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SENADA INDONESIA COMPETITIVENESS PROGRAM

# A REVIEW OF SELECT POLICIES OF THE INDONESIAN MINISTRY OF INDUSTRY

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# A REVIEW OF SELECT POLICIES OF THE INDONESIAN MINISTRY OF INDUSTRY

# ACKNOWLEDGMENTS

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| | |
|---|---|
| AFTA | ASEAN Free Trade Agreement |
| API | *Asosiasi Pertekstilan Indonesia* (Indonesia Textile Association) |
| ASEAN | Association of Southeast Asian Nations |
| ASMINDO | *Asosiasi Industri Permebelan dan Kerajinan Indonesia* (Indonesia Furniture Association) |
| ASPERINDO | Association of Indonesian Express Delivery Service Companies |
| BDS | Business Development Services |
| BKPM | *Badan Koordinasi Penanaman Modal* (Investment Coordinating Board) |
| CBU | Completely Built Up |
| CKD | Completely Knocked Down |
| CEFED | Center for Furniture Design and Development Indonesia |
| CSR | Corporate Social Responsibility |
| Desperin | Department of Industry |
| DPR | (House of Representatives) |
| GDP | Gross Domestic Product |
| GOI | Government of Indonesia |
| ICT | Information and Communication Technology |
| IFSC | Indonesia Footwear Service Center |
| IMF | International Monetary Fund |
| ISO | International Standard Organization |
| JFDC | Jepara Furniture Design Center |
| JICA | Japan International Cooperation Agency |
| KADIN | (Indonesia Chamber of Commerce) |
| M&E | Monitoring and Evaluation |
| MoF | Ministry of Finance |
| MoI | Ministry of Industry |
| MoIT | Ministry of Industry and Trade |
| MoT | Ministry of Trade |
| NTB | Non-tariff Barriers |
| PP | (Presidential Decree) |
| R&D | Research and Development |
| SOE | State Owned Enterprises |
| SME | Small and Medium Enterprises |
| TA | Technical Assistance |
| TPT | Textile and Textile Product |
| UPT | *Unit Pelayanaan Teknis* (Technical Service Unit) |
| US | United States |
| USAID | United States Agency for International Development |
| UU | *Undang Undang* (Law) |
| WTO | World Trade Organization |

# EXECUTIVE SUMMARY

Indonesian exports in most major labor-intensive manufacturing sectors, with the notable exception of garments to the U.S., have lost market share over the last several years. Against this challenging backdrop, the USAID program SENADA seeks to enhance the competitiveness of five value chains - autoparts, garments/textiles, furniture, home accessories and footwear. This study, undertaken as part of SENADA's business environment activities, analyzes Ministry of Industry (MoI) policies that impact the five value chains and provides recommendations for increasing their effectiveness.

Current policy at MoI is laid out in the National Industrial Development Policy (2005), which identifies priority sectors and analyzes the challenges and opportunities facing these industries. Cluster formation and strengthening are identified as a core methodology for promoting industrial growth. A total of 32 sectors are considered strategic under the Industrial Policy, divided into long-term, medium-term, supporting and small and medium enterprise sectors. While the Policy does identify some pilot sectors, most of the sectors prioritized are established industries. Of the five sectors covered by the SENADA project, autoparts, garments/textiles and furniture are served by specific departments at MoI. Home accessories falls under the SME department and footwear falls under the miscellaneous industry department.[1]

The private sector points to broad business environment constraints- notably weak infrastructure, rigid labor laws, tax and custom office irregularities, and a generally inconsistent regulatory regime- as the primary obstacles to increased competitiveness. These issues are largely absent from the current set of activities at MoI which generally seek to address firm-level weaknesses and market opportunities.

MoI sponsors policy and implements a wide range of activities that affect the five industries that are the focus of the SENADA project. These fall into the following broad categories:

- **Tariff policy.** This is generally aimed at ensuring an adequate supply of raw materials to priority industries. MoI sponsors policies that attempt to prohibit export of domestically produced raw materials while supporting duty-free import of raw materials.

- **Taxation.** MoI's major current initiative is providing for fiscal incentives for new investment in select sectors and regions (30 percent tax credits on income over 6 years, accelerated depreciation and loss carry forward). The decree could be strengthened by providing clearer criteria for selecting qualifying sectors; undertaking a study to estimate and minimize the redundancy rate; and ensuring compliance with relevant tax legislation.

- **Trade promotion.** MoI sponsors international / domestic trade show participation by firms in all strategic sectors. Areas that could be strengthened include firm selection, preparation of participants and booths and setting subsidies. These issues could be addressed by outsourcing these activities to private firms or lending government support to private efforts.

[1] Note that at the time of finalizing this report (April 2008) the Ministry of Industry was announced that it was about to release a new industry policy document that highlights 23 focus sectors. It is not expected that this new document will represent a major departure from industry strategies articulated previously. Moreover it appears that all the sectors discussed in this paper are covered in this new document. See *Pemerintah Segera Menetapkan 23 Jenis Industri Prioritas* (Government to soon name 23 priority industries) *Kontan Harian* 17 April 2008.

- **Business development services**. MoI provides technical services to all sectors, including trainings, research and development centers, and shared production facilities. These programs face a number of challenges that limit their effectiveness including high subsidy levels and supply-driven program design. The government may wish to partner with private-sector provided business development services (BDS) as an alternative to directly providing services.

- **Credit lines**. MoI in 2007 provided Rp 225 billion (approximately US$ 22 million) in subsidies to textile and garment factories to upgrade production machinery. The scheme could be improved by first analyzing the redundancy rate and then using this analysis for the development of more effective targeting mechanisms. There are also compliance issues with international trade agreements that should be addressed in any future rounds.

- **Infrastructure design**. MoI sponsors a number of industry-specific projects including a dedicated port facility for automobiles, an industrial estate for textile manufacturers and another for tanneries. This is an important area for MoI to explore further. More extensive communication with the private sector would increase the impact of these projects.

- **Information dissemination**. This is a potentially powerful area for MoI to work in but is currently under-explored. The Ministry may wish to partner with private sector associations to promote Indonesian brands and share overseas market information with domestic producers.

- **Accreditation and standardization**. MoI supports a number of activities to promote certification among Indonesian companies. Examples include sponsorship for a number of demonstration firms to receive ISO certification, WRAP or SA 8000 certification. While in most cases, these activities are best conducted by private sector companies and associations, the government can assist by providing information on international standards and models.

A number of general recommendations would allow the Ministry to more effectively carry out its mandate of supporting industrial development:

- Human resource capacity at MoI would benefit from increased specialization in economics, business and legal areas relevant to the policy work of the Ministry. This would allow staff to analyze the broader economic impact of demands put forward by industry associations and ensure that government enacts programs and policies that will benefit the economy as a whole.

- Programs would be strengthened by developing solid monitoring and evaluation criteria and integrating the criteria from program inception. This would help the Ministry to learn what works or does not work and apply the information to future programs. Staff incentives should be linked not only to quantitative outputs and successfully expending budgets but also to qualitative outputs tracked by monitoring and evaluation. This would insure that staff is rewarded for integrating monitoring and evaluation findings in future program development.

- The level and targeting of subsidies should receive particular attention in evaluations. Indeed, the level of subsidies across program activities should be re-evaluated as to their unintended impact on firm selection and service quality. Funds currently used for subsidies could usefully be redeployed to providing more resources to MoI staff, enabling them to more effectively carry out their work.

- The Ministry should prioritize improved coordination with other economic departments, horizontally and vertically. Conflicting initiatives by different ministries confuse investors and complicate the regulatory environment. Better coordination is required not only across central government departments but vertically to provincial and local governments as well. This is particularly true given Indonesia's significant decentralization.

- Related to this is the need for better and increased information for external audiences. MoI does not currently prepare public documents on its programs outside of press releases. General information on programs – their availability and how they are progressing- would raise the profile of the Ministry and assist in outreach to potential clients. This would also help MoI broaden its consultation beyond the limited number of chambers with which it currently interacts. Activities to disseminate information about the Ministry's activities and policies could include printed collateral, webclips, newsletters and publications of monitoring and evaluation reports.

Implementing these recommendations may require some budgetary realignment as well as external technical support in some cases. In addition to overall organizational development enhancements, a number of targeted technical assistance programs would allow the Ministry to improve the design of existing programs. These include studies to measure the redundancy rate of selected programs; training on monitoring and evaluation methodologies; and guidelines on effective trade show management and setting subsidy levels. Such assistance would strengthen the Ministry to optimally fill its role representing and supporting Indonesian industry and, more specifically, the five value chains that SENADA seeks to support.

# 1. INTRODUCTION AND METHODOLOGY

## 1.1 INTRODUCTION

SENADA is a four-year project financed by the United States Agency for International Development (USAID) that seeks to generate growth, jobs and income by increasing the competitiveness of Indonesia's major labor-intensive light manufacturing industries. SENADA's activities strengthen the competitiveness of five industry value chains: footwear, furniture, auto parts, garments and home furnishings. The business enabling component of SENADA complements the value chain work by identifying and removing policy impediments to these industries.

The Ministry of Industry (MoI) is mandated within the government of Indonesia to design and implement policies to support industrial sector contribution to GDP and employment. The purpose of this study is to analyze MoI policies affecting SENADA's value chains and to provide recommendations for increasing their effectiveness. The study limits itself to policies either enacted directly by MoI (through ministerial or director general decrees) or sponsored by MoI but enacted under another authority (for example, the 2007 presidential decree on fiscal incentives). Policies and activities by provincial and local government Department of Trade and Industry (DoIT) (the departments have not been separated at local levels of government) are not covered unless they directly carry out programs of the central government.

MoI is implementing a broad range of activities, both policy-related and at the firm level, to assist priority sectors. Policy initiatives include tariff and taxation regulations intended to make Indonesia more competitive with ASEAN countries. Firm level assistance includes business development services provided directly by regional MoI offices, sponsorship for firms to attend trade shows, subsidized credit, and free technical advice for certification. MoI faces significant demands from industry chambers for protection and subsidies in designing these interventions.

## 1.2 METHODOLOGY

The study began with a mapping of MoI policies and activities related to the five target sectors. In the absence of any centralized information or detailed workplan this required interviews with each relevant Director General and department head[2]. SENADA's value chains do not neatly match departments at MoI and in some cases value chains (for example, textiles and garments) are covered by both their own separate department serving large firms as well as activities under the SME unit. Matrices of MoI activities and policies by sector are available in Appendix 1.

The research team then selected five policy initiatives for further study: tradeshow support, a textile machinery subsidy, fiscal incentives, the Jepara cluster program, and a SME consultancy regulation. The programs were selected based on both negative and positive criteria: (1) the likelihood that the program could serve as a model for future industry support programs; and (2) the potential distortions the initiative might introduce into the economy or damage that the program might do to competing private-sector initiatives.

In-depth interviews were held with relevant policymakers, industry associations, business owners, and implementing agencies (if any). Meetings with business owners to solicit their views on the

[2] The only document that comprehensively lists each Directorate's activities is the annual budget which is considered a non-public document.

effectiveness of government programs were primarily held outside of Jakarta in areas with a high concentration of the industry in question. So for example, the research team traveled to Yogyakarta and Jepara to meet with furniture manufacturers, Bandung to meet with footwear and textile manufacturers, and Solo and Yogyakarta to meet with home accessories manufacturers. Provincial MoI officials were interviewed in East Java, Yogyakarta and West Java and local government officials were interviewed in Bandung and Jepara. These interviews took place over a three-month period from October 2007 to January 2008. A complete list of meetings is provided in Appendix 2. Secondary sources consulted to supplement the interviews are listed in the bibliography.

# 2. INDUSTRIAL POLICY OVERVIEW

## 2.1 INTERNATIONAL TRENDS AND BEST PRACTICES

International experience suggests that the most important role for government in facilitating industrial development is to provides and environment conducive to business enabling activities and growth. This includes providing a stable legal and macroeconomic framework, minimal regulation that is transparently and consistently applied, good quality infrastructure, and an educated workforce. Open markets, and the ability to attract foreign direct investment, have been shown to have a positive influence on technology transfer and capital infusion. Efforts to promote industrial growth in the absence of these factors are likely to have a marginal impact at best.

The efficacy of industrial policy — even its necessity — is a contentious issue among economists[3]. Mainstream economics would suggest that government efforts to support and direct industrial development will be ineffective at best and at worse will redirect investment and private sector activity to less efficient outcomes than would have been reached by the market operating freely. One commonly cited problem with industrial policy is that government officials are unlikely to be successful at picking sectors for support as they are insulated from the market realities faced by the private sector. Another concern is that the policy tools used tend to be highly distortionary — tax incentives, subsidized credit, tariff and non-tariff barriers- opening up possibilities for rent-seeking and the creation of vested interests who will resist dismantling the program[4]. Indeed, at their most interventionist, efforts by government to select and support particular industries has resulted in resource-draining failure. For example, import substitution policies common in developing countries in the 1960s and 1970s largely resulted in unsustainable firms that required significant protection and subsidies to survive[5].

Despite the challenges, almost every country implements some form of industrial policy. Even in countries that have officially disavowed industrial policy for the reasons discussed above, programs are in place to attract investment or support small business. In East Asia, the inclination has been highly interventionist with some success stories (Japan, Taiwan, and Korea) that have been difficult to replicate in other environments. The role of government in fostering this success is debated[6]. Studies have not found any clear evidence that subsidies, tax incentives or trade protection in those countries resulted in higher productivity growth. Hard targets linking support to performance is a feature of those programs that is rarely replicated (Hernandez).

For the ASEAN countries that lend themselves to the most direct comparison with Indonesia, the story is one of attempts to direct industrial development that have had limited impact. In particular, efforts to promote national industries have largely failed. Other ASEAN efforts actively being benchmarked by MoI, for example, tax incentives in Malaysia, have been shown to be ineffective. Tax holidays provided to pioneer industries in Malaysia were found in one study to impose a net penalty on investors[7].

Proponents of industrial policy point to a number of best practices. For example, "New Industrial Policy" eschews picking winners and focuses instead on defraying the costs related to developing new market niches by facilitating better information flows within value chains and

[3] See Bonaglia, Hernandez, Ogutcu, and Rodrik for discussions of the efficacy of industrial policy.
[4] See Rodick (2007) for arguments against industrial policy.
[5] See Siebert (2002).
[6] See Stiglitz and Yusuf (Eds.), (2002), Rethinking the East Asian Miracle, Oxford University Press.
[7] Broadway et al quoted in Hernandez.

between public and private organizations (Bonaglia and Fukasaku). D. Rodrik, an academic influential among those developing New Industrial Policy, recommends that industrial policies reflect the following design principles:

- Incentives should be limited to "new" activities.
- Sunset provisions should be automatic.
- Clear benchmarks for success and failure must be established.
- Implementing agencies have demonstrated competence and are autonomous from politics.
- Leadership must come from a high-ranking official.
- Private sector engagement must be systematic.

MoI may wish to integrate more systematically these best practices in its future policy and programs. Areas to focus on would include targeting pioneer sectors rather than established ones; providing clearer criteria for firm-level success; providing clear provisions for ending support, and; broadening private sector consultation beyond the main sectoral chambers currently providing input.

## 2.2 OVERVIEW OF INDONESIAN INDUSTRIAL POLICY— PAST AND PRESENT

### 2.2.1 PREVIOUS INDUSTRY POLICY

Indonesia throughout the 1970s pursued a state-led industrialization strategy characterized by a comprehensive import substitution program to develop a number of consumers, intermediate and capital good industries (Hill 1996). Their establishment was fostered through various policy interventions including a restrictive foreign investment regime, a large scale public investment program and the provision of incentives to a select group of companies in the form of subsidized credits, protection against foreign and sometimes domestic — competition among a host of other discretionary benefits (Hobohm 1987). Such a strategy was buttressed by both the strong nationalist sentiment that had re-emerged in policy making circles (in response to the liberalization efforts of the late 1960s and early 1970s) and the oil export windfall which provided the necessary finance for the expanded role of the state (Robison 1987). As a result, notes Hobohm (1987), Indonesia did not fully exploit a number of market oriented export opportunities in labor intensive manufacturing (such as textiles, garments, electronics and footwear) until deregulation enabled export diversification in the mid 1980s. Rather, emphasis during this period was given to heavy state-run industries such as steel, fertilizer and cement.

The government was forced to ease its state-led industrial strategy in the early 1980s in response to falling oil and commodity prices. Exchange rate devaluation and banking sector deregulation were undertaken. The latter included removal of the interest rate ceiling, the credit ceiling and a reduction in liquidity credits. In addition, the government also undertook some tax and trade reforms. The range of tariffs was reduced from an initial 0 to 225 percent to 0 to 60 percent, with most tariffs ranging from 5 to 35 percent. The second major reform at this time was the improvement of customs and port procedures. All operations relating to import and export goods by the customs department were handed over to private companies. This served to significantly streamline and simplify customs procedures and thus reduce export bias (Hill 1996).

