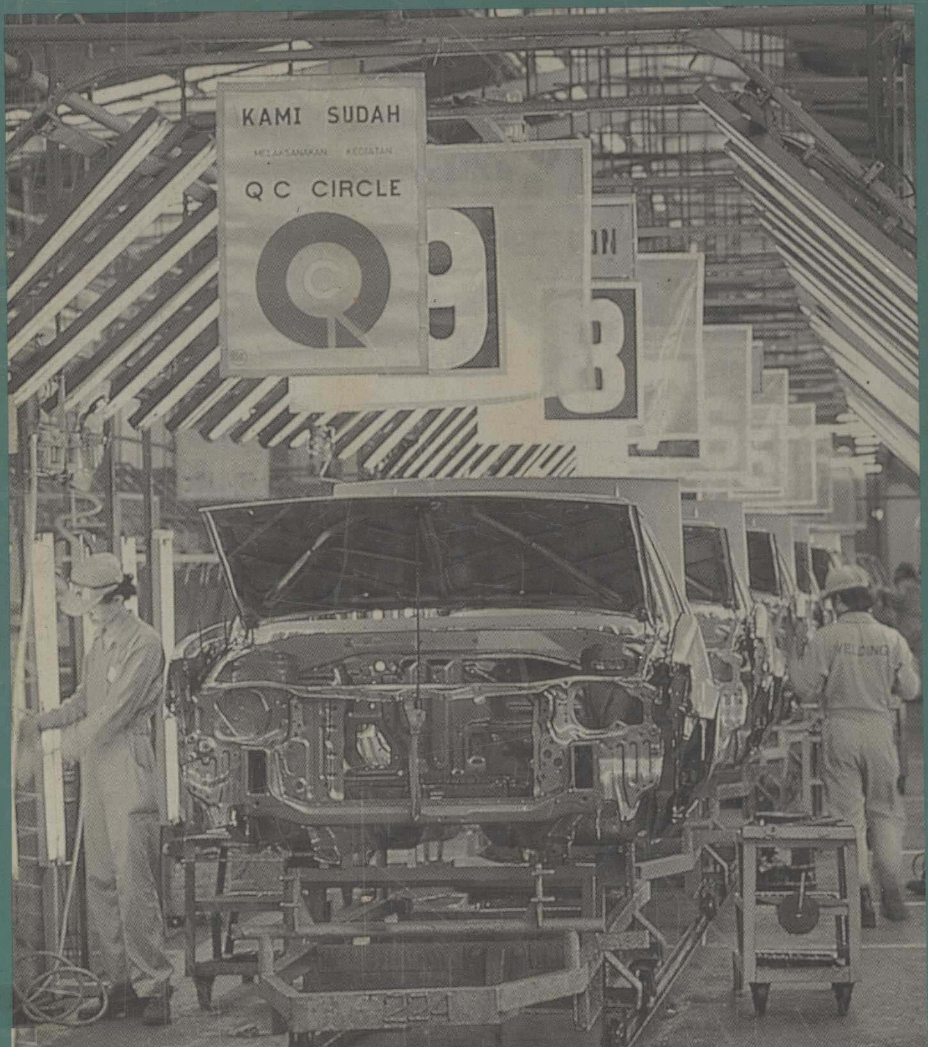
Hal Hill

Foreign Investment and Industrialization in Indonesia



East Asian Social Science Monographs

Foreign Investment and Industrialization in Indonesia

Hal Hill

SINGAPORE
OXFORD UNIVERSITY PRESS
OXFORD NEW YORK
1988

Oxford University Press

Oxford New York Toronto
Delhi Bombay Calcutta Madras Karachi
Petaling Jaya Singapore Hong Kong Tokyo
Nairobi Dar es Salaam Cape Town
Melbourne Auckland
and associated companies in
Berlin Ibadan

Oxford is a trade mark of Oxford University Press

Published in the United States by
Oxford University Press, Inc., New York

ISBN 0 19 588884 7

British Library Cataloguing in Publication Data

Hill, Hal
Foreign investment and industrialization in Indonesia.
—(East Asian social science monographs).
1. Economic assistance—Indonesia
I. Title II. Series
338.91′09598 HC447

ISBN 0–19–588884–7

Library of Congress Cataloging-in-Publication Data

Hill, Hal, 1948–
Foreign investment and industrialization in Indonesia.

