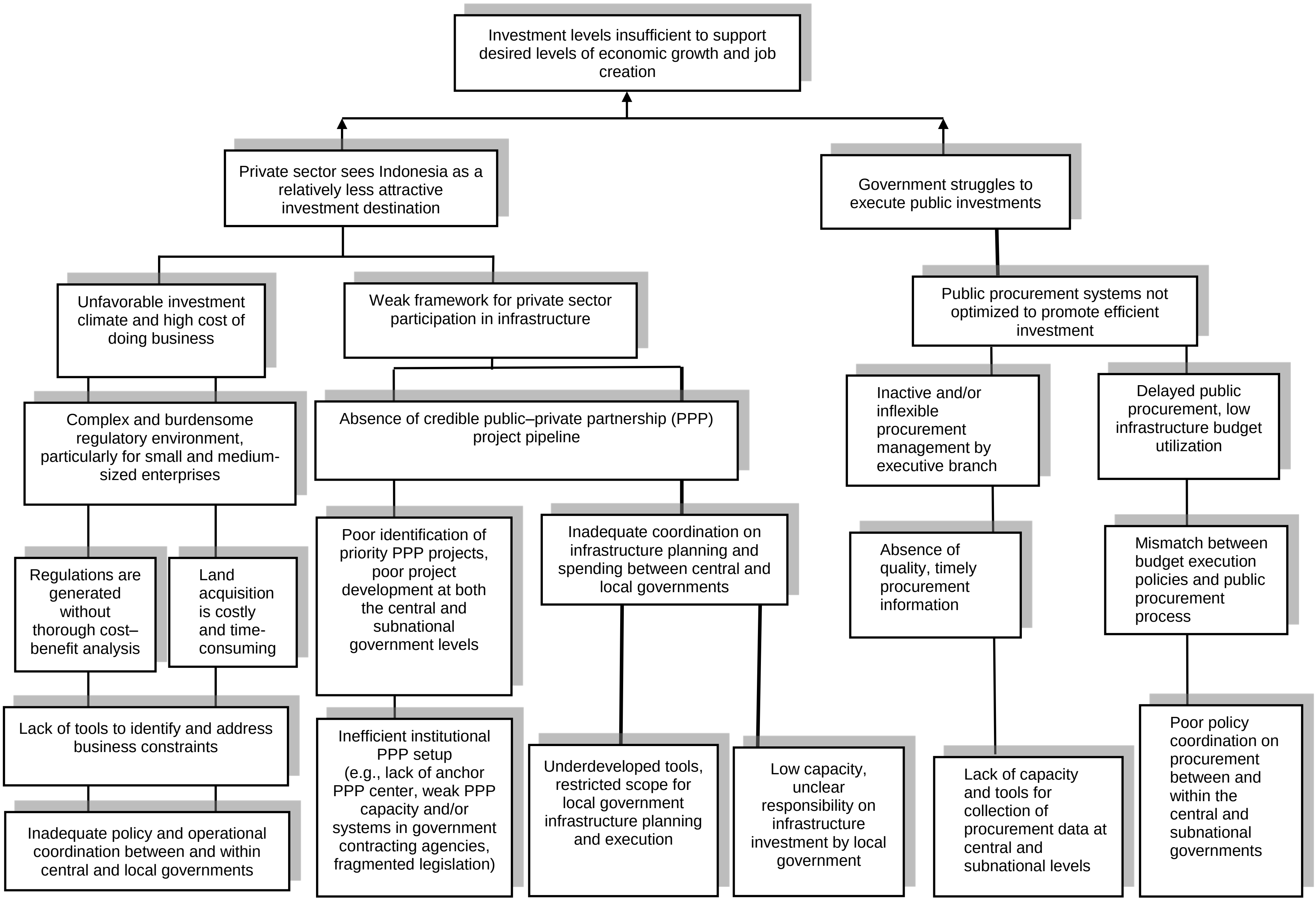
[14] ADB. 2013. *Technical Assistance for the Sustainable Infrastructure Assistance Program*. Manila.

[15] World Bank. 2017. *Second Indonesia Fiscal Reform Development Policy Loan Project*. Washington, DC.

[16] ADB. 2017. *Report and Recommendation of the President to the Board of Directors: Policy-Based Loan for Subprogram 2 to the Republic of Indonesia for the Financial Market Development and Inclusion Program.* Manila; ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 2 to the Republic of Indonesia for the Fiscal Policy and Expenditure Management Program.* Manila; and ADB. 2017. *Report and Recommendation of the President to the Board of Directors: Policy-Based Loans for Subprogram 2 to the Republic of Indonesia for the Sustainable and Inclusive Energy Program*. Manila.

[17] ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Technical Assistance Loan to the Republic of Indonesia for the Accelerating Infrastructure Delivery through Better Engineering Services Project*. Manila.

Problem Tree for Industry and Trade



Source: Asian Development Bank.