Continuously falling oil prices finally forced the government to abandon its import substitution policy and embark on an export-promotion policy. This was marked, rather officially, by a massive 45 per cent devaluation of the rupiah in 1983. Steps were taken to support exporters including the introduction of a new duty drawback scheme exempting imported inputs from all duties and regulation. The scheme also allowed exporters to import directly without import licenses. Efforts to spur exports were matched by liberalization in the investment regime with measures removing the obligation for foreign firms to establish joint ventures with Indonesian partners and reductions in minimum capital requirements. These reforms continue into the present with the issuance of the new Investment Law and Investment Negative List in 2007[8].

Throughout the New Order period, government controlled business associations and chambers although to a far lesser degree than other parts of civil society. The Indonesian Chamber of Commerce (KADIN) was made the official apex organization representing businesses in Indonesia. Sectoral associations were also supported or formed by the government. The relationship was predominately top-down with government "consulting" business associations to inform them of new policy directives rather than soliciting private sector views. Corporatist relationships meant that the primary function of associations was to help members obtain government favors rather than serving as an independent voice or providing services to members. This history is useful to the discussion below because MoI continues to consult primarily with industry associations created during this time.

While reforms had largely stalled by the mid-1990s, the 1997/98 economic crisis resulted in another round of liberalization. Under agreements with the International Monetary Fund (IMF), significant trade reforms were undertaken aimed at reducing tariffs and non-tariff barriers and promoting exports. Simple average tariff rates were reduced from 20 percent in 1994 to 9.5 in 1998 and 7.5 in 2002 (WTO 1998, 2003). The government removed many trade restrictions affecting import licenses, local content schemes, trade monopolies and marketing arrangements. The government also committed to gradually removing export taxes and eliminating all other types of export restrictions, such as quotas and provincial taxes levied on inter-provincial and inter-district trade.

As in many countries, liberalization in Indonesia has thus far been more the result of push than pull factors. Globalization is commonly seen as a threat rather than an opportunity, despite the 7.5 percent average growth rates experienced under the export-led strategy of the later New Order years. Protectionist attitudes are widely held among officials and continue to be reflected in policymaking. This is partly historical but also the direct result of lobbying by the private sector which is under increasing pressure from global competition. Recently, trends can be seen towards increased trade barriers and persistent protection for some products including textiles and automobiles (Takii and Ramstetter). The assumption that the role of government is to direct the economy rather than facilitate private sector development remains prevalent. This attitude is common not only among government officials but also among many businesses in Indonesia who often expect government to perform functions that would be better served through the initiative of their own associations.

### 2.2.2 CURRENT INDUSTRY POLICY

Given the political and economic realities of a more deregulated and open economy, the GOI now has fewer industry policy mechanisms at its disposal. A commitment to macroeconomic and budget discipline has limited funds available for large programs, including credit lines and stimulus packages. Accession to the WTO and AFTA have curtailed tariffs and other trade barriers. The emphasis has thus turned to increasing competitiveness of industry chains through targeted measures.

The current government plan was formed following the 2005 split of the Ministry of Industry and Trade into two separate Departments. It is laid out in the National Industrial Development Policy (2005), known in Indonesian as the White Paper, with very similar policy directives likely to continue in the near future with the impending issuance of the National Industrial Policy (2007) as a Presidential Decree. Dropping the overarching framework of the past, current policy seeks to help

[8] Nonetheless, 25 sectors remain closed to foreign investors with another 300 areas of activity conditionally open to investment to protect domestic SMEs. In addition, non-tariff barriers are multiplying by some measures (Takii and Ramstetter).

labor-intensive industries survive the increasingly competitive global market through relatively ad hoc efforts. The White Paper identifies priority sectors and analyzes the challenges and opportunities facing them. Official policy promotes cluster formation and strengthening as a core methodology for promoting industrial growth. This is reflected in the objectives of "strengthening competitiveness, deepening domestic value chains and spurring cluster formation"[9]. As will be discussed, this emphasis on clusters, the merits of which can be debated, has not yet been uniformly implemented.

The White Paper devotes significant space to selecting priority sectors and distinguishes between strategic industries for long-term and medium term development. Core clusters identified as priorities for the medium-term development program, which runs through 2009, include:

- Food and beverage
- Fishing
- Textiles
- Footwear
- Palm oil
- Timber (including rattan)
- Rubber
- Paper and pulp
- Electrical equipment
- Petrochemicals

Three long-term strategic industries (agro processing, telematics and transport) are also identified as well as a large number of supporting or SME-related industries. In total, 32 sectors are considered strategic under the Industrial Policy. Such a large number has raised concerns that selection was guided more by political concerns than economic ones (Thee 2006). Tighter selection criteria would assist the Ministry in planning interventions and directing scarce resources. A number of these sectors relate to agriculture or natural resources which fall under the authority of separate Ministries.

MoI is concerned with the processing or value added components of the production process and represents the interests of manufacturers. This can result in Ministries being at cross purposes, as in the case of rattan where MoI is pressing for bans on exports of rattan to ensure cheap supply of raw materials to furniture makers[10]. This directly counters the interests of rattan producers and the trade liberalization agenda of other ministries. The need for improved coordination between ministries is a consistent theme of this report.

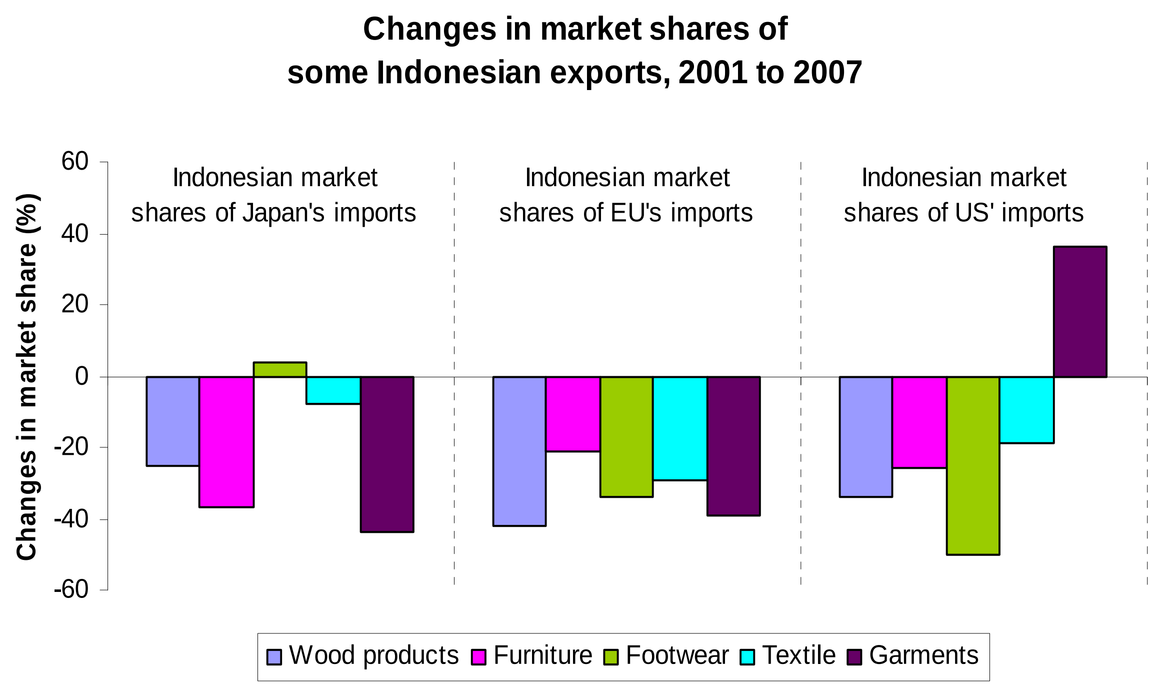
Of the ten priority sectors, textiles, footwear, timber (furniture), and transportation (auto parts) are pertinent to the SENADA program and are thus included in this review. In addition, home accessories receives support under the SME Directorate's handicrafts programs. A matrix of MoI initiatives by sector is available in Appendix 1. Not all the activities listed in the White Paper are being implemented yet; conversely, there are activities being implemented at MoI which are not mentioned in the White Paper.

In order to reinforce the White Paper and frame policy going forward, MoI will shortly issue a new presidential decree referred to as the Industrial Roadmap which was scheduled for passage in October 2007 but has been delayed pending comments from other technical ministries (only the Ministry of Trade has commented to date). The Industrial Roadmap is intended to encourage other ministries to take account of the white paper in their own planning and is very similar in its analysis and planning to that earlier document. Enactment is expected in the first half of 2008.

The challenge that Indonesia faces in spurring industrial growth is substantial. Exports in almost all labor-intensive manufacturing sectors, with the notable exception of garments exports to the US, have lost market share over the last several years as shown in the figure below. Several analysts link

[9] National Industrial Development Policy (2005).
[10] See Bisnis Indonesia "Stop Rattan Export", October 10, 2007 and "Mega Slams Rattan Exports", November 20, 2007.

this fall to the increasingly uncompetitive labor regulations in Indonesia- including minimum wage laws that are forcing some manufacturers to relocate and severance requirements that are among the most restrictive in Southeast Asia- as well as deteriorating infrastructure[11.] Measures to address these issues are notably absent from MoI's strategy and workplan although many companies interviewed felt they are the primary area in which government action is required[12.]




Notes:
1. Export market share in 2007 is defined as the share of exports over the period of Q2 2006 to Q1 2007.
2. The products are defined based on SITC Revision 3, except for Japan. Japanese data are compiled from the closest three- or five-digit catagories of its major commodities.

Source: Adapted from Ramstetter and Takii (2007), p.313.

The sectors shown in the graph are all considered priorities under the White Paper despite the fact that they are long established in Indonesia. This is symptomatic of MoI's focus on preserving existing, and even failing, industries rather than facilitating the establishment of new pioneer industries. For example, in January, MoI announced that it is considering providing fiscal incentives to investors willing to take over collapsed footwear manufacturers[13].

MoI is concerned with protecting employment in the manufacturing sector but it is unclear that the measures being taken address the underlying reasons why these industries are losing competitiveness. International best practice would also suggest that focusing on new industries, rather than established ones, is a more appropriate role for the government as it attempts to influence market outcomes[14.]

[11] See Soetrisno for a private sector perspective on GoI policies.
[12] These issues are also not addressed in the Investment Law. See Takii and Ramstetter.
[13] Kontan Newspaper, "Incentives for Footwear Manufacturers", January 23, 2008. Bisnis Indonesia quotes MoI Director General for ILMTA as saying "the Ministry will prioritize optimizing sunset industries." See Bisnis Indonesia "ILMTA sector projected to grow 4.45 percent" February 13, 2008.
[14] See Bonaglia and Fukasaku and Rodrik (2007).

# 3. REVIEW OF SELECT POLICY MEASURES

The Ministry of Industry implements or sponsors a wide range of policies and programs with the intention to catalyze growth in priority sectors. These are grouped and discussed in this section with case studies provided for select initiatives. Most of these policy tools attempt to influence private sector performance through the provision of subsidies and other incentives. Efforts to improve the business environment are not a primary focus and the potentially positive role Government can play in disseminating information to industry players also remains relatively unexplored.

### 3.1 TARIFFS

MoI has sponsored a number of measures for consideration by Team Tariff and the Ministry of Finance. These generally focus on ensuring an adequate supply of raw materials to priority industries. This is in response to the concerns of industry chambers regarding their perceived inability to compete against other Asian countries — particularly China — because of the low quality or high price of domestically produced inputs. MoI sponsors policies that attempt to prohibit export of domestically produced raw materials on the one hand while supporting duty-free import of raw materials on the other.

Thus, in the footwear sector MoI has sponsored a 30 percent export tax on raw leather while also sponsoring duty-free imports of leather (0 percent on wet blue). Similarly, tariffs on cotton imports have been reduced to 0 percent to support the domestic textile industry and rates on steel imports are also at 0 percent to support the auto industry.

Indonesia's accession to the WTO and AFTA trade agreements means that tariffs on tradable goods are generally decreasing rather than increasing. For example, in autoparts, Indonesia is in the process of harmonizing tariffs to meet WTO requirements which will result in reducing tariffs for completely built up CBU vehicles to a maximum of 40 percent and completely knocked down (CKD) to a maximum of 10 percent (from prior rates of 80 percent and 40 percent respectively). MoI remains concerned about cheap imports and particularly illegal smuggling (i.e. goods being brought in evading import or luxury duties). Both of these issues are cited in the White Paper as challenges.

MoI continues to support tariffs on goods that would compete with domestic manufacturers, particularly of capital goods. For example, MoI is proposing to halt the issue of import permits for used capital goods in order to protect domestic manufacturers[15]. Similarly, discussions with the autopart association indicate that they would like to see duty free imports of rubber, glass and plastics but MoI has refused to support this in response to countervailing demands by domestic producers. These issues highlight the occasional contradictions between protecting domestic manufacturers generally and supporting strategic sectors such as textiles which need to upgrade machinery or autopart manufacturers, which are considered a next generation industry.

Attempts to assist domestic manufacturers through tariff barriers have had mixed success. Import and luxury duties on tradable goods have been difficult to enforce due to Indonesia's porous maritime borders and weaknesses in the customs and tax offices. Export bans or tariffs on primary raw materials may work to decrease rather than increase the supply of necessary inputs as they depress prices and producers respond by reducing production. A cost/benefit analysis of these measures would assist MoI in better calculating whether such policies are likely to be effective.

[15] Bisnis Indonesia, "Import Permits for Used Capital Goods should be stopped in 2009", February 27, 2008.

Further study may find that addressing barriers to domestic trade, for example, upgrading aging transport infrastructure or reducing local government tolls and user fees (both formal and informal), may be a more useful way to ensure increased supply of domestic raw materials.

Summary of Recommendations:

1. Undertake economic analysis of any proposed tariffs or non-tariffs barriers to ensure that overall impact on the economy is desirable.
2. Consider studying supply chain constraints to address raw material shortages through non-distortionary measures.
3. Ensure coordination across departments so that tariff policies are consistent with other efforts to promote priority sectors.

## 3.2 FISCAL INCENTIVES

MoI's major taxation initiative in recent years has been the provision of fiscal incentives for new investment. The Ministry is keen to compete with ASEAN competitors for investment and feels that tax incentives are an important part of those countries ability to attract investors [16]. The fiscal incentive measure is also a longstanding demand of private chambers of commerce[17]. The MoI sponsored regulation, Presidential Decree PP1/2007 provides a tax credit of 30 percent on income over 6 years (5 percent per year), accelerated depreciation and extended loss carry forward.

The regulation applies to new or expanded capital investment approved (not realized) in 2007 in priority sectors or under-developed regions (primarily eastern Indonesia). In line with the new Investment Law, the regulation does not discriminate between foreign and domestic investors. The measure also reflects international best practice in being performance based rather than expectation based. Facilities are received after, not before, the investment is made.

The effectiveness of tax incentives in attracting investment is debatable. While there is some evidence to suggest that fiscal incentives can influence investment decisions, other factors appear to be more decisive. In many studies done across the region and internationally, investors claim that tax incentives are not as important when making investment decisions as considerations of the business environment, infrastructure, or workforce availability and suitability[18].

The redundancy rate (investments that received the incentive- effectively a government subsidy- but that would have been made even without the tax holiday) can be quite high. This leads many economists to argue against tax incentive schemes on the basis that they reduce government revenues without effectively influencing investment decisions. Given the fiscal considerations and potential loss to the government, it is important that governments carefully evaluate how to reduce the redundancy rate of fiscal incentives.

The box below, using the example of Vietnam, illustrates many of these challenges.

[16] For example, Malaysia offers a 70 percent tax holiday on income for pioneer industries and a 100 percent exemption for industries willing to locate to Sabah and Sarawak. See www.lowtax.net/lowtax/html/offon/malaysia/malinv.html

[17] See Tempo Interactive, "Entrepreneurs Demanding Tax Exemption", December 13, 2007.

[18] See Morisset and VNCI Policy Paper #2 for discussion of the effectiveness of tax incentives.

**DO FISCAL INCENTIVES PROMOTE INVESTMENT? LESSONS FROM VIETNAM.**

A study by the USAID-funded Vietnam Competitiveness Initiative (VNCI 2004) sought to clearly depict, and better understand, the impact of Vietnam's current corporate income tax (CIT) incentives regime for domestic companies. It was based on an empirical survey of 140 private, domestic companies in three locales in southern Vietnam: Tien Giang province, Binh Duong province, and Ho Chi Minh City. Half of the firms surveyed were receiving CIT incentives, and half were not.

International best practice would suggest that an investment incentives regime should be: i) relatively selective and carefully tailored; ii) performance-based; iii) designed as simply and clearly as possible; iv) rule-based, and not open to discretionary or subjective decision-making; and v) that its implementation is both equitable and transparent. In most of these regards, Vietnam's current CIT incentives regime has considerable room for improvement. Three key areas are mentioned below:

1. **High redundancy leading to waste of scarce fiscal resources**. Only 14 percent of firms in the sample receiving CIT incentives claimed that they had made deliberate changes to their investment projects specifically in order to qualify for CIT incentives, typically by increasing the number of employees, increasing the scale of production, or moving their production activity to an industrial zone. Less than 6 percent of firms receiving CIT incentives said they definitely or probably would *not* have made the same investment decision without the provision of CIT incentives. The overall estimate of the redundancy rate of CIT incentives, across the full sample, was just under 83 percent. The resulting public subsidy equivalent (ie. the amount of CIT revenue foregone for an equivalent amount of additional investment made as a result of the CIT incentive) -- using the standard tax rate of CIT of 28 percent -- was between 62 percent and 75 percent (depending on whether or not one considers the time value of money), across the full sample.