(East Asian social science monographs)
Bibliography: p.
Includes index.
1. Investments, Foreign—Indonesia—History—20th century. 2. Indonesia—Industries—History—20th century. I. Title II. Series.
HG5752.H54 1988 332.6′73′09598 87–31367
ISBN 0–19–588884–7

Printed in Singapore by Kim Hup Lee Printing Co. Pte. Ltd.
Published by Oxford University Press Pte. Ltd.,
Unit 221, Ubi Avenue 4, Singapore 1440

Preface

THERE are several reasons for a book-length examination of foreign investment and industrialization in Indonesia. First, the role of foreign involvement in its manufacturing sector is something of a puzzle. It is clear to any observer that the 'foreign presence' is ubiquitous in the modern sector, and yet all available statistical information points to comparatively modest foreign investment inflows and foreign ownership. A second reason is that Indonesian manufacturing experienced extraordinarily rapid growth in the fifteen years after 1967. To better understand this historically unprecedented growth episode, it is important to examine the role of contributing factors, of which foreign investment has undoubtedly been one.

There is, third, the fact that foreign investment in Indonesia has been a contentious issue. When critics of the current regime—both local and foreign—list their grievances, the government's alleged 'open-door' policy towards foreign investment is generally prominent. Finally, the book is in part a response to the challenge that the subject is not worthy of examination because the research and statistical data base is so weak. When I commenced work on the book, it was surprising how *much* had been written on foreign investment in Indonesia, even if much of the material was not easily accessible. Moreover, the range and quality of Indonesian economic statistics have improved enormously in the last decade, such that they are now among the best in South-East Asia.

The purpose of this book is to analyse and integrate this material in the framework of the theory of direct foreign investment, and in the context of general economic developments in Indonesia since 1965. It is not my intention to promote a particular set of arguments for or against foreign investment in that country. Indeed, throughout the study I maintain that a more important consideration is the broader macro and industrial policy environment. I believe Indonesia could have secured a much higher proportion of the benefits of foreign investment over the last two decades if these general policies had been more conducive to the emergence of an efficient and internationally competitive manufacturing sector. In this sense, to conduct a debate concerning the benefits and costs of foreign investment, without reference to this general policy environment, is a somewhat sterile exercise.

Although the study is concerned primarily with foreign investment, an underlying theme—perhaps paradoxically—is the role of the state in

Indonesian industrialization. I accord a central role to the state for three reasons. First, the state is a major investor in the manufacturing sector. State enterprises in Indonesia play a dominant or major role in industries which are often the preserve of foreign investors in less restricted commercial environments. Notable examples include petroleum refining, fertilizers, steel, and aircraft. The second reason is the state's role in the trade regime, itself a critical determinant of the extent, composition, and contribution of foreign investment in Indonesia. For example, Indonesia's high (and highly dispersed) effective protection for much of manufacturing has both induced considerable capital inflow—of an import-substituting nature—and greatly affected the profitability of such investment. Finally, the state has played a key role as a regulator. Investment regulations have determined the entry modalities of foreign firms (for example, some important industries, such as automobiles, are closed to new foreign equity), and the nature of the investment decision.

There are an unusually large number of caveats associated with this book. The first, and most obvious, is that the study has proved to be a data-intensive exercise, and the conclusions are only as sturdy as the data base permits. As noted, Indonesian economic statistics have improved immeasurably in the last decade, but there are still many gaps. I have been careful to highlight existing shortcomings and, where these remain considerable, I hope I have not 'pushed' the data further than warranted. Similarly, Indonesia is in a state of flux, and some parts of the study will date fairly quickly. Two recent, inter-connected events illustrate this proposition. When I first commenced serious work on the subject, in 1984, Indonesia's foreign investment policy was a fairly restrictive one and manufactured exports were miniscule. At the time of final drafting, in the first half of 1987, there had been major changes: investment policies had become a good deal more liberal, and manufactured exports had grown substantially.

The book is primarily an examination of the economics of foreign investment. As an outside (but I hope sympathetic) observer, I am acutely conscious of the fact that foreign investment—and foreign involvement more generally—raises a wide range of complex social, political, and cultural issues, especially so for a country little more than forty years after Independence. I recognize the strength of nationalist sentiment in Indonesia, and the fact that domestic ownership is considered by many to be a 'public good'. I also recognize that political structures—in Indonesia as much as elsewhere—not infrequently impede the adoption of 'first-best' economic policy prescriptions. All an outsider can offer is an analysis of current policies and implications of alternative scenarios, for the consideration of domestic policy-makers.