2. **Overly complicated and non-transparent procedures**: Another important result relates to the general perception that the current CIT incentives regime is complicated and not well understood by many firms. Just under 59 percent of all firms in the survey thought the current tax incentives regime is too complex and difficult to understand, compared with 25 percent that disagreed. Over 87 percent of firms thought a simpler CIT incentives regime — that was uniformly applied to all investors, both local and foreign — would be better, compared with just 5 percent that disagreed. Based on comments made by some firms, it appears that a substantial proportion believe the time and costs entailed in acquiring a CIT incentive certificate exceed the tax savings to be subsequently derived, particularly for start-up businesses, and therefore do not bother applying for CIT incentives, even though they may well be technically eligible.

3. **Incentives poorly targeted.** As with most industry policy measures in Vietnam, fiscal incentives have been poorly targeted in terms of promoting investment in less developed regions and in small-medium sized business. This is demonstrated by the fact that most firms receiving incentives have opted to qualify by meeting the more easily certifiable criteria of making changes to the business (such as increasing exports, employees, investment etc) than investing in a less developed region. Likewise incentives tend also to be enjoyed by larger firms. Firms receiving incentives were only average 7.5 times larger in terms of investment capital and 3.8 times larger in terms of labor than firms not receiving incentives

Source: VNCI Policy Paper #2 'Fiscal Incentives for Domestic Investment in Vietnam: Are they Effective?', by Nguyen Thi Canh, Hoang Thu Pho, Cung Tran Viet, Nick Freeman and David Ray.

In the case of PP1/2007, no clear criteria are given for selecting sectors. The list largely focuses on sectors identified in the White Paper, but this is not exclusively or consistently done. For example, the footwear industry does not receive the incentives although it is identified as a priority sector under the White Paper while pharmaceutical raw materials, which is not listed as a priority sector, is included. Pharmaceuticals, as a potential pioneer industry for Indonesia, are in fact a better candidate for the fiscal incentive because the risks, and associated costs, of investment are higher. A more rigorous methodology for selecting the priority sectors in the Industrial Policy, focusing on pioneer rather than established industries, would have a beneficial impact on decision-making for policy tools such as this.

While the list of sectors in the PP is valid for three years, MoI can review the sectors eligible for the tax holiday on an as-needed basis. With the regulation only one year old, MoI is already under pressure from a number of industries to expand the current list[19]. Such frequent consideration of the priority list leaves the entire process open to political lobbying with the risk that decisions will be made based on the strength of the industry chambers or individual investors rather than a long-term view of Indonesia's economic development. MoI is aware of this problem and has requested technical assistance in evaluating which industries, if any, should be included in any expansion of the preferences.

Related to the challenge of selecting applicable sectors, it is clear from discussions with counterparts at MoI that no analysis has been carried out to estimate the redundancy rate of the incentives. As will be discussed below, some of the sectors included, for example textile machinery, have been experiencing increased investment in recent years even in the absence of the tax holiday or other government incentives[20]. Conversely, investment in eastern Indonesia where infrastructure and skilled labor are in short supply, are currently given equal incentives with investment on Java. It is likely that incentives would need to be much higher for eastern Indonesia than Java in order if they are to be effective. As MoI seeks to implement the incentive program and expand it to new sectors, it is recommended that they undertake a study to estimate the likely redundancy rate of the tax holiday. A cost-benefit analysis estimating whether gains made through the subsidies would compensate for the loss in tax revenue would also be prudent. MoI should also benchmark Indonesia's regulation with other fiscal incentive programs in the region and more closely examine whether other country's schemes have been successful.

For the time being, it appears that the tax incentive is not yet being implemented as the regulation was passed under a tax law (UU No. 6/1983) that does not recognize fiscal incentives[21]. While the Investment Law (UU No. 25/2007) enacted in April 2007 does refer to such incentives, until a new tax law is approved by the House of Representatives (DPR) allowing fiscal incentives, the Ministry of Finance says it cannot implement this regulation. At the time of writing, members of the DPR have indicated they are unlikely to approve such a provision[22].

Should they finally pass a tax law that allows fiscal incentives, the regulation may need to be reissued so that it refers to the proper authorizing legislation. MoI has indicated that the upcoming Presidential Decree (PP) enacting the industrial roadmap will include provisions for incentives to five sectors: manufacturing, agro-industry, transportation, electronics and information technology. It is unclear whether the new PP would supplant PP 1/2007 or more likely reinforce it. It is important that MoI ensure that these various regulations/laws are consistent so that investors feel comfortable that the incentive will be applied as expected.

While MoF and BKPM claim they are not yet providing the facility because of these legal issues, media reports indicate that 52 firms were granted fiscal incentives in 2007[23]. The research team was unable to obtain a list of these firms from any of the Departments involved (MoI, MoF, and BKPM). Interviews

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[19] Business News, "Implication of Industrial Incentives", January 30, 2008, reports that 29 sub-sectors have been recommended by various ministries for inclusion under the regulation.

[20] See James, W. "Indonesian textiles and apparel: A new dawn for a 'Sunset Industry'?, March 12, 2008.

[21] The implementing regulations for this decree can be found in PER 67/PJ/2007. While outside the scope of this research, a review of the implementing regulations and the evaluation called for in the original decree (to be completed after the first year of implementation) would be a useful exercise for a separate study.

[22] Jakarta Post, "House says government tax holiday plan not possible", January 14, 2008.

[23] Business News, "Implication of Industrial Incentives", January 30, 2008 quotes Minister of Industry Fahmi Idris as saying that 184 companies applied for the incentives but only 52 met the requirements.

with firms in sectors eligible for the incentive indicate that the incentive is not being widely advertised at this time; many of the firms, including leading firms in these sectors, were unaware of the regulation.

Despite demands by some industry chambers for the incentives, it is worth noting that firms interviewed for this study questioned the effectiveness of the scheme saying that other factors were more important in influencing investment and that firms were unlikely to choose an instrument that would deepen contact with the tax authorities. This view is also expressed in some media coverage. Bisnis Indonesia quotes the General Chairman of the Automotive and Motorcycle Parts Industry Association as saying that while the incentive was a good measure, the policy was not enough to encourage new investments in the sector and that to boost local investment the government should "simply ensure policy consistency or sustain existing policy"[24]. Similarly, Business News cites "land appropriation, arduous bureaucratic procedures and illegal levies" as "actual needs" the government should be addressing[25].

Summary of Recommendations:

1. Undertake a study of the potential redundancy rates of fiscal incentives
2. Target only pioneer industries for incentives.
3. Re-evaluate incentive rates for eastern Indonesia and other under-developed locations to ensure that compensation for increased costs is adequate to attract investors.
4. Consider setting a longer timeframe for re-evaluating eligible sectors (e.g. every 3 years rather than every year) to increase certainty for investors.

### 3.3 TRADE PROMOTION

Trade promotion formally became the responsibility of the Ministry of Trade when the Ministry of Industry and Trade was separated into two Departments in 2005. However, MoI continues to sponsor trade show participation by industry members for all the sectors it supports. This includes domestic and international shows. For example in 2007, MoI sent eight footwear firms to the GDS show in Dusseldorf and for furniture, MoI sponsored firms to go to Shenzen, China and Valencia, Spain. Similar support is provided by the Ministry for SMEs and Cooperatives, the Ministry of Trade, the Investment Coordinating Board as well as local and provincial governments. In most cases, these programs are targeted at SMEs.

Sponsorship generally includes the cost of the booth and the shipment of samples. Many firms receive supplemental funding for transportation from their local or provincial governments which dedicate a portion of the local budget to tradeshow support. Thus, for some number of firms the effective subsidy approaches 100 percent with the business owner paying only for lodging and food while attending the show.

One of the justifications given by officials for the high subsidy levels is that the tradeshow support is primarily intended for SMEs. This targeting poses its own challenges. Most SMEs do not produce in sufficient quality and quantity to meet export demand and even those that do export generally use intermediaries (wholesalers) to handle the formalities or consolidate orders[26]. MoI is aware of these limitations and has tried to address them by in some cases physically visiting firms to ensure that they meet international quality standards and by offering classes to participating firms on obtaining letters of credit, obtaining an export license, etc.

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[24] Bisnis Indonesia, "Component Producers Doubt Tax Incentive Effectiveness", February 19, 2008.
[25] Business News, "Implication of Industrial Incentives", January 30, 2008.
[26] See Berry and Sandee (2005) for more on the export characteristics of SMEs.

MoI commonly selects firms through their provincial level offices. The provincial offices in turn solicit names of potential firms from local governments. Local governments do not have comprehensive lists of firms in their area as business licensing is not automated in most places and so officials do not have access to a database of firms. Because of the potentially huge demand for participation in the program, officials rely on personal networks to identify firms rather than putting out an open call for bids. In other words, firms are selected because they are personally known to officials working at the local industry and trade office. Another common method employed for selecting firms is to ask the main sectoral associations to find volunteers among their members. Because these selection methods reach only a small number of firms, there is a perception by many industry actors (business owners, industry associations and even government officials) that the same firms attend year-after-year.

Private sector companies use a number of methods to ensure quality tradeshows. Selection of firms is based on criteria that include technical, legal and financial capacity to export. Qualifying firms must demonstrate a history of exporting, staff dedicated to handling export orders, whether the firm has internet access to communicate with foreign buyers, whether their financial institution can process letters of credit, etc. In addition to firm selection, the preparation for the show, including the design of the booth and preparation of the buyers, is undertaken with significant leadtime. Attendees and show organizers dedicate considerable effort to preparation including sample selection, shipment and pricing specification as well as developing sales materials including brochures, DVDs and other promotional materials for distribution to potential buyers. Participating firms must be prepared to answer questions from buyers regarding lead times, container dimensions, sample shipment and export formalities.

From the perspective of the Indonesian private sector, MoI's tradeshow activities could be improved through more rigorous, competitive methods for the selection of firms and better preparation of the tradeshow booth and experience itself. Selection of firms should focus on ensuring that firms are producing export-quality goods and are able to successfully meet buyer demands in terms of consistency, quality, and volume. Evaluating firms that apply would require information on whether they have exported in the past, how successful they have been at past tradeshows, and whether they know how to calculate pricing for export (for example, including costs related to FOB and CIF).

Moving to a competitive bidding process has a number of important advantages as MoI seeks to raise the profile of domestic products and support increased export sales. These include:

- **Competition to participate.** Would reduce (i.e. compete down) the subsidy provided by government to individual producers, allowing more firms to be assisted and/or allowing resources to be redistributed to improved show preparation.

- **Requiring a significant contribution by firms**. Would encourage a self selection process whereby the most committed and capable producers able to make best use of the subsidy would emerge as the highest bidders.

This more rigorous process would have the effect of eliminating many SMEs but would raise the overall success rate of the tradeshows and would improve the branding of Indonesian producers as reliable, high quality business partners. This is important because some firms that are successfully exporting indicated to researchers that they take care to obtain their own booths at shows MoI is attending to prevent their products from being associated with the low quality products that MoI is sponsoring. Changing the focus from small firms to larger firms that are better able to export may in the long run be more useful to the industry overall.

Implementing a competitive bidding process and preventing firms from attending year after year or approaching multiple agencies would require improved coordination between departments sponsoring trade show participation and between levels of government. Although inter-departmental coordination meetings do take place, they may need to be improved so that selection criteria are implemented consistently across units. Local government offices would need to have increased resources to handle a widely advertised competitive process or, conversely, have technological upgrades and resources to identify and contact all exporting firms in their area inviting them to bid. This may require investment in databases and email applications in order to communicate with and track firms effectively.

In addition to firm selection, business owners and chambers also feel that the quality of the shows themselves needs to be upgraded[27]. Feedback from firms indicates that booths are often poorly located and are not professionally or attractively presented. Again, this reflects limited resources at MoI. For overseas shows, there is an impression that liaison with the Indonesian Embassy trade officers is weak, resulting in little or no information on trends in the country or the focus of the show. Without this information, producers bring samples that are not relevant to buyers resulting in feeble sales. Firms are often notified of their selection (or even the opportunity) at the last minute and this also inhibits their ability to prepare for a successful event. Finally, they feel it would be useful for the government sponsor to host "buyers only" meetings to attract wholesalers and importers as many shows are also open to the general public. All of these steps would require increasing resources spent on preparation prior to the show.

**INDUSTRY FEEDBACK ON MOI TRADESHOWS**

The lack of coordination between departments and producers in regards to trade shows was a common problem highlighted during interviews. For example a large chamber representing footwear manufacturers related that they were approached by the event organizer of Indoleather, a domestic industry show sponsored by MoI, asking for them to interest their members in purchasing booths. The chamber helped them find paying participants only to be approached two weeks prior to the show by MoI directly inviting members to fill 40 free booths that the Ministry was making available. This caused embarrassment to the chamber (which had effectively sold something free to its members) and highlights the lack of coordination between departments and their implementing organizations.

Industry chambers that have assisted MoI to find participants in the past also express concern about the poor coordination between sponsoring organizations (see box) and in some cases find that MoI is sponsoring attendance at shows that are not relevant to their sectors. For example, members of the Indonesia Autoparts Association say they no longer attend the government shows because they are not specific to the autopart industry and relevant buyers don't attend.

It is difficult to obtain concrete information on sales generated by attendance at the tradeshows. A fundamental problem is the conceptualization of "sales". The purpose of tradeshows is to promote products, establish relationships with potential buyers, and obtain orders over the medium-term. However, some officials treat tradeshows as a retail opportunity with an assumption that the companies' purpose is to sell the samples they have brought with them. MoI officials will therefore claim that a show is very successful because the firms "sold out".

Given this conceptual issue, it is unclear whether the government undertakes any longer-term follow-up with firms to see what sales were ultimately generated from contacts made at the show. The government, usually MoT, will set a target for revenues generated at each show and tracks

[27] Bisnis Indonesia, "Indonesia Association of Tradeshow Companies calls for Stop to Impromptu Exhibitions", January 11, 2008.

sales at the shows they help sponsor. MoI appears to use this MoT data to report on success or they receive information from the industry associations that sent members. MoI may wish to invest in a longer-term process of surveying firms six months to one year after their attendance at the show to evaluate how the show was helpful to them either in terms of deals completed or design innovations achieved. Again, this is something that could be outsourced to a private firm if MoI does not have the in-house capacity to undertake such a survey.

Interviews with firms who have attended the shows indicate that they do not find the shows particularly lucrative. That is not to say that they don't value attendance. But from the perspective of many business owners, the shows, particularly international ones, are more useful for learning about trends in their industry than in actually generating sales. Many of these owners suggest that the government should take a more strategic view of the value of these shows, evaluating them not only for their success in generating sales but also seeing them as an opportunity to highlight Indonesian products and allow Indonesian businesses to learn more about what products are internationally competitive. Unfortunately, MoI faces institutional constraints that work against such improvements. When justifying budget allocations for tradeshows, immediate returns resonate more strongly than longer-term capacity building.

Improving the management of the shows may require hiring professional staff or outsourcing management of events to private organizations with a proven track record of holding successful tradeshows. In the absence of hiring external professionals, concrete directives to MoI staff as well as regional offices engaged in the selection process would address some of the immediate problems. A technical assistance project focusing specifically on tradeshow support is discussed in the final recommendations. Without changes, the governments activities in fact risk damaging branding for Indonesian products overall as privately-run shows are associated in buyers' minds with poor quality publicly funded shows.

<u>Summary of Recommendations:</u>

1. Set concrete selection criteria for firms that focus on export-readiness.
2. Consider implementing an open bidding process to identify firms .
3. Consider reducing subsidy levels to firms to allow more firms to participate and self-select.
4. Allow more lead-time for organizers and participating firms to prepare for shows.
5. Consider outsourcing the organization of tradeshows and/or providing public funds to subsidize private trade shows rather than organizing shows directly.
6. Survey participating firms to evaluate medium-term impact on profits and to gather feedback on tradeshow quality.

### 3.4 BUSINESS DEVELOPMENT SERVICES AND HUMAN RESOURCES TRAINING

Business development services (BDS) commonly refer to any non-financial services provided to firms to improve their operations or sales. MoI provides technical services and trainings to firms in all of the sectors it supports. In many cases, these are legacy programs, carried over from prior strategies and industrial policies which once supported a countrywide network of technical support units (UPT), Research and development centers (*balai besar*), as well as ad hoc training curricula. The purpose of the UPT is generally to make production available to microenterprises. Under Indonesia's decentralization, authority for the UPT has been transferred to local governments. MoI continues to provide support, usually for capital goods, but operating budgets now come from the local budget and staff report to local government rather than the Ministry. The research and development centers continue to operate directly under MoI and new design centers are being built to support the new cluster initiative.