I hope this book will be of interest to three groups of readers. The first is a scholarly audience, including those with an interest in the Indonesian economy, and industrialization and business in developing countries. The second group is what might be termed the 'development industry'—international organizations and development agencies—for whom I hope I have provided a reasonably complete account of an important facet of

Indonesian development in the last twenty years. Finally, in return for the generous co-operation of the domestic and foreign business community in Indonesia, the book may perhaps provide an overview of a system which they obviously understand far better than a non-participant.

It is appropriate to end an introduction to a study of foreign investment with an acknowledgement of the many debts I have incurred in researching and writing the manuscript. Many Indonesian officials have assisted in providing information or explaining policies. Without naming individuals, I wish to thank staff at the Capital Investment Coordinating Board (BKPM), Bank Indonesia, and the Department of Industry. I am particularly appreciative of the support given by staff of the Central Bureau of Statistics (BPS). The Head of the Industry Section, Mr Sugiarto, generously provided access to unpublished industrial statistics.

Parts of the book have been presented to seminars at the Institute for Economic and Social Research (LPEM), University of Indonesia; the ESCAP/UNCTC Joint Unit on TNCs in Bangkok; the Department of Economics and Statistics, National University of Singapore; and to my Department at the Australian National University. I am very grateful to seminar participants for many useful comments.

I have benefited greatly from the constructive comments of several people kind enough to read all or part of earlier drafts. These people include Heinz Arndt (whose comments, as usual, were unsurpassed in quality and range), Bruce Glassburner, Mac Hill, Peter McCawley, Chris Manning, Thee Kian Wie, Louis Wells, and Kunio Yoshihara. Needless to say, I alone am responsible for remaining errors of fact and interpretation.

I am equally grateful to the many other people who assisted. These include Anne Armstrong, who typed much of the first draft of the manuscript and generally made life pleasant; Kris Bowmer and Libby Giugni, who also cheerfully assisted with typing; Corrine Condie, who ably assisted with the data analysis in Chapter 7; and Hazel Richter, who cast a characteristically eagle eye over the penultimate draft.

Department of Economics
Research School of Pacific Studies
Australian National University
Canberra
June 1987

HAL HILL

Pertamina	State-owned oil company
PLN	(*Perusahaan Listrik Negara*) State Electricity Corporation
PMA	(*Penanaman Modal Asing*) foreign investment
PMDN	(*Penanaman Modal Dalam Negeri*) domestic investment
PN	(*Perusahaan Negara*) state enterprise
Pribumi	Indigenous Indonesian
PT	(*Perseroan Terbatas*) limited liability
PTPM	(*Panitia Teknis Penanaman Modal*) Technical Team for Investment
PUSRI	State-owned fertilizer company
Repelita	(*Rencana Pembangunan Lima Tahun*) Five-Year Development Plan
RUP	(*Rencana Urgensi Perekonomian*) Economic Urgency Plan
Santri	Devout Moslem
SE	(*Sertifikat Ekspor*) Export Certificate
Sensus Industri	Industrial Census
SI	(*Statistik Industri*) Industrial Statistics
SK	(*Surat Keputusan*) (Regulation), *Menteri* (of the Minister), *Direktur Jenderal* (of the Director-General)
Supas	Intercensal survey
UNCTC	United Nations Centre on Transnational Corporations

Notes

Spelling of Indonesian words: In all cases the new (post-1972) spelling is employed.

Currency: US dollars are quoted unless otherwise stated.

Exchange rate: Since the April 1983 devaluation there has been a 'managed float' of the rupiah. The average rupiah : US$ rate in 1984 was Rp 1,026; in 1985 it was Rp 1,111. The rate shortly after the September 1986 devaluation was Rp 1,640.

The Indonesian financial year is 1 April to 31 March.

Introduction

FROM 1967 to 1984, the Indonesian economy grew remarkably quickly, with gross domestic product (GDP) increasing at an annual average rate of almost 8 per cent. Such a period of sustained and rapid growth was unparalleled in the country's history. It was in marked contrast to the patchy record of the 1950s and, especially, to the economic decline and soaring inflation of the first half of the 1960s. Moreover, not only has Indonesia's performance since 1967 been very good in historical perspective, it has also compared favourably with its dynamic neighbours in ASEAN and North-East Asia.

Industrialization has been an integral part of Indonesia's economic recovery and growth. In the mid-1960s, Indonesia was perhaps the least industrialized among the large developing countries, certainly compared to Asia's other two giants, China and India. The manufacturing sector consisted primarily of simple consumer goods and resource-processing activities; much of the small factory sector was state controlled; and in many respects manufacturing had changed little since the country's first period of industrial growth in the 1930s. After 1966, manufacturing production expanded rapidly, so much so that this sector's share of a fast-growing GDP increased by about 50 per cent in less than two decades. In the first decade after 1966, manufacturing growth was concentrated in a wide range of consumer and intermediate goods—the so-called 'easy phase' of import substitution. More recently, since about 1980, the first serious push for backward integration into capital goods production and for labour-intensive and resource-based manufactured exports got under way.

Indonesia's industrialization since 1966 has been fuelled by the rapid import and dissemination of foreign technologies and products. The adoption of more liberal economic policies facilitated these imports, but they were hastened in particular by the promulgation of the Foreign Investment Law of 1967. The Law represented an almost complete reversal of Indonesia's policy towards foreign investment. Perhaps even more important, it was symbolic: it was a major signal to potential foreign investors, and to the domestic business community, of the 'New Order' government's economic and development priorities.

During the last half century, foreign investment policy in Indonesia has encompassed virtually the entire spectrum of postures, from an 'open-door' position, to hostility and to expropriation of foreign capital. The late colonial

Introduction

FROM 1967 to 1984, the Indonesian economy grew remarkably quickly, with gross domestic product (GDP) increasing at an annual average rate of almost 8 per cent. Such a period of sustained and rapid growth was unparalleled in the country's history. It was in marked contrast to the patchy record of the 1950s and, especially, to the economic decline and soaring inflation of the first half of the 1960s. Moreover, not only has Indonesia's performance since 1967 been very good in historical perspective, it has also compared favourably with its dynamic neighbours in ASEAN and North-East Asia.

Industrialization has been an integral part of Indonesia's economic recovery and growth. In the mid-1960s, Indonesia was perhaps the least industrialized among the large developing countries, certainly compared to Asia's other two giants, China and India. The manufacturing sector consisted primarily of simple consumer goods and resource-processing activities; much of the small factory sector was state controlled; and in many respects manufacturing had changed little since the country's first period of industrial growth in the 1930s. After 1966, manufacturing production expanded rapidly, so much so that this sector's share of a fast-growing GDP increased by about 50 per cent in less than two decades. In the first decade after 1966, manufacturing growth was concentrated in a wide range of consumer and intermediate goods—the so-called 'easy phase' of import substitution. More recently, since about 1980, the first serious push for backward integration into capital goods production and for labour-intensive and resource-based manufactured exports got under way.

Indonesia's industrialization since 1966 has been fuelled by the rapid import and dissemination of foreign technologies and products. The adoption of more liberal economic policies facilitated these imports, but they were hastened in particular by the promulgation of the Foreign Investment Law of 1967. The Law represented an almost complete reversal of Indonesia's policy towards foreign investment. Perhaps even more important, it was symbolic: it was a major signal to potential foreign investors, and to the domestic business community, of the 'New Order' government's economic and development priorities.

During the last half century, foreign investment policy in Indonesia has encompassed virtually the entire spectrum of postures, from an 'open-door' position, to hostility and to expropriation of foreign capital. The late colonial the new business opportunities and they brought in much-needed capital and technology. But it will be argued that their development contribution has been greatly inhibited by the trade regime, and by a comparatively weak bureaucracy which has appropriated, for the country as a whole, a lower share of the 'rents' to foreign investment than could have been the case under alternative policy scenarios.

Why study foreign investment and industrialization in Indonesia? The first reason is, simply, that Indonesia is the world's third largest developing country, and it has been a major recipient of capital since the late 1960s. Any study of the subject in the Third World can therefore hardly afford to ignore Indonesia. Secondly, and related to the first point, Indonesia exemplifies a particular policy environment—common to many developing (and not a few developed) countries—which, as noted, limits the potential gains from foreign investment: a comparatively liberal policy towards these investments, accompanied by a highly regulated and protected manufacturing sector, and by authoritarian political structures. Indonesia's experience with foreign investment is thus of relevance to many other developing countries, not only because of the magnitude of investment flows but also because the essential elements of the policy environment are replicated in many other countries.