For SENADA's six value chains, the services currently being offered by MoI include:

- **Footwear**. The primary government program for the sector is the Indonesia Footwear Service Center (IFSC) in Surabaya. The IFSC aims to provide quality, design, research and development, consulting, market information and matchmaking services. The center is not yet fully operational because anticipated assistance from an international donor failed to materialize. According to MoI, the center serves 200 firms, primarily SMEs, per year. MoI also supports a Research Center for leather, rubber and plastics in Yogyakarta and funded new machinery for a leather service center (UPT) in East Java in 2007. They are also providing training to tanneries on cleaner production methods.

- **Furniture**. In addition to support for the Jepara furniture and Cirebon rattan clusters, MoI provides trainings in Jakarta on finishing, production techniques and skill training. MoI covers all costs except for transport (many firms receive the travel funds from their local government). MoI is also cooperating with the Ministry of Forestry on a pilot project to develop sustainable wood products. The investment for the pilot will come primarily from a state-owned enterprise which will develop new technologies for hardwood alternatives such as bamboo, coconut and acacia.

- **Autoparts.** MoI supports a number of research and development centers providing technical services and trainings in stamping, heat treatment, etc. In addition, there is a proposal in the 2008 budget to open an Auto Design Center in Bandung.

- **Garment and textile**. MoI runs 13 research and development centers across the country on products including textiles, leather, and batik. The research and development center in Yogyakarta assists 1,000 firms per year and 90 percent of these are sponsored by their local government to attend trainings. In addition, there is a large network of UPT which lend machinery to cooperatives of SMEs. The management of these UPT is handled by local governments but the budget continues to come mainly from the central government. At the behest of the Indonesia Textile Association (API), MoI is also planning on opening a Training Center in Central Java next year.

- **Home Furnishings and handicrafts**. In addition to support for 15 UPT across the country, MoI hires trainers in each region to provide support to small and micro enterprises. In 2007, a new pilot was launched in which three firms from each province in eastern Indonesia were brought to Jakarta for a training-of-trainers on various technical issues. This was done at 100 percent subsidy, including travel, on the understanding that the participants would share this knowledge with other companies once they returned.

MoI continues to launch new programs focused on firm-level assistance for SMEs. For example, a recent regulation (37/M-IND/PER/6/2006) launched a new consultancy service (modeled on a Japanese program) that has government employees providing a diagnostic analysis to firms at a 100 percent subsidy rate. This includes a SWOT (Strength, Weakness, Opportunity and Threat) analysis and review of financial management and production systems. Firms that qualify will then be referred to more specialized services at a 90 percent subsidy.

The level of subsidy for specialized consultants is mandated in the regulation. The program is still not operational as the first year has been dedicated to identifying provincial government employees qualified to do the diagnostic work. MoI is now in the process of identifying government employees who can do the more specialized consulting services (those with some sort of private sector background or sectoral expertise). Once that process is complete, private BDS providers may bid on contracts where there are no public-sector employees with the necessary expertise.

Another new initiative intended to assist SMEs is the One Village One Product (regulation No. 78/2007). Based on a Japanese model, the methodology seeks to identify and promote unique cultural products manufactured by clusters of SMEs. BDS services and financing are then directed at this cluster in an attempt to enlarge the market base for the product. The program is still in the planning stage with the government deciding on implementing criteria[28]. International best practice in BDS provision emphasizes the importance of developing private sector markets for BDS, with sustainability a key concern. In this scenario, government intervention to support BDS is aimed at facilitators (for example, non-profits supporting the development of the sector) rather than directly to firms. Services to end users are provided on a near cost recovery basis and the BDS provider itself faces commercial pressures to cover operating costs[29].

The shortcomings in Indonesia's government-provided BDS services are well documented. These include supply-driven program design resulting in products that are not relevant to firms and bureaucratic management in which employee incentives are not linked to performance. The services provided under all the MoI programs are heavily subsidized, up to 100 percent for many of the programs. This severely compromises sustainability since programs become reliant on government budget transfers rather than generating their own funds that can be used to upgrade and maintain facilities. The result in Indonesia has been aging machinery and deteriorating buildings which reduce utility to clients and affects staff morale.

High subsidy levels also risk crowding out private sector providers as no independent service provider would be able to compete with the lower prices of a successful subsidized program. The situation has not much changed since the beginning of the decade when a study concluded that: "the combination of being free to the client and the enormous size of the target group (small-scale enterprises) has resulted in a pattern of 'one-shot' services to small firms, with little possibility of follow-up." (Berry et al: 378). Many external evaluations have recommended that government BDS services be either run on a commercial basis or privatized[30].

Officials justify the subsidy levels saying that services are targeted at SMEs who cannot be expected to pay for services and/or that the centers are new and not yet fully operational. The first point reflects deeply-held attitudes by many officials in Indonesia that SMEs require protection and support despite international research that has shown that SMEs are willing and able to pay for services that are of value to them[31]. The latter point implicitly recognizes that the services are of limited utility to firms, at least for the time being. Lowering subsidy levels and operating government BDS centers on a commercial basis would have a number of important benefits including:

- **Centers would have to increase their responsiveness to clients.** Since only valued services will sell, hard budget constraints means that BDS staff would need to spend considerable time designing programs that meet the needs of target clients.

- **Lower subsidy levels and/or charging fees.** Would generate resources that could be used to extend services to much larger numbers of clients. Funds could also be put toward capital improvements, which would increase utility to clients and improve staff morale.

Feedback from the private sector is highly critical regarding the quality of the services provided. A number of examples provided by interviewed firms illustrate the problems with the government BDS centers. One of the services offered to textile producers by the government-run BDS center is testing

[28] Investor Daily, "Ministry of Industry Implements Three OVOP Requirements", February 28, 2008.
[29] Asian Development Bank, 'Best Practices in Providing BDS to SME', (2002).
[30] See ADB Technical Assistance Policy Papers (various), Niemann, F, Sandee, H. (various).
[31] See Fernando, McVay, and Polatajko on international examples of SME willingness to pay for BDS services.

for thread count. However, the center has such a poor reputation that buyers will not accept their analysis. Companies instead use private firms that are more expensive but are considered reliable. Other manufacturers give the example of technical service centers where SMEs can use machinery on a fee basis. Because the centers run on government office hours the machines are only available to firms until 3pm. This renders the service of limited utility to a firm trying to meet deadlines for orders. In another example, many chambers interviewed for the study feel that trainings are of such poor quality that provincial MoI offices must offer travel money and other incentives to interest firms in attending.

It appears that MoI performs little impact evaluation on the effectiveness of its BDS programs that could assist in redressing these issues. More fundamentally, the failure to adopt recommendations by external evaluators signals that the commitment to providing highly subsidized, firm-level support is guided by social justice and equity concerns rather than questions of economic impact. This is an extension of the government's commitment to assisting SMEs; programs are viewed not seen as economic programs but as welfare programs intended to uplift disadvantaged economic groups[32].

Happily, assisting SMEs and running more effective programs by professionalizing staff, lowering subsidies and supporting private-sector run BDS providers, are not conflicting objectives. Providing public funds to subsidize start-ups of private BDS services would help develop a real, functioning market that could provide quality services to a large number of firms of all sizes. Fees on a sliding scale could result in larger firms cross-subsidizing smaller firms at levels that still ensure quality services. MoI may wish to examine the feasibility of running its existing services at gradually increasing levels of cost recovery until they could be privatized, although this might require some capital improvements upfront to bring services up to a level that clients are willing to pay for.

### 3.4.1 CASE STUDY: CLUSTER SUPPORT

Strengthening clusters is identified in the White Paper as one of the main forms of government support for industry under the current strategy.[33] Clusters can be defined as geographically proximate business units working within the same sector along with associated institutions encompassing distributors and suppliers as well as producers[34]. While clusters occur naturally among industries in every country, and have been shown to enjoy higher productivity than non-clustered firms, the ability to influence cluster development is highly controversial. Government efforts to support clusters face the same problems as industrial policy overall- government officials are not successful at "picking winners" and so selecting which industries or clusters to support is fraught with problems of distorting the economy through subsidies or directing investment to inefficient outcomes.

The role of clusters in Indonesian manufacturing is well documented, particularly for SMEs[35]. For example, BPS data from 1989 finds that 75 percent of employment in the furniture sector was in clusters with the corresponding number for textiles, garments and footwear at 49 percent (Burger et al, pg. 291). Clusters are found to be most active in sectors that are exporting with companies making joint marketing efforts, subcontracting each other, and splitting up large orders beyond the capacity of smaller firms to fill. Recommendations have been made in the past to focus efforts on improving the business environment for these clusters by strengthening contract enforcement, improving

[32] See Berry et al (2001) in which the authors state, "Official assistance to small enterprises is deeply embedded in a philosophy that government has an obligation to guide and uplift the weaker groups in society, who are working overwhelmingly in small businesses."
[33] The research team is indebted to Henry Sandee for insights on clusters in Indonesia.
[34] Asian Development Bank,"Best Practice in Developing Industry Clusters and Business Networks'.
[35] See Asian Development Bank, "Best Practice in Developing Industry Clusters and Business Networks', Burger, K., Kameo, D., Sandee, H., Sandee, H. and Rietveld, P., and Sandee, H. and van Dierman, P. for more information on clusters in Indonesia.

infrastructure, and facilitating private-sector BDS providers. The reasoning behind such an approach is that clusters are more easily targeted than individual firms and are likely to have a multiplier effect because of the dynamism that already marks their operations.

Efforts by MoI to support clusters date to the 1970s and the Program Pembinaan dan Pengembangan Industri Kecil (BIPIK). The program at that time provided BDS services through public extension officers, provided subsidized credit and joint production facilities. The current White Paper does not lay out any particular strategy for engaging in cluster work nor does it discuss what types of programs may have influenced the Ministry to adopt clusters as a focus of the midterm development plan. No technical guidelines have been developed outlining how cluster support programs are to be implemented. This has led to some confusion with different units taking different approaches.

In general Directorates have typically begun the process by identifying what clusters exist in their priority sectors. The Indonesian Bureau of Statistics gathers data on employment in clusters and this may have been used to assist the mapping[36]. Clusters deemed particularly strong or strategic are then being selected for support. To date, this has included the well known wood furniture cluster of Jepara, which according to MoI is the only cluster with full up- and down-stream linkages, as well as rattan furniture producers in Cirebon and a shoe cluster program in West Java.

As Jepara is the farthest advanced initiative by MoI to support clusters, the research team examined the program there in more depth to better understand the government's approach to cluster development[37]. Jepara is a well recognized furniture cluster producing primarily for export and is well linked to international buyers. While sales there increased through the beginning of this decade, they have declined in recent years and the cluster is considered to be under stress, partly due to inconsistent quality and partly due to wood supply issues.

The first step that MoI took in Jepara was to establish a Working Group that brought together representatives from the provincial Industry and Trade office, the local government furniture service center (UPT), and the Indonesia Furniture Association (ASMINDO). The local chapter of ASMINDO has 400 members, mostly large companies, representing just under 20 percent of the furniture companies active in Jepara. ASMINDO is closely associated with the government, regularly providing policy input, and holds a quasi-official role in running the Working Group.

Following the establishment of the Working Group, the provincial industry office (Dinas Perindustrian, Pedagangan, dan Koperasi) then conducted a number of workshops providing theoretical background on clusters (for example, their importance and how they can be developed). These workshops emphasized the role of government in facilitating better coordination along the supply chain as private sector participants agree that this would be a useful role for government to play. Since these workshops, the Working Group has met only sporadically and rather than examining supply chain issues, the private sector members of the group have used the forum to promote possible activities to be funded by the government.

This was the genesis for the Jepara Furniture Design Center (JFDC). Industry members of the Working Group introduced the idea of a center that would give companies information on international trends and provide advice on updating designs. The government agreed to establish the center and is providing office space, staff, and equipment (including four computers with design

[36] A cluster is defined statistically in Indonesia as at least 20 firms in a village engaged in the same activity.
[37] Site visits and interviews were made to the government institutions supporting the cluster (Jepara Furniture Design Center which operates directly under MoI and the Jepara UPT which operates under the authority of the local government) as well as representatives from the Cluster Working Group, ASMINDO the national furniture producer association, and private furniture companies.

software, printers, and photography equipment). Although the project was initiated two years ago, JFDC is yet to provide services to the public. The only activity currently being run out of the center is an annual design competition being co-sponsored by ASMINDO and MoI. The next planned activity is a mapping of furniture products by the local government.

The center is led by a volunteer Steering Committee consisting of seven people with furniture industry backgrounds. The Steering Committee does not oversee the management of the center but rather provides design ideas that will be developed at the center and then made available to furniture companies. For the moment, the intended clients are mostly members of ASMINDO. MoI has not said whether there will be a charge for services.

In addition to the Working Group and the JFDC, the cluster support includes the local government UPT and ASMINDO. A visit to the UPT found that machinery made available to clients dates from the 1970s. Many of the machines are not in service because they are so old that they cannot be repaired. MoI continues to give capital goods (nine new machines were provided in 2006) but the overall quality of the facility and its machinery remain poor. The building is not maintained, the showroom is empty, and staff spend as much time away from the facility as possible. Nonetheless, microenterprises unable to purchase their own machinery do continue to use the facility indicating that there is a need for access to capital equipment.

While not necessarily representative of what other efforts might look like, the Jepara case demonstrates that in approaching clusters, MoI may end up merely expanding the existing model of BDS rather than implementing an innovative new approach to industry development. The private sector perspective is that the cluster program has been largely unsuccessful. One key problem identified by cluster participants is a lack of coordination across local and national government. The cluster approach is a MoI initiative. It is unclear whether provincial and local governments have sufficient 'ownership' of the program, or feel that they have the tools to implement such an approach in a meaningful way. There is also a sense that incentives have not been given to provincial officials to implement the program well. Funds and training are limited and staff promotions are not linked to providing high quality services. The other weakness pointed to by furniture manufacturers is that government staff lack industry knowledge and thus the programs and services are often divorced from the actual problems experienced by companies. This feedback reinforces the need for the private sector to take the initiative in developing such industry support programs.

In Jepara, such efforts are represented by the Center for Furniture Design and Development Indonesia (CEFED)[38]. CEFED is a nonprofit organization founded in 2003 in Semarang, Central Java, by five furniture companies in cooperation with Diponegoro University,. CEFED now produces a monthly sectoral bulletin, WoodBiz, with industry-specific information and marketing opportunities. The organization provides monthly training on topics such as wood drying, pricing strategy, production planning and inventory control and design. Trainings are on a fee basis and are often sold out.

CEFED also conducts seminars with foreign speakers to educate producers on international trends and is developing a certification program. This is an excellent example of private-sector led BDS provision and confirms that such an approach is possible in Indonesia in areas where government-provided BDS has failed. This could serve as an excellent model for future private sector led efforts that MoI could encourage. MoI may wish to showcase such examples and consider supporting such privately run centers as one way of supporting cluster development and transforming its BDS activities.

[38] For more information on CEFED see their website at http://www.cefed.info/index.php.

Central and regional governments continue to develop new cluster initiatives around the country. Given the experience in Jepara, as well as earlier problematic programs, it is clear that a new model is needed if such efforts are to be worthwhile. The focus should be brought back to removing barriers along the value chain rather than trying to upgrade individual firms. Most importantly, the lead initiative for the development of clusters should rest with the private sector. The government may wish to revitalize the Working Groups, serving as a neutral facilitator of discussions related to improved coordination and information sharing along the supply chain. Areas to examine would include strengthening enforcement of contractual arrangements, improving the supply of infrastructure, removing regulatory barriers to the sector, etc. These should be identified through consultation with as broad a range of private sector actors as possible rather than relying on one or two chambers as partners.

<u>Summary of Recommendations</u>:

1. Re-evaluate subsidy levels and consider replacing full subsidies with sliding scale fees that allow centers to run on a commercial basis while still serving SMEs.
2. Consider supporting private-sector run BDS providers rather than extending services directly.
3. Implement regular monitoring and evaluation (including customer satisfaction surveys) of all BDS programs and tie budget allocations to customer satisfaction and cost recovery.
4. Reorient cluster initiatives towards coordination among firms along the supply chain rather than BDS services.
5. Increase local government capacity on supply chain analysis.

## 3.5 CREDIT LINES

The cost and availability of credit is a common complaint of business owners in Indonesia and consequently an area of concern to MoI. Indonesia suffered particularly badly during the 1998 financial crisis in which large firms defaulted at much higher rates than the SME sector (which were protected by their limited access to the financial sector and foreign-denominated debt). Coming out of the crisis, Indonesia has made significant strides in establishing macroeconomic stability but still has work to do in building the financial infrastructure which would allow lending institutions (bank and non-bank) to better manage risk. The absence of credit bureaus, a weak legal system which makes it difficult to seize assets from defaulters, human resource constraints among lending officers, and regulatory barriers to innovative financing instruments raise the price of capital and inhibit lending. These structural issues are, of course, outside the jurisdiction of MoI.

Improved fiscal discipline has limited technical departments' ability to offer subsidized credit schemes on the scale of the past. Nonetheless, one of the signature programs of MoI in 2007 (and carrying forward into 2008) was a program providing Rp 225 billion (approximately US$ 22 million) for subsidies to textile and garment factories upgrading production machinery. As this program could serve as a model for future MoI programs (or indeed be copied by other Ministries) it is worth examining in detail[39].

### 3.5.1 CASE STUDY: TEXTILE MACHINERY UPGRADING SUBSIDY

Last year, the Director General for Textiles enacted regulation No.81/ILMTA/PER/3/2007 providing subsidies for the purchase of modern textile machinery as the cornerstone of MoI's efforts to increase the competitiveness of Indonesia's textile sector. The regulation cites industry association

[39] MoI is also participating in a SME credit guarantee scheme that does not directly impact the value chains being focused on here. See Kontan, "A look at the opportunities and capital offers from the government", December 31, 2007, for more details.

data that most companies are working with machines that average 20 years in age, 3-4 generations behind the latest technology. The regulation justifies the program by citing the importance of the industry for exports, employment, and foreign-exchange earnings and the need to encourage firms to upgrade their machinery if they are to retain market share.

The program was adopted after sustained advocacy by the Indonesian Textile Association (API) and is intended to address a perceived credit crunch caused by the unwillingness of lenders to finance textile companies because of their "sunset industry" status. It is unclear to what extent MoI researched whether restricted access to finance is in fact the primary reason firms are delaying capital good upgrading although clearly for some firms, particularly medium ones or textile exporters losing market share, this can reasonably be assumed to be a factor. The program offers two mechanisms to subsidize machinery upgrades:

1. Scheme I provides a rebate of 11 percent of the purchase price of new production machinery. Firms are responsible for arranging their own financing[40]. This is the primary mechanism with a budget of Rp. 175 billion, or 78 percent of the total funds.
2. Scheme II offers a soft loan at 8 percent annual interest over 5 years[41]. The loan is for 75 percent of the purchase price with the business owner contributing a 25 percent down payment.

The maximum amount firms can receive for either scheme is 5 billion rupiah (approximately US$ 500,000). Given that this amount constitutes 11 percent of the machinery price for Scheme I but 75 percent of the machinery price for Scheme II it is clear that the mechanisms are intended to meet the needs of different types of firms purchasing different types of equipment. The regulation makes provisions for three implementing organizations:

1. An organization to administer Scheme I on behalf of MoI, responsible for verifying the eligibility of firms and the purchase of the machinery.
2. An organization to verify that the machinery meets the requirements of the program and is being purchased at market rates.
3. A non-bank financial institution to administer the soft loan.

MoI published a request for offers in local papers on two occasions but only three firms, all state-owned, bid. PT Sucofindo was awarded the contract to administer Scheme I, PT Surveyor Indonesia to provide independent verification of machinery and PT Madani Venture Capital to implement Scheme II. The limited competition for implementing partners presumably raised the cost of the program. PT Madani is charging MoI 10 percent for the funds it has contributed to the scheme (the finance partner was required to contribute 10 percent of their own funds to reduce moral hazard).

The process of applying for the schemes is laid out in the technical guidelines of the regulation and includes precautions to ensure against fraud by firms. The process for the rebate involves supplying general company information along with proof of purchase for the machinery. The implementing organization verifies this information, including three site visits prior to, during and after the installation of the machinery, along with verification that there was no price inflation in the purchase. Companies that received the rebate felt the process was complicated and time-consuming. One firm interviewed had to dedicate two employees full-time to manage the process including frequent travel to Jakarta. As will be shown, these were very large firms who presumably can absorb this cost relatively easily.

[40] This is strange given the underlying assumption that firms were facing tight liquidity. If access to finance was the presumed market failure, requiring firms to arrange their own financing hardly addresses the problem.

[41] At the time of writing, commercial loans are available at 12-14 percent although interest rates were higher when the regulation was passed. Equivalent annualized rates at leasing companies, a more common form of credit for this type of purchase, run at around 14-18 percent.

The application for Scheme II is roughly similar to applying for a commercial loan. The primary difference is that firms are required to submit a feasibility study. For most of the medium or smaller firms interested in applying for the loan, this would require hiring an external consultant. There are no guidelines for what the feasibility study should cover, making assessment difficult for the implementing agency. The table below compares the requirements of Scheme II to those at a leasing company or commercial bank[42].

**Summary Comparison of Application Process- Scheme II**

| | SCHEME II | LEASING FIRM | BANK |
|---|---|---|---|
| **Annualized Interest Rate** | 8 percent | 14 - 18 percent | 12 - 14 percent |
| **Terms** | 5 yrs | 1 yr | 5 yrs |
| **Technical Aspect** | Same | Same | Same |
| **Legal Aspect** | Same | Same | Same |
| **Financial Aspect** | • Financials<br>• Letter committing to self-financing.<br>• Letter showing company is not on financial black list | • Financials | • Audited financials |
| **Other** | • Feasibility study | • Credit history<br>• list of suppliers and customers<br>• list of machinery already owned | • Credit history<br>• list of suppliers and customers<br>• list of machinery already owned |
| **Time** | 50 days | 7 days | 20 days |

The major difference, and disadvantage, of applying for the subsidized loan as opposed to a commercial loan is that it takes much longer to process: 50 days instead of one week in the case of a leasing company or 20 days at a commercial bank. The time required to process loans under Scheme II are a result of the approval process which is significantly more complicated than for a commercial loan. Whereas in a bank the decision to lend is largely made by the lending officer with approval from a manager, the approval process for Scheme II involves a number of agencies.

PT Madani accepts the applications, verifies that they are complete, and submits a pre-nomination list of complete applications to MoI. PT Surveyor then verifies the price of the machinery, a process which includes a site visit to the firm. Firms meeting the technical requirements regarding the machinery they wish to purchase are then referred back to PT Madani which assesses their financial ability to undertake the loan. Finally, PT Madani sends a list of approved firms with a fund withdrawal request to MoI.

[42] See Appendix 3 for a detailed side-by-side comparison of the requirements for the three institutions.

### 3.5.2 IMPLEMENTATION TO DATE

Both schemes were announced and socialized through provincial level workshops held in May/June 2007. This roadshow was attended by approximately 500 firms. Of the funds allocated for Scheme 1, Rp. 128 billion (or 73 percent) was expended in rebates made to 78 firms. Of firms attending the socialization, 135 firms asked for more information on Scheme I and 89 asked for application. Eighty-three (83) of those eventually submitted an application and 78 firms were approved for the rebate. The fact that almost all firms who applied for the rebate were approved indicates that firms self-selected out if they were unable to meet the requirements of arranging financing and ensuring delivery within the eligible six month period.

For Scheme II, there were 100 applicants of whom only 33 were deemed to have submitted complete applications. This indicates that the majority of applicants would have faced difficulty obtaining commercial financing since the application requirements are roughly the same. PT Surveyor then verified that the machinery they wished to purchase met the government's specifications. Twenty-two (22) firms met that threshold and of those 18 were able to qualify in financial terms (i.e. had cash flow high enough to support loan repayment). Those 18 were given the loan. The difficulty in qualifying for the loan meant that absorption of these funds was relatively weak at 25 billion out of 80 billion allocated (only 31 percent). The average loan was for Rp 1.5 billion ($150,000) indicating a purchasing price of Rp. 2 billion (US$ 200,000). The soft loan, because of its size, is thus more attractive to medium than large firms but the criteria and approval process mean that firms that are not bankable in the commercial banking system will also not qualify for Scheme II.

- **Effectiveness — Scheme I.** The intention of the subsidy is to provide an incentive to firms to upgrade equipment on the assumption that this will allow Indonesia to maintain its competitive position in the sector. For the subsidy to be successful, it should therefore influence firms' investment decisions to purchase capital goods. If the subsidy ends up being granted to a large number of firms who would have purchased equipment even without the subsidy then the program is thought to be redundant and the government is wasting scarce public resources. Minimizing redundancy is hence a crucial element of good policy design and implementation. This requires some analysis to estimate the redundancy rate of the program and then on the basis of this analysis, subsequent actions to improve targeting (i.e. to reduce redundancy). There are two issues that raise concerns that the redundancy rate for Scheme I may be overly high.

  The *first* relates to the size of the companies receiving the rebate. The average size of the rebate given was US$ 200,000 (Rp 2 milyar). At 11 percent of the purchase price, this indicates machinery purchases worth on average approximately US $2 million. Sources of financing for the machinery came from commercial banks (50.34 percent), self-financing (48.93 percent), machinery suppliers (.14 percent), and non-bank financial institutions (.6 percent). This means that roughly half of the firms were able to finance a US $2 million purchase out of savings, profits, or equity deals. One assumes that only the largest firms would be able to do this, which is confirmed by employment data collected from firms receiving the rebates: the average size is 1,725 employees.

  While MoI is not collecting sales data from the firms, it is possible to extrapolate that average sales for a firm this size would be roughly Rp. 250 billion (US $26 million) annually. This means that the rebate is going to some of the largest firms in the sector. This raises the question as to whether firms of this size are likely to be influenced by a subsidy that represents a very small percentage (approximately 1 percent) of their annual turnover. It is likely that in most of these cases, rather than influencing the decision to upgrade machinery, the rebate may have served as a "bonus" rewarding their decision to make a capital investment.

The *second* indication of a possible high redundancy rate for Scheme I is that firms were able to arrange financing, negotiate specifications on the machinery with suppliers, and arrange for delivery in the six month window provided by the program. Given the time required just to take delivery on machines, it seems surprising that firms that were not already considering purchasing would have been able to take advantage of the rebate. API, the industry chamber which lobbied for the subsidy, claims that firms were able to arrange this so quickly because the lobbying process took years and the private sector was on "standby" for the actual passage of the regulation. This is possible, and it is also possible that more firms will make plans to purchase given widespread expectations that the program will be carried forward into 2008.

The anecdotal evidence is mixed. The research team interviewed a range of textile and garment firms to solicit their feedback on the scheme. Responses included a large firm (2,000 employees) which had not applied because it was able to finance machinery themselves and did not think that larger firms should receive the subsidy. Another large firm (3,000 employees) which did receive the rebate had already made the investment decision prior to the policy being announced and in fact that machinery was already installed in the factory making compliance very easy. They indicated that they were interested in purchasing additional machines in 2008 if the rebate continued. A medium firm interviewed had already upgraded 75 percent of their machinery in 2005 and were thus unable to take advantage of the rebate this year. However, they indicated that they might buy additional capital goods in 2008 to take advantage of the rebate.

Rewarding firms that are doing well is not necessarily a poor outcome since the subsidy is allowing successful firms to free up capital for additional investment and it is possible that the rebate is convincing firms to upgrade. However, without a fuller study to measure the redundancy rate, it is impossible to know whether the rebate will influence firms to upgrade machinery or not. It is recommended that MoI undertake such a study, interviewing firms who received the rebate this year to determine how the subsidy influenced their investment decision. Such research is important for the government as it decides in future years whether to continue allocating scarce public funds to this kind of support.

A more fundamental question relating to effectiveness is whether the underlying assumptions behind the subsidy are correct. Recent reports suggest that both credit to the sector and imports of textile machinery have picked up recently[43]. Many firms interviewed indicated that they had waited to upgrade not because of capital constraints but because the enhanced technology was not necessary to produce their orders. More importantly, all firms interviewed, whether or not they had received the subsidy, felt that the program was unlikely to increase exports or competitiveness overall. They say this is because outdated technology is not at the core of the industry's problems and instead cite labor regulations, electricity costs and irregularities at customs as the real issues threatening the textile industry's competitiveness[44].

- **Effectiveness — Scheme II.** Questions of effectiveness for Scheme II are quite different from Scheme I. There may be a legitimate market failure- limited access to finance by medium firms- although even this is questionable given recent data showing that lending in the SME sector increased significantly in 2007[45]. However, the Scheme does nothing to address this barrier because it has the same requirements as a commercial loan. There are not many attractive options for the government in this case. Past programs to relax requirements or provide credit guarantees have failed because of moral hazard problems. MoI is aware of these issues and specifically designed the program to prevent such problems.

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43 See James and *Warta Kota* "Banks Start to Eye TPT Industry", December 31, 2007.
44 These concerns are echoed in external analyses as well. See James, W. (2008).
45 Kontan "Credit surges as interest slips", December 31, 2007

Given the limited effectiveness of Scheme II, MoI may wish to consider retiring this instrument and only implementing the Scheme I rebate program. The transaction costs would be higher for the smaller firms, but if the subsidy is justified for large firms, presumably a larger subsidy to smaller firms is equally justified. The rebate has the additional advantage of being less distortionary to the financial sector than a subsidized loan because it doesn't directly compete with commercial banks.

Feedback from firms regarding Scheme II included criticism that the application process was too bureaucratic. Some firms said they were not interested in the subsidy because they prefer to rent machinery rather than purchase as this gives them maximum flexibility in responding to orders. Other small firms were unaware of the scheme indicating that socialization relied heavily on API's members who are predominately large firms.

### 3.5.3 WTO ISSUES

Another issue that must be addressed should the government decide to continue the subsidy is WTO compliance. The WTO, which Indonesia joined in 1995, prohibits its members from providing direct subsidies to exporters. These fall under the category "prohibited subsidy". The agreement also allows other Members to take action against subsidies that cause harm to them, under the category "actionable subsidy". Prohibited subsidies can be brought before WTO Dispute Settlement body, and WTO Members can take trade retaliation if the subsidy is not removed. Actionable subsidies can be taken to the WTO also, or can be addressed by Members in domestic countervailing duty (CVD) investigations which can result in duties being imposed on the subsidized exports, if they are shown to cause injury.

The textile subsidy regulation justifies the scheme based on the need to maintain foreign exchange earnings and take advantage of global markets and refers explicitly to increased export revenue as an objective/output. Such language provides a strong basis for a WTO finding of the scheme as a prohibited subsidy. This leaves open the possibility that another WTO member could take countervailing measures or bring the issue to the WTO Dispute Settlement body. Either of these actions would of course have a negative impact on the Indonesian textile sector, affecting all firms for the sake of subsidizing a few. Indonesia is at particularly high risk because its main export market is the US which has been active in pursuing real and alleged injury caused by subsidy programs in Indonesia.

Simple amendments to the language of the decree deleting these references would reduce (but not eliminate) risk of WTO action or countervailing duty. For example, as currently written, the purpose and objective of the regulation (section C) "to assist TPT Industry in performing machinery/equipment renovation, to improve technology, competitiveness efficiency and productivity of national TPT industry" is not objectionable. However, under targets (section D) the bullets for "increase export amounting to RP 1.42 billion (US $156 million)/year" and "improve TPT export to US $11.8 billion in 2009" move the subsidy into the prohibited area. Dropping these export targets and focusing instead on general employment, investment, and production figures is one primary recommendation.

Another way that MoI could limit exposure to WTO action against the program would be to limit firms to a subsidy equal to or less than 2 percent of annual turnover. This would be an actionable, rather than prohibited, subsidy under the de minimize rule in Article 27.10 of the Agreement on Subsidies and Countervailing Measures. Given the size of the firms receiving Scheme I, it is possible that many of the firms are already falling into this category. The fact that the Ministry was unaware of the WTO implications when they drafted the regulation highlights the need to increase in-house capacity. In the division of MoIT into two separate departments, those with WTO and trade law knowledge were all assigned to MoT. Improved coordination between the Ministries could have perhaps averted this situation. Training on the implications of Indonesia's trade agreements would be useful to staff generally, and particularly the staff of the MoI legal unit.

### 3.5.4 Monitoring and Evaluation

Another area that needs to be addressed is the monitoring and evaluation of the program. The regulation provides for controls against fraud including physical inspection that machinery is installed and remains on site and independently verifying that market rates were paid. In terms of impact analysis, the regulation calls for evaluation of "the improved technology's impact on productivity" but the assessment agency, PT Surveyor, was unable to complete this evaluation because their contract expired in December, too soon after the installment of the machinery to determine impact. Future contracts will be required for an assessment. A more serious problem is that baseline data was gathered on employment and production volume *but not sales* for firms receiving Scheme I and production volume and sales *but not employment* for Scheme II. This makes it impossible for MoI to fully assess the impact of the program on the variables it explicitly seeks to improve.

When asked for evaluations of the program to date, MoI furnished a report prepared by PT Sucofindo. The report claims to have catalyzed 1.55 trillion rupiah in investment– presumably the total amount spent on machinery by firms participating in the program. Without estimating the redundancy rate it is of course impossible to say how much of this investment can be attributed to the program. The report also claims that the program contributed to new employment of 4,000 people, although it is unclear how this figure was obtained since. Employment prior to the investment is known for firms in Scheme I but not Scheme II.