A third reason is that the role of foreign investment in Indonesia continues to be a controversial issue. Opinion on the matter, in the popular press and in the research community, is sharply divided. Whenever criticism of the government has surfaced during the New Order, it has invariably focused on the alleged excessive dependence on foreign capital, on foreign (often meaning domestic Chinese) control over the economy, and on concessions to foreign enterprise. Not infrequently the debate has generated more heat than light. It is now almost two decades since the 1967 Law was introduced, and an assessment of the costs and benefits of foreign investment is therefore timely.

A final reason for the study is that the secondary data base is now much improved, notwithstanding the considerable deficiencies which still exist. There is, moreover, a substantial body of literature on foreign investment in Indonesia, particularly in the manufacturing sector. Much of this literature is not widely accessible, however, and a good deal of the survey research on which it is based was conducted before 1980. One aim of this study is to review and distil the main findings from this work, and to point to new areas where research is required.

Foreign investment in manufacturing is the primary focus of this book. In fact, foreign investment in the petroleum industry has been a good deal larger since 1966. But data on the latter investments are extremely poor, and the policy issues (for example, optimal exploitation, taxation, and production-sharing arrangements) differ somewhat. Manufacturing was also chosen for other reasons. One, as noted, is that it has already been the subject of scrutiny, including several informative field surveys. Another is that foreign investment in manufacturing is *visible*—in contrast to enclave investments in petroleum—and therefore invites public comment. Foreign investors' interaction with the domestic business community, in addition, raises important issues of technology transfer and the development of indigenous entrepreneurship. Yet another reason for selecting manufacturing is that it has been the largest recipient of foreign investment among sectors within the jurisdiction of the Capital Investment Coordinating Board (*Badan Koordinasi Penanaman Modal*, hereafter referred to as BKPM). Lastly, the choice was influenced by the author's research interest in industrialization in Indonesia and the ASEAN countries.

This book concentrates mainly on the period after 1966, but we begin, in Chapter 1, with a brief review of developments during the colonial era and the first two decades of Independence. The story before 1966 is relatively straightforward. Extractive and plantation investments were dominant up to 1939, while political developments effectively deterred foreign investors after 1945. Chapter 2 provides an overview of industrialization in the New Order period, to set the stage for later discussion. Particular emphasis is given to the growth in production, and to the equally rapid structural transformation of industry.

The analysis of foreign investment after 1966 begins in Chapter 3, with an examination of the policy environment towards foreign investors. After a brief episode of very liberal policies, from 1974 the environment became a good deal more restrictive, and it remained so until the mid-1980s, when economic stagnation forced the government to offer more concessions to foreign firms. Later in this chapter, there is an examination of aggregate trends in foreign investment since 1967, and their relation to the policy environment. The importance of foreign investment in Indonesia compared to other developing countries is also assessed.

The following two chapters investigate the composition of foreign investment. Chapter 4 looks at the major investors in manufacturing. Japan is dominant, but sizeable investments have also come from other countries. The discussion of source countries is related also to the general literature on major characteristics of investing countries, focusing especially on Japan and the United States, and developed and developing countries. Next, in Chapter 5, the distribution of foreign investment within the manufacturing sector is examined. Using unpublished data from the annual *Statistik Industri* (SI, or Industrial Statistics) series, it is also possible to identify the industries in which foreign investors play a major role, as compared to state and domestic private firms.

Chapters 6 and 7 address two of the more contentious issues concerning foreign investment. Chapter 6 seeks to determine whether the factor proportions of foreign-owned firms differ significantly from those of other ownership groups. It is frequently argued that foreign firms adopt excessively capital-intensive technologies in developing countries, thereby making little contribution to employment generation. The Indonesian data, though limited, throw some light on this issue. The diffusion of technology from foreign to domestic firms is examined in Chapter 7. Unlike the previous chapter, it is far more difficult to reach strong conclusions. The 'development contribution' of foreign firms is a complex subject, because the so-called 'linkages and leakages' are very difficult to identify and measure. There have, however, been a number of useful firm surveys in Indonesia which, while not definitive, are at least suggestive