Because the scheme closed in November 2007 and the report was written in January 2008, data on employment following the investment is not yet meaningful. The evaluation also claims that production capacity was increased on average 10-15 percent and that energy efficiency improved on average 6-18 percent. These figures presumably come from the technical evaluation of the machinery. However, claimed improvements to productivity (based on total production divided by employees) are also questionable given the problems with the employment data. These problems with the report reinforce the need for MoI to strengthen its monitoring and evaluation process in order to have valid, meaningful feedback on program impact.

Addressing the recommendations made here would strengthen the program but do not reach to the heart of the matter of whether the policy is addressing a genuine market failure. Many large firms are already investing in capital upgrades and have access to financial markets. Medium firms may have structural access to credit problems but this is not addressed by Scheme II which has the same requirements and conditionality as most commercial loans.

### 3.5.5 A Future Round of the Program

During the finalization of this report, MoI issued a new regulation, *Director General Regulation No. 07/ILMTA/PER/3/2008,* to continue the TPT Machinery Upgrading Assistance Program for another year. The source of this regulation is the Peraturan Menteri Perindustrian (Industry Minister's Regulation) no. 15/M-IND/PER/3/2008. Although a draft of the regulation is not yet publicly available, press releases have given some information on the design of the new round of subsidies. Because of difficulties in expending Scheme II funds in 2007, MoI indicates that it will reallocate the next round, dedicating Rp 350 billion to the rebate and only Rp 50 billion to the soft loan. Socialization of the new round will take the form of sending letters to firms[46]. It is unclear how these firms will be identified and whether there will be an application process open to all interested firms.

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[46] See Bisnis Indonesia "ILMTA Sector Projected to Grow 4.45 percent", February 13, 2008 and Business News, "TPT Restructuring Funds not yet Absorbed Optimally", December 28, 2007.

As called for in the recommendations made here, MoI has removed language directly related to export promotion from the objectives or outputs of the program and has instead focused objectives towards production and employment figures. This reduces the risk of WTO action on the basis of the program being a prohibited export subsidy and is commendable. However, the new regulation now includes a provision encouraging import substitution, another form of prohibited subsidy under the Agreement on Subsidies and Countervailing Measures (ASCM).

Manufacturers will receive a 15 percent subsidy for purchasing domestically made capital goods but only 10 percent for purchasing imported machinery[47]. As discussed already, any countervailing duty related to a prohibited subsidy could affect small and medium scale industry even if they did not receive any subsidy. It is strongly recommended that MoI consult with a trade lawyer to discuss the ramifications of this removal and reconsider the import substitution provision to avert any potential harm to the industry.

It is also critical that MoI, in implementing this second round of subsidies, investigate and exploit any possible avenue for reducing the risk of future remedial trade action taken against Indonesia, as made available by the above-mentioned *de minimis* rule in Article 27.10 of the Agreement on Subsidies and Countervailing Measures.

Summary of Recommendations:

1. Undertake a study analyzing the potential redundancy rate of both Scheme I and II and readjust targeting as necessary.
2. Undertake analysis of machinery import data as well as recent financial sector data to determine that support to the sector for capital goods upgrading remains appropriate.
3. Revise language of the regulation, and where necessary, provisions of the regulation, to reduce exposure to possible WTO action.
4. Explore possible options for protection as provided by the de minimis rule in Article 27.10 of the Agreement on Subsidies and Countervailing Measures.
5. Strengthen monitoring and evaluation provisions to ensure that all targeted outputs are being tracked (e.g. employment, production and profitability of firms).

### 3.6 SUPPORTING INFRASTRUCTURE

A potentially important area of intervention by MoI, and certainly by the Government of Indonesia, is addressing Indonesia's aging and insufficient infrastructure. Recent surveys among investors and business owners have identified poor infrastructure- particularly transportation links facilitating access to markets and the reliable availability of electricity- as one of the primary business environment challenges facing the country[48]. The scale of the problem requires a government-wide effort which is being advanced under separate initiatives; MoI sponsors ad hoc projects to address industry-specific constraints.

One example is a new dedicated port facility for export and import of autos and autoparts that opened in late 2007 at Indonesia's main container port Tanjung Priok, in Jakarta. The facility will have a capacity of 350,000 cars per year and was largely funded by the state-owned enterprise which operates the port. As part of the Ministry of Trade's broader efforts to reform the Customs Agency, special efforts have been made to improve border clearance at the auto port.

[47] Bisnis Indonesia, "Purchasers of Local Textile Machinery Eligible for 15 percent Subsidy", March 28, 2008.
[48] See IFC, *Doing Business 2008,* World Economic Forum, *Global Competitiveness Report 2007-2008,* and Zavadjil.

Industry representatives welcome the new development but feel that it does not go far enough[49]. They would like to see increased capacity and express concern that plans to build linking infrastructure have not been realized, which will limit the cost savings provided by the new facility, have not been realized. Road and rail links to the port are plagued by floods and congestion and will continue to make transport costs uncompetitive. Industry chambers are also still waiting to learn the new handling charges at the port before deciding whether the dedicated port will effectively reduce costs.

MoI is also supporting the creation of a 500 hectare industrial estate outside of Bandung meant to house textile and other industries currently located in flood zones. This site is still in the planning stages and has been complicated by difficulty in obtaining the required land. MoI has also prepared a hazardous waste site in Bandung to dispose of waste from textile/garment manufacturers. This is to bring Indonesia into compliance with its obligations under the Basel Convention. According to the industry chamber, API, the site is primarily meant to dispose of waste from coal-powered generators which companies are increasingly using as the price of electricity rises. API would prefer that the government instead address the larger issues regarding electricity supply.

Another industrial site is underway outside of Yogyakarta where MoI worked with the provincial government to create a tannery industrial estate that is meant to provide modern waste disposal, reducing the environmental impact of the industry on local communities. Anecdotal evidence suggests the site is not yet successful: only three firms have agreed to relocate to the site because of the difficulty of sourcing raw materials in the vicinity.

Improved communication with the private sector would help these efforts to be more successful. Infrastructure is an area where government investment could have real impact on private sector development, and the Ministry is an important advocate for industries. One potential role for MoI would be facilitating dialogue between industry and other Departments that are more directly involved in infrastructure planning. This could include hosting regular multi-department roundtables or working groups that bring companies and planning officials together to set priorities.

Summary of Recommendations:

1. Host multi-department, public-private working groups to ensure that proposed projects adequately reflect the needs of industry.

## 3.7 INFORMATION DISSEMINATION

Facilitating the flow of information is a potentially valuable role for government, working together with private sector associations. First and foremost, government should provide information on regulations and laws applying to a sector and how companies can most easily comply with these requirements. One of the reasons that transaction costs in Indonesia are relatively high is that regulations are often obscure and their application is frequently arbitrary. Helping both foreign investors and domestic companies to better understand and comply with the regulatory environment and making sure that regulations are as streamlined as possible is an area where MoI should consider engaging in the future.

Another area where governments often provide support is in circulating information on market trends to domestic producers and, conversely, promoting domestic producers in overseas markets. MoI engages in this type of activity to a very limited degree. For example, the Ministry produces a directory of footwear and tannery companies and another of handicraft producers. However,

[49] Jakarta Post, "Car Exporters Demand Bigger Terminal", February 22, 2008.

feedback from industry groups is that the MoI directories do not cover all firms, and could be improved by adding information on products and production capacity.

MoI could work jointly with industry associations to design an information program that would be led by the private sector but assisted by MoI resources. Other governments, for example, assist in collecting information on regional trade opportunities or trends in strategic products and provide these to industry associations for dissemination to their members. The government could also make much stronger efforts at promoting Indonesian brands overseas by working with marketing consultants and purchasing media in industry journals.

Summary of Recommendations:

1. Support private-sector led efforts to promote Indonesian brands, both domestically and overseas
2. Work with Indonesian embassies in select markets to gather and disseminate end market information to Indonesian firms and chambers of commerce

### 3.8 ACCREDITATION AND STANDARDIZATION

The development of industry standards and certification is helpful in promoting Indonesian products as desirable brands. In most countries, such work is carried out by non-governmental industry associations, such as the *Better Business Bureau* or various quality seals. Such private sector-led institutions are under-developed in Indonesia although some industries (e.g. autoparts) do have voluntary industry standards.

MoI supports some activities to promote interest in certification among Indonesian companies, although this is still a small part of their portfolio. Examples include sponsorship for a limited number of demonstration firms to receive ISO certification. In 2007, MoI provided free consultants to eight footwear firms to identify what issues the company would need to address to receive ISO approval. Firms were then required to pay the cost of any required upgrades themselves. MoI offered a 15 percent subsidy for the cost of certification to the smaller firms; the large firms had to pay these expenses (amounting to 15-20 million rupiah or approximately US $2,000) themselves. A similar program was supported for textile firms- seven firms were provided a consultant to receive WRAP or SA 8000 certification. Other departments, such as handicrafts, socialize the importance of trademarks and ISO certification without subsidizing or facilitating the process. For batik, MoI is sponsoring a trademark program that would allow manufacturers the ability to copyright their batik designs.

One of the more innovative pilots by MoI is a corporate social responsibility (CSR) compliance program targeting garment manufacturers. They are compiling information on labor, environmental and other CSR requirements by large overseas buyers and will then socialize these to firms beginning 2008. This is particularly useful because the largest sectoral association in this field, API, does not provide this information to its members.

Another CSR and export related program, being co-sponsored with the Ministry of Forestry, is intended to reduce the use of illegal timber in furniture manufacture. The problem of illegal lumber is endemic in Indonesia and a very serious challenge to the sustainability of the furniture industry which has relied on cheaply available raw materials to enhance its competitiveness. With increased international attention to the problem, buyers are asking for certification that the wood used in furniture production is legal and in some cases, as for the European market, sustainably harvested. Additionally, domestic shipments of wood are commonly stopped by police, military, and others increasing the costs of raw materials through rent-seeking and affecting timeliness of supply. The proposal by the Ministry of Forestry and MoI to assist manufacturers to assure a steady supply of legal wood is to create depots run by the Ministry of Forestry where all the wood would be certified as legal. Manufacturers would then purchase at these depots. Transport would presumably be handled directly by the government to circumvent the transit problems. The Ministry is currently performing feasibility studies in North Sulawesi, Central Kalimantan, East and Central Java.

Given the nature of illegal logging in Indonesia, the more structural problems are unlikely to be solved in the near-term. It is therefore encouraging that the government is trying to address the problem. Unfortunately, the proposed program, by expanding government involvement in the supply chain, may not improve the situation. The poor track record for government-run facilities in Indonesia raises concerns that a government licensed and run depot is likely to have management problems as well as leaving wood supply open to political manipulation and rent-seeking if tight controls are not put in place.

Summary of Recommendations:

1. Support private-sector led efforts to develop and voluntarily enforce industry standards that will protect consumers and increase competitiveness

# 4. CONCLUSIONS AND RECOMMENDATIONS

As has been shown, MoI is actively implementing a wide range of programs to encourage growth in its priority industrial sectors. Some of the areas in which it could be most usefully engaging the private sector, such as information dissemination or accreditation, remain underdeveloped. Other policy tools that distort private sector development, such as subsidies and fiscal incentives, require closer examination to assess whether the trade-offs are generating sufficient gains to justify the use of public resources. While proving causality between policies and eventual gains in employment, productivity, or output is often difficult, the fact that many of the policy tools being chosen by MoI have had limited impact in the past, both in Indonesia and in other countries, raises concerns about their effectiveness.

The record of governments around the world trying to influence industrial development is mixed at best. Given the limited scope for government to effectively promote industrial development, the objectives of the Ministry should be modest. MoI should focus on its role representing the voice of industry within the government, avoiding pressures to advance narrow sectoral interests and instead promoting an overall vision of how Indonesia can achieve higher levels of competitiveness. The role of government in facilitating, as opposed to directing, economic growth tends to be poorly understood by many in government and the private sector. A newly articulated vision for MoI's activities could usefully emphasize this facilitating role to both internal and external audiences.

Discussed below are a number of problems, typically common to all industry support measures being pursued at MoI.

## 4.1 PROGRAM DESIGN CAPACITY

This overview of MoI's programs highlights the Ministry's challenges in designing and implementing effective programs. This is partially the result of human resource constraints. Few staff members have the economic or business background that would allow them to consider what policy tools would be most effective in specific cases. Nor do officials have budgets to engage consultants who could provide them with such expertise.

The result is the implementation of programs that are recycled or carried forward regardless of their past effectiveness, as in the tradeshow support or BDS programs. There is a widely held sense by both officials and business owners that MoI should be working in these areas even though current efforts are acknowledged to be sub-optimal. Most government officials will point to resource constraints as the reason why programs aren't working, focusing on lack of coverage for services. Business owners will point to the poor quality of services and the lack of professional staffing but still insist that it is important that the government engage in the activities. What is missing is a willingness to try new models that could address both of these concerns; for example, running BDS programs on a commercial basis would allow more firms to take part and would generate the income needed to hire private sector trainers and management. Making such a shift would require changing incentives for officials to reward risk-taking and value qualitative over quantitative targets.

New initiatives appear to be heavily influenced by counterpart industry associations. This is positive in the sense that MoI is trying to be responsive to the private sector. However there is a distinction between being responsive to, and being 'captured' by private sector interests. The role of the government is to engage stakeholders and then make measured decisions about what solutions would be best for the economy as a whole. Industry associations in Indonesia, as elsewhere, seek protection and support from the government. That does not mean they should receive it. Because industry associations are lobbying for narrow sectoral interests, their policy positions are likely to benefit their constituents while often being injurious to others. For example, while the rattan cluster in Cirebon may complain of a shortage of raw materials, implementing a ban on export of rattan is likely to reduce rather than increase the supply in the long run as prices are depressed with the loss of the export market. Recognizing potential unintended consequences requires an analytical background that the industry chambers often do not have.

Another area in which MoI needs to strengthen its capacity is legal expertise. One of the reasons that the wording for the TPT subsidy was not drafted more carefully to limit exposure to WTO action is that the Ministry no longer has trade lawyers on staff; they were all assigned to MoT during the reorganization in 2005. While better coordination and consultation between the Ministries could have caught this issue, clearly some in-house capacity would be useful if the Ministries are to remain separate in the future. Poor legal advice may also have contributed to the passage of PP1/2007 on fiscal incentives despite an overall Tax Law that does not recognize such incentives.

## 4.2 MONITORING AND EVALUATION

Related to challenges in program design is a need to strengthen the monitoring and evaluation framework of MoI's programs. For monitoring and evaluation to be effective, data collection must be integrated from the beginning of the program. This requires clarity on expected outputs and outcomes, something MoI is increasingly attempting in the design of its activities. However, implementation remains problematic. Collecting data on the impact of activities is often outsourced to sub-contractors or partner organizations as an after-thought to the more central activities they are undertaking.

So for example, MoI included evaluation of the TPT subsidy in the scope of work of PT Surveyor but implementation delays meant the contract expired too soon after the end of the program for the evaluation to take place. Baseline data was not collected on all of the variables the program is expected to influence, making it impossible to measure impact. External technical assistance in designing and implementing Monitoring and evaluation would be desirable so that a more systematic approach is taken to evaluating the impact of MoI's programs.

Equally important is increased political commitment to incorporating such evaluations into future program design. As the study has shown, MoI continues to replicate problematic projects despite previous external evaluations showing limited impact or unintended negative consequences. Improvements require a change of incentives so that bureaucrats are not judged solely by their ability to expend their allocated budgets but on whether or not they have used their budget efficiently on programs that have significant and demonstrable impact. Leadership on Monitoring and evaluation issues would have a positive reinforcing effect on improving program design.

## 4.3 SETTING SUBSIDY LEVELS

One of the consistent challenges across activities is how to ensure that programs are accessible to firms who would benefit while maintaining sustainable programs that do not unnecessarily compete with private markets. Research suggests that these two aims are not as contradictory as might seem as most firms, even small ones, are willing to pay for services and activities that positively impact their bottom line.

Requiring departments providing services such as BDS or tradeshows to operate on a cost-recovery basis would have the impact of improving services rather than limiting availability. Subsidies at a higher policy level, such as the textile credit scheme or the tax incentive facility, require close examination of the redundancy rate in order to limit the application of subsidies to where they would be most useful.

MoI would benefit from undertaking a general review of its subsidy levels and implementing guidelines that reflect international best practice in this area.

In general it appears that MoI is setting subsidy levels at too high a rate, which results in the attraction of 'second best' firms to participate in programs. At high rates of subsidy participating firms are not required to demonstrate any real commitment to a program, and can easily pull out, or worse perform badly, with no real cost. Setting lower rates of subsidy (perhaps through the bidding out of subsidy programs which would results in bidding down of subsidy levels) would lead to a self-selection process where the most committed participants would emerge. As lower subsidy levels translate into higher internal costs of participation, participating firms would have greater incentive to make the most out of the subsidy. Failure to do so would result in economic losses. It is thus important that MoI better understand the perverse impact of subsidies on incentives, and at every point should adopt a policy of minimum necessary subsidies to achieve desired policy objectives.

### 4.4 INTER-AGENCY COORDINATION

The review has seen that coordination could be improved between MoI and other economic-related Ministries as well as lower levels of government. Barriers to improved coordination at the central government level are often political and stem from competing objectives or constituencies. Poor coordination also arises due to the inherent difficulties of communication across Departments, as in the case of difficulties related to trade shows or the lack of buy-in from local governments to central government agendas on cluster development. As organizations have their own agendas and priorities, it is natural that attempts to coordinate can fall short. This requires commitment from leadership, signaling to staff that coordination is valued and that time should be devoted to engaging in better communication with counterpart organizations.

### 4.5 INCREASED INFORMATION FOR EXTERNAL AUDIENCES

Outside of very broad policy documents, such as the National Industrial Development Policy, there are almost no public documents on the programs and activities of MoI. This applies to both marketing and outreach information – for example, brochures, annual reports, or external publications - that would raise the profile of MoI in the public sphere- as well as internal planning documents. At the most basic level, Director Generals cannot provide a list of activities under each of the Directors in their divisions. The only internal document that provides such information is the annual budget which is not shared externally. Press releases are the only regular form of communication to external audiences.

Regulations are now available online and this is a very useful source of information for those programs enacted through regulations, but this does not cover large areas of activity. So for example, it is quite easy to obtain the regulation enacting the TPT subsidy or the fiscal incentives but there is no equivalent information available on tradeshow or BDS support. Even where the regulations exist, they provide quite good detail on the design of projects but no information on their implementation. Again, press releases are the only widely available external communication on how programs are progressing. Information more detailed than this requires physical visits to the Ministry to request information.

These bottlenecks are problematic in several practical ways. First, the paucity of external communications means that firms cannot find out about the services MoI provides unless they are members of one of the associations which have an institutional relationship with the Ministry. This means that not all firms are being given the opportunity to participate in the programs. It also contributes to the kinds of problems seen in the tradeshow program where the government communicates with the same firms year-after-year. Second, better information would strengthen the legitimacy of MoI as a partner to the private sector. Many firms may not be aware of how much MoI is trying to do on the behalf of their industry. Well explained programs, broadly disseminated, would raise the profile of the Ministry as a capable and active development partner. Third, readily available information on the initiatives and programs of MoI would facilitate inter-agency coordination.

The flip side of the lack of supply of information is that many parts of MoI are relatively isolated from the firms that are their clients. For example, of the Directorates surveyed for this study, only the Directorate for Automobiles and Auto Parts interacts with any regularity with international investors. Most Departments meet regularly with their counterpart sectoral association (e.g. ASMINDO or API) and consider that sufficient outreach and consultation with the private sector. The SME Unit doesn't meet with firms at all and relies on provincial and local governments to consult with small businesses and communicate their needs up the bureaucracy. The lack of broad and regular consultations with the industry actors whom the Ministry is meant to represent and serve constitutes a weakness of the organization that could be addressed relatively easily with existing resources.

## 4.6 POSSIBLE FOLLOW-ON MEASURES.

MoI has not received significant donor assistance for several years. The Japanese continue to provide short-term consultants but other donors, such as the ADB, have pulled back on assistance and many, including USAID and the World Bank, chose to focus on the Ministry of Trade when the former MoIT split, rather than MoI. There are a number of areas in which even short-term assistance could strengthen the functioning at MoI. These recommendations for future activities are not necessarily directed at SENADA but are for the consideration of other donors who may be interested in providing support.

- **Guidelines on effective trade show management.** Given that every Directorate at MoI is supporting trade show activities, technical assistance to improve the quality of these programs would have wide-ranging impact. Guidelines would need to be heavily influenced by the private sector and be as concrete as possible to assist staff at all levels (including provincial and local governments) to implement recommendations. TA for trade shows would have the added benefit of improving the overall branding of Indonesian products as poor quality government-run shows are now competing with private initiatives and potentially reducing their impact. TA could include development of criteria for selecting firms or new models in which MoI support private sector organizers with funds rather than trying to directly implement the program themselves.

- **Study to measure the redundancy rate of selected programs.** One of the recommendations arising from the study of the TPT rebate/loan subsidy is that MoI undertake a firm-level analysis of the redundancy rate for the program. Similar analysis, along with a cost/benefit analysis, would be useful in selecting which sectors should receive the fiscal incentives. While any government program will have some redundancy, it is important that there be a clear understanding of how effectively programs are influencing investment decisions as policymakers decide whether to renew the program. This is particularly true for the regulation on TPT upgrading and the regulation on fiscal incentives, both of which are dedicating public funds to subsidize very large companies.

- **Workshop on monitoring and evaluation.** As described above, training on Monitoring and evaluation would be useful in improving data collection, project design, and impact evaluation. This could easily be done by local firms in Indonesia and would not require significant new resources on the part of MoI to implement improved systems. While the training could usefully target all levels of staff, a more limited, but still useful, audience would be the Planning and Budget Officer in each Directorate. This is the person currently charged with collecting data on implementation.

- **Guidelines on setting subsidy levels**. Staff at all levels of MoI would benefit from exposure to best practice on the issue of subsidies. This could include trainings, the issuing of guidelines, or intensive capacity building within a cross-cutting unit, for example the research and development department. Emphasis would need to be placed on the potential harmful effects of subsidies, using examples from Indonesia, and how prices can be set in such a way to effectively target beneficiaries.

# APPENDICES

## APPENDIX 1: MATRIX OF MOI PROGRAMS BY VALUE CHAIN

### 1- MOI INDUSTRIAL POLICY – AUTO PARTS

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| **Tariff harmonization**<br>Under WTO requirements, IND has between 2005-2010 to gradually reduce tariffs on:<br>Completely built up (CBU) to max. 40 percent<br>Completely knocked down (CKD) to max 10 percent | All firms | | |
| **Import duty relief on raw materials**<br>Rates on steel reduced from 5-15 percent to 0 percent<br>Rates on rubber to be between 5-15 percent<br>Rates on glass, plastic, fabrication reduce to 5 percent | All firms | For the autopart industry it would be better to have no tariff on raw materials but this has been blocked by local producers. | PerMenKeu 34/2007 |
| **Tariff reduction on capital goods**<br>Reduces rates to max 5 percent for component industry from previously being treated under general tariff regime | All firms | Industry thinks this is one of the lowest rates in ASEAN. | SK Finance 135/2000 |
| **Duty free import of components and materials for re-export** | All firms | It is very difficult to get reimbursed for this. Takes a long time and is not 100 percent. There is a way of paying no duty up front if you submit to audits but this poses other problems because of misunderstandings with the tax office. | PerMenKeu 62/2005 |
| **Tax incentives for investors**<br>For new and expanded investment [fixed assets], will get 30 percent of total investment as tax credit (at 5 percent of total investment per yr over 6 yrs). Also has provision for offsetting fiscal loss. Applies to all investment for 4 wheel; for 2 wheel applies to engines and other named | Limited Liability companies investing in listed sectors and regions | They believe that the incentive scheme is equivalent to that of other ASEAN countries and thus unlikely to influence foreign investors. | Presidential Regulation 1/2007 |

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| parts | | | |
| **Supportive infrastructure — Special port**<br>Government funded development of dedicated port at Tajung Priok for import/export of cars and autoparts. This is 80 percent completed and should be opened this year. Working with customs, etc. to ensure fast, transparent operation. SOE operating the port provided most of the money and there will be rail and toll road linkages. Capacity of 350,000 cars per year once running. | Importing and Exporting firms | Problems at the port are significant (delays on entering the port and loading can be up to 10 days) so they welcome this effort. However, to their knowledge the dedicated toll road or rail link is just an idea for the future not something being realized right now. Existing road to the port suffers from flooding and traffic congestion so until connecting infrastructure is addressed there will still be additional costs related to transport. Also, they worry that handling charges at the new port will be too high. | |
| **Trade shows**<br>Sponsor free booths at Indonesian trade shows for SMEs | SMEs. Unclear how many firms reached. | Assn does not participate because MoI only gets booths at general trade shows. The Indonesia booth will have all different types of products together and buyers are not specifically to the automotive industry so its not useful. MoT does auto industry shows but not MoI. They would like to have information on international autopart shows (who are the buyers, etc) but MoI doesn't compile this type of information. | |
| **TA for SMEs/ Tier 2 firms producing autoparts**<br>Program to increase productivity, etc. Training provided free but company has to pay for travel to Jakarta. | Cooperate with associations to announce program and recruit firms | | |

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| A JICA project ending this year assisted 80 firms in Jabodetabek by placing consultants on site to work on productivity issues. MoI sent someone to learn from their experts and hopes to continue this project on their own. | using criteria developed with KADIN. | | |
| **Research and development Centers**<br>There are a number of *balais* working on technical issues such as stamping, heat treatment. There will be a dedicated Center in Bandung for auto industry | Number of clients unknown | | |
| **Auto Part Design Center**<br>Proposed program to open incubator next year | N/A | Think this could be useful if it focuses on after market and is professionally run. They think the government will try to hire retired engineers and also get Japanese assistance so the center is responsive to private sector. | |
| **Vehicle certification**<br>There are voluntary industry standards and also certification centers but these are run under separate Department for National Standardization. | Unknown | | |

## 2- MOI INDUSTRIAL POLICY - GARMENTS

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| **Subsidized credit**<br>Line of 255 billion rupiah to subsidize credit for textile manufacturers to buy machinery. This is divided into 2 schemes. 1st scheme for total of 175 billion (IDR) and the 2nd one for total of 80 billion (IDR).<br><br>1st scheme is rebate. The company will have discount of 11 percent of the price of the machine (the price of machine is issued by DIPA MoI). The maximum amount of discount is 5 billion (IDR). The company must have self financing.<br><br>2nd scheme is soft loan with interest of 8 percent/year (commercial rate is 14 percent) repayable over 5 years through state-owned financial institution. The amount of loan is minimum 100 million (IDR) and max 5 billion (IDR). The soft loan can be used 100 percent for investment or 80 percent investment and 20 percent of working capital. | 78 firms received the rebate; 18 firms received the subsidized loan. | Because the application and qualification requirements for this program are the same as a normal commercial loan it is difficult for SMEs to qualify. Collateral requirements are hard to meet and the 5 year term of the loan is considered too short for the production cycle. | Director General Regulation No. 81/ILMTA/PER/3/2007 |
| **Tax incentives for investors**<br>Terms as described under autoparts. | Limited Liability companies | | Presidential Regulation 1/2007 |
| **Trade show**<br>Pay for booths for textile and garment SMEs at the CCC. Often local government will assist with money for travel. Also do displays in the lobby of the MoI building. | Unclear number of firms benefiting. | Yogya FGD firms claim that this is helpful to them and that they closed deals that helped them expand. On the other hand, they haven't been willing to pay for attendance themselves in later years. | |
| **CSR compliance program**<br>New effort by MoI to try and help buyers know and | | | |

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| comply with social standards of international investors. They are compiling information on the standards and will then do socialization and trainings | | | |
| **WRAP or SA 8000 Certification**<br>Provided free consultant to 7 firms to help them obtain certificate. Also doing socialization in West and Central Java. | 7 firms | | |
| **Intellectual Property Rights Clinic**<br>Provide 50 percent subsidy and expediting service to assist SMEs to register patents and trademarks. | SMEs that contact local DINAS are eventually referred to the Ministry for assistance | | |
| **Technical Assistance- balai besar**<br>13 across country, eg. textile in Bandung, leather and batik in Yogya.<br><br>Balai in Yogya assists 1,000 firms per year with training and 90 percent of these are sponsored by their Dinas Pemda. The balai is launching a pilot project on batik certification/labeling. | | Industry finds these divorced from the needs of firms. For ex., the machinery they offer is only available for use during government office hours of 8-3 so it is impossible for a firm to use the machines to fill an order. | |
| **UPT**<br>Aim (not current reality) is to provide full service BDS to SMEs across the country. UPT provide machinery to groups of SMEs that can jointly manage (possibly through cooperative) the machines which remain property of central government. They also provide TA/training. Central government does not charge a fee for this but local government can charge. This is the main program of the SME Division for garments/textiles. Management is run by local government but budget mainly comes from central government. | SMEs<br><br><br>144 UPT total in all sectors across Indonesia | | |
| **Technical training- other** | | | |

| Initiatives | Beneficiaries | Industry Feedback | Regulation |
|---|---|---|---|
| MoI is sponsoring training on latest high speed machinery in each province. Companies have to pay 500,000 Rp pp for the 5 day course | | | |
| **Garment Training Center**<br>Plan next year to open a center in Central Java but still working on management and budget issues with local government. Will provide market facilitation services. | Will be open to firms of all size | | |
| **Infrastructure**<br><br>*Waste Disposal site*<br>This year working in Bandung to prepare a site for hazardous waste disposal to bring industry in line with Basel Convention.<br><br>*Industrial Estate*<br>Working with provincial government to identify and develop a 500 hectare site that would allow industries in flood zones to move. Will include non-garment/textile industries as well. | | | |

## 3- MOI INDUSTRIAL POLICY - FOOTWEAR

General Policy: Footwear is under Misc. Industries and their focus is on leather shoes as they understand that the industry for sports shoes is already well developed and does not require their support. They are following a cluster approach for the footwear roadmap (2005-2010). Their primary concern is how to improve the leather industry to increase domestic content.

| Initiatives | Beneficiaries | Industry Feedback |
|---|---|---|
| **Export tariffs on leather**<br>30 percent on raw leather | | |
| **Exemption from import tariffs on leather**<br>(0 percent import tax on wet blue) | | |
| **Incentives to investors willing to take over failed factories**.<br>The government plans to provide fiscal incentives under PP1/2007 for investors willing to take over failing or closed shoe factories. The initiative was announced in Jan 2008 and is not yet operating. | | |
| **Trade shows**<br><br>1. GDS trade show in Dusseldorf<br>Subsidize booth and cargo one-way for producers to attend. This is the third year Deperin has supported this and feels it is very successful. They sponsor firms in cooperation with Propinsi Jatim and say last year Deperin had 8 firms attend and Propinsi had 12 firms.<br><br>2. Indo Leather Footwear (2007)<br>Subsidize booth for footwear and tanneries | Participants selected thru ASPERINDO. 16 firms last year (6 from JABOTABEK 10 from East Java)<br><br>Provided 150 booths again thru ASPERINDO | Low demand because of cost and vendor quality issues. Conflicting reports about number of deals resulting.<br><br>Higher quality firms (eg Fortuna) pay to attend themselves and also go to Milan which is a higher quality design shoe. The companies the government is sending aren't at this level of quality and so Deperin doesn't sponsor for Milan. |
| **Industry directory**<br>Annual listing of footwear and tanneries | | Considered unsatisfactory by association because of incomplete information |
| **ISO Certification**<br>Provided free consultant to 5 SME firms in West Java. Any upgrades the consultant identified as necessary for ISO the firm has to pay themselves. MoI subsidizes 15 percent of the cost of the ISO fees. | Program began in 2006. In 2007, 5 SMEs and 3 large-scale firms benefited. | |

| Initiatives | Beneficiaries | Industry Feedback |
|---|---|---|
| Firms were selected on basis of names provided by provincial govt. Deperin then visited the firms to evaluate their market potential, sound financial management, etc. In East Java, they supported 3 large firms to do this in the hopes of spurring other firms to copy the example. Consultant was provided free but company paid for all improvements and the full cost of the ISO process (15-20 juta) themselves. | | |
| **Leather Design Center**<br>Centers opening or opened in East and West Java in cooperation with local universities | | |
| **Various UPT**<br>eg IND Footwear Service Center, Centre for Research on Leather, Rubber and Plastics in Yogya, leather UPT in Magettan. These institutions are providing subsidized services in leather production, certification and Research and development | Footwear center reaches 200 users/ yr. The UPT are focused on SMEs | |
| **Technical assistance for tanneries**<br>Intended to reduce waste in production | Unclear | |
| **Tannery site in Yogya**<br>Working with provincial government to try and create an industrial estate specific for tanneries. Province will build wastewater facility that will be operated by a .company that will charge tanneries to dispose of sludge | | |

## 4- MOI INDUSTRIAL POLICY – HOME ACCESSORIES

| Initiatives | Beneficiaries |
|---|---|
| **Tradeshow**<br>Last year sponsored booths at gift shows in Tokyo, California and Germany. Deperin pays for booth and sample transport. Firm pays for travel. Pemda proposes firms and they select from this shortlist.<br><br>Also do a number of domestic expositions | 10-15 SMEs go to each of the international shows. |
| **ISO 9000 Certification**<br>Do socialization on importance of trademarks and ISO certification. Send consultants to firms. | |
| **Skill Training**<br>Hire trainers in each region to do various trainings on weaving, women's entrepreneurship, etc. New pilot this year involved a ToT in Jakarta for three companies from each remote area who are supposed to help other firms once they go back to their region. This was done at 100 percent subsidy including travel. | |
| **UPT**<br>Have 15 UPT for weaving, 5 for ceramics, 14 for embroidery and 20 for wood/woodcarving | |
| **Eco-labeling for wood products**<br>This is under Ministry of Forestry but they provide input to the policy | |
| **Directory of Handicraft firms** | |

## 5- MOI INDUSTRIAL POLICY - FURNITURE

| Initiatives | Beneficiaries | Industry Feedback/Regulation |
|---|---|---|
| **Cluster project for SMEs in Jepara**<br>Have created a complex providing design and consultancy services, production facilities (drying machines and other equipment), and training. Collaboration with local government and Bogor Institute for Technology which will help them with promotion and marketing (build website, identify potential buyers, etc). The staff of the center is under the local government. At the moment these services are being given at 100 percent subsidy but there are plans to charge once the center is better established. If this pilot is successful, in the future they will expand the concept to clusters in Yogya, Solo and other sites. | N/A | The private sector thinks the initiative is ineffective- the Working Group meets irregularly, the Jepara Design Center isn't offering services two years after inception and the production facilities provided through the UPT are outdated. |
| **Training outside of Jepara**<br>MoI also invites SMEs to attend trainings in JKT. In 2007 they have done:<br>- 3 trainings on finishing (x 30 participants)<br>- 1 training on production<br>- 3 on-the-job skill training (x 20 participant)<br>Cost of external consultant/trainer is fully subsidized but companies in theory pay their own transport. In reality, most receive funds for this from their local government. | 150 firms | |
| **Rattan cluster in Cirebon**<br>Have established a rattan design center but it is unclear whether there is already a full service center as in Jepara for wood furniture. Services also free as this was just opened this year. | | |
| **UPT**<br>Service Centers for various aspects of SME production around the country. | | |
| **Trade shows**<br>Provide booths at both domestic and international shows. This year international shows were the Shanzen show in China were all the SMEs sold out their product and Valencia, Spain. MoI will sometimes pay for shipping | Sent 40-75 firms to Shanzen.<br><br>10 people to Spain. | |

| Initiatives | Beneficiaries | Industry Feedback/Regulation |
|---|---|---|
| samples but SME pays for their own travel. They wanted to provide 100 percent subsidy but MoF wouldn't allow them.<br><br>In collaboration with ASMINDO. About 60 percent of firms from ASMINDO and 40 percent referred to Deperin by provinces. Deperin's staff visits the business to make sure that their product is internationally competitive.<br><br>Have had buyers from China and Spain attend the domestic shows. They claim that they track the resulting deals but it may be just general statistics from MoT. They also hear back from ASMINDO on how successful it was. | For the international shows it tends to be med firms since small firms don't have necessary quality.<br><br>Maybe 40-50 SMEs in domestic tradeshows. | |
| **Research and development Centers** | | |
| **Annual Design Competition**<br>In cooperation with ASMINDO sponsor a Indonesia Good Design Selection for an exposition with invited international buyers | | |
| **Teak Labeling**<br>Cooperate with Ministry of Forestry on licensing for teak and potential future labeling of sustainably harvested wood | | |
| **Wood Terminals**<br>Idea is to establish depots where all wood will be legal so that the businesses can come and buy there and not have to deal with the transport issues related to wood. They are doing feasibility studies to set this up in Sulut, Kalteng, Jatim, and Jateng. Ministry of Forestry would staff the terminals to check the incoming wood. | | |
| **Sustainable product pilot**<br>A SOE under Ministry of Forestry is going to invest in a Research and Development Center to develop new technologies to process more sustainable kinds of wood or wood alternatives (coconut, acacia, bamboo, etc.) Proposed site is in Bogor. | | |

| Initiatives | Beneficiaries | Industry Feedback/Regulation |
|---|---|---|
| **Rattan export ban**.<br>In the process of approaching the Coordinating Minister directly to lobby for a complete ban as opposed to quotas (alternative proposal being advanced by MoT). | | |
| **Tax incentives for investors**<br>For new and expanded investment [fixed assets] off of Java. Terms as described above for autoparts. | Limited Liability companies investing in fixed assets off of Java | PP1/2007 |

# APPENDIX 2: LIST OF MEETINGS

## INDONESIA GOVERNMENT OFFICIALS

1. Agus Tjahajana Wirakusumah, Secretary General, Ministry of Industry
2. Andang Fatati Nadya, Secretary of Directur General of Small and Medium Scale Industry, Ministry of Industry
3. Ansari Bukhari, Director General of Textile and Multifarious Industry, Ministry of Industry
4. Arryanto Sagala, Director of Textiles and Textile Product Industry, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
5. Budi Darmadi, Director General of Industry of Transportation Equipment and Information Communication Technology, Ministry of Industry
6. Elim Lolodatu, Head of Promotion, Investment and Marketing, Directorate of Chemistry and Building Material, Directorate General Small and Medium Industry, Ministry of Industry
7. Endang Retno S., Deputy Director of Industrial Cooperation, Directorate of Textile and Textile Product Industry, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
8. Endi Dwi Cahyono, Business Climate and Institutionalization, Directorate of Craft Industry, Directorate General Small and Medium Industry, Ministry of Industry
9. Euis Saedah, Deputy Director of International Cooperation, Ministry of Industry
10. Gde Putu Astawa, Program Development Sub Division, Directorate Textile and Product Textile, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
11. Hamzah, Head of Multilateral and Bilateral Cooperation Sub Division, Center for International Cooperation, Ministry of Industry
12. Heru Nugroho, Deputy Director of Textiles and Textile Product Industry, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
13. Lina Sumarlina Sjam, Department of Industry and Trade, West Java Government
14. Lukieko, Deputi Planning Division, Capital Investment Coordination Body (BKPM), Jakarta
15. Made Dharma, Directorate of Craft Industry, Directorate General Small and Medium Industry, Ministry of Industry
16. Moch. Lukmanulhakim, Department of Industry and Trade, West Java Government
17. Moekti Soejachmoen, Tim Member, Export and Investment Enhancement (PEPI), Jakarta
18. Nugraha Soekmawidjaja, Director of Multifarious Industry, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
19. Nyoman, Fiscal Office, Ministry of Finance
20. Paryono, Technical Service Unit (UPT), Department of Industry, Trade and Cooperation, Jepara Government
21. Pudjo Prajogo, Head of Business Climate Sub Division, Directorate Multifarious Industries, Directorate General of Metal, Machinery, Textile and Multifarious Industry, Ministry of Industry
22. Ramelan Subagyo, Head of Center for International Cooperation, Ministry of Industry
23. Sakri Widhianto, Director General of Small and Medium Industry, Ministry of Industry
24. Setio Hartono, Director of Chemical and Building Material, Directorate General Small and Medium Industry, Ministry of Industry

25. Soerjono, Deputy Director for Standard and Technology, Directorate General Transportation Equipments and ICT Industries, Ministry of Industry
26. Suharto, Head of Division for Law Product Evaluation, Secretariat General, Ministry of Industry
27. Sunartono, Head of Program Sub Division, Directorate Land and Air Transportation Equipments, Directorate General Transportation Equipments and ICT Industries, Ministry of Industry
28. Syahbeno, Head of Department of Industry, Trade and Cooperation, Yogyakarta Government
29. Titik Anas, Tim Member, Export and Investment Enhancement (PEPI), Jakarta
30. Unsuruddin, Head of Business Climate and Institutionalization, Directorate General Small and Medium Industry, Ministry of Industry
31. Yan S. Tandiele, Directorate General Transportation Equipments and ICT Industries, Ministry of Industry
32. Yusran, Director of Clothing and Handicraft, Directorate General Small and Medium Industry, Ministry of Industry
33. Zahidiputra Puar, Deputy Director for Industrial Cooperation and Investment Promotion, Directorate of Forest and Crop Products, Directorat General of Agricultural Based and Chemical Industry
34. Zulkifli Rasjid, Deputy Director for Resources and Fund's Facility, Directorate General Small and Medium Industry, Ministry of Industry

**PRIVATE SECTOR REPRESENTATIVES/BUSINESS OWNERS**

1. Agus Rahaja, Vice President of PT. Dayani, Jakarta
2. Akhmad Fauzi, Chairman of Indonesian Furniture Industry and Handicraft Association, Local Commission of Jepara, Jepara
3. Amir Panzuri, Director, Indonesian Craft Industry Development Institution (APIKRI),Yogya
4. Anis Eko Hartanto, Jepara Furniture and Craft Design Center (JFDC), Jepara
5. Arwin, founder, Center for Furniture and Development Indonesia (CEFED), Semarang
6. Bambang, Director of PT. Mondrian, Klaten, Central Java
7. Budi Prajasa, Director of trading agent for garment product, Jakarta
8. Dadang, Director of PT. Multigarmen Jaya, Jakarta
9. Danny Lukita, Owner of PT. Fit-U Garment, Bandung
10. Eko Haryanto, Director of Astra Otopart, Jakarta
11. Erland, Director of PT. IndoTaichen, Jakarta
12. Handrian, Director of Eurotex, Yogyakarta
13. Jamhari, Leader of Cluster Rembug kluster, Jepara
14. Leasing Officer, PT Orix Finance Indonesia, Jakarta
15. Rafael, Commercial Credit Manager, Bank Niaga, Bandung
16. Rafael, Commercial Loan Manager, Bank Niaga Bandung Chapter
17. Robby T, Marketing Manager of PT. Gading Wana Raya Lestari, Jakarta
18. Robby, Director of PT. Mataram Tunggal Garmen, Yogyakarta
19. Thomas, Director of PT. Gabella, Yogyakarta
20. Wawan Harmawan, Director of PT. Harpa, Jogjakarta
21. Yehuda Pandu D.H., Journalist, WoodBiz Indonesia, Center for Furniture and Development Indonesia (CEFED), Semarang

## STATE-OWNED COMPANIES

1. Agus Mufrizon, Regional Senior Manager, SBU of Government and International Institution Services, PT. Sucofindo
2. Bambang Isworo, Project Manager, SBU of Trade and Finance Services, PT. Surveyor Indonesia
3. Commercial Credit Officer, PT. Bank BNI, Jakarta
4. Darmawan Rachmantoyo, SBU of Trade and Finance Services, PT. Surveyor Indonesia
5. Firdaus Badarudin, Team Leader, SBU of Government and International Institution Services, PT. Sucofindo
6. Linda C. Adela, Corporate Communication, PT. Surveyor Indonesia
7. Punjul Prabowo, Project Officer, PT. PNM Venture Capital
8. Rohindra Meison, Project Officer, SBU of Government and International Institution Services, PT. Sucofindo
9. Syamsuri, Project Officer, SBU of Government and International Institution Services, PT. Sucofindo
10. Teguh Soepadminto, Team Leader, PT. PNM Venture Capital
11. Tony Prasentiatono, Banking analyst

## DONOR INSTITUTIONS

1. Don Johnson, ADB finance consultant
2. Henry Sandee, World Bank consultant
3. James Lockett, Indonesia Trade Assistance Project
4. Joseph Koesnaidi, Indonesia Trade Assistance Project

## APPENDIX 3: COMPARISON OF LOAN APPLICATION REQUIREMENTS

| REQUIREMENTS | SCHEME 2 | LEASING COMPANY | COMMERCIAL BANK |
|---|---|---|---|
| Technical aspect | Offer letter from the distributor/agent that sell the Machinery. The letter has to detail all technical specification of the machines the company wants to buy. | Offer letter from the distributor/agent that sell the Machinery. The letter has to detail all technical specification of the machines the company wants to buy. | Offer letter from the distributor/agent that sell the Machinery. The letter has to detail all technical specification of the machines the company wants to buy. |
| Legal aspects | 1. Company act<br>2. Tax Number (NPWP),<br>3. Company registration certificate (TDP),<br>4. License for business operation, either for production or trading<br>5. Identification card (ie. KTP) | 1. Company act<br>2. Tax Number (NPWP),<br>3. Company registration certificate (TDP),<br>4. License for business operation, either for production or trading<br>5. Identification card (ie. KTP) | 1. Company act<br>2. Tax Number (NPWP),<br>3. Company registration certificate (TDP),<br>4. License for business operation, either for production or trading<br>5. Identification card (ie. KTP) |
| Financial aspect | 1. Financial reports:<br>a. Balance sheet, for the past two years, minimum,<br>b. Cash flow,<br>c. Bank statements of the company, for the past four years,<br>2. A letter which states the firm's willingness to provide self-financing.<br>3. A letter from bank that states that the firm is on the list of bad debtors. | 1. For loan application greater than 1 billion Rupiah:<br>a. Financial statements (balance sheet and income statement)<br>b. Bank statements.<br>2. For loan application of up-to 1 billion Rupiah or less:<br>a. Bank statements. | 1. Financial reports, for the last two years, must be audited by registered public accountant.<br>2. For loan application of up-to 1 billion Rupiah: Any financial documentation, which will be used by the bank to create financial reports. |
| Other requirements | 1. Feasibility study, which has to describe and explains:<br>a. Organization and management,<br>b. Business plan,<br>c. Machinery upgrading/buying plan, | 1. Credit history (ie. the list of creditors of the company).<br>2. The list of any suppliers and customers (Including some potential customers). | 1. Credit history, but this bank check this through report<br>2. The list of any suppliers and customers (including some potential customers). |

| REQUIREMENTS | SCHEME 2 | LEASING COMPANY | COMMERCIAL BANK |
|---|---|---|---|
| | d. Production,<br>e. Marketing,<br>f. The current financial situation of the firm. | 3. The list of machinery that the company owns at the moment. | 3. The list of machinery that the company owns at the moment.<br><br>4. Feasibility study for loan application of more than 5 billion Rupiah. |
| Procedure | 1. The company submit the application letter for the scheme<br><br>2. Preliminary selection by PNM, based on:<br>a. The completeness of the required documents,<br>b. The business aspect of the proposal and finance,<br><br>3. Based on the preliminary selection, PNM submits:<br>a. Penjelasan Ringkas Rencana Pembiayaan CPPU, CPPU is the applicant.<br>b. Ringkasan data CPPU,<br>c. Daftar Pra-Nominasi, to MoI.<br><br>4. MoI then checks these documents.<br><br>5. LPI (ie. Surveyor Indonesia - SI) verifies technical aspect of the machine and price of the machinery.<br><br>6. SI reports back to MoI on the verification, within 21 days. | 1. The company asks the supplier of the machinery for price quotation.<br><br>2. The price quotation is then submitted to the leasing company, and the leasing company then creates its own quotation to be offered to the company.<br><br>3. Verifying process, including visit to the company.<br><br>4. Processing all information after the company visit.<br><br>5. Time for approval:<br>a. For a lease of less than 1 billion Rupiah: 5-7 days,<br>b. For a lease of more than 1 billion Rupiah: two weeks.<br><br>6. If approved, a contract will be signed.<br><br>7. The leasing company verifies that the machine is installed. | 1. The company asks the supplier of the machinery for price quotation.<br><br>2. Verifying process, including visit to the company.<br><br>3. Processing all information after the company visit.<br><br>4. Time for approval:<br>a. For a lease of less than 1 billion Rupiah: 5-7 days,<br>b. For a lease of more than 1 billion Rupiah: two weeks.<br><br>5. If approves, a contract will be signed.<br><br>6. The leasing company verifies that the machine is installed. |

| REQUIREMENTS | SCHEME 2 | LEASING COMPANY | COMMERCIAL BANK |
|---|---|---|---|
| | 7. MoI instructs KMM (ie. Sucofindo) to held a technical meeting, also with PNM, to discuss the verification result.<br><br>8. MoI submits the verification result, done by SI, and the results of the meetings to PNM for a basis to determine whether the applicant is eligible or not for the subsidy.<br><br>9. PNM conducts a final evaluation. This basically examines the feasibility study.<br><br>10. PNM then writes the offer letter to the applicant, withinthe period of 21 days.<br><br>11. At the same time, PNM submits an application for disbursing the fund to Dirjen Industri Logam Mesin Tekstil dan Aneka, MoI. PNM must attach the following documents:<br>a. Daftar Nominasi CPPU,<br>b. Ringkasan data CPPU,<br>c. Ringkasan Proposal Investasi,<br>d. The copy of the PNM's offer letter,<br>e. Form for receipt of payment,<br>f. Copy of the PNM account,<br>g. Profile of PNM,<br>h. Copy of Surat Penetapan LPP (???)<br>i. Copy of the MoU between MoI | | |

| REQUIREMENTS | SCHEME 2 | LEASING COMPANY | COMMERCIAL BANK |
|---|---|---|---|
| | and PNM,<br>j. Letter stating the ability of PNM to disburse the fund to the applicant,<br>k. Legal statement (ie. Berita Acara) for the clearing of the fund to be given to the applicant.<br><br>12. A MoI official, ie. Pejabat Pembuat Komtment (PPK) issues a letter to pay out the fund, and then send to a relevant official to clear the fund (ie. Pejabat Penguji dan Penandatangan Surat Perintah Membayar)<br><br>13. The Pejabat then issues another letter to pay out the fund, and send it to a government body outside MoI (ie. Kantor Perbendaharaan Negara - National Treasury Office)<br><br>14. The Office then clear the fund and transfer the fund to PNM,<br><br>15. PNM, on behalf of MoI, transfers the fund to the applicant, based on the contract between PNM and the applicant, within 10 days period. *Note: it's not clear when the contract is assigned, presumably after PNM receive the fund.* | | |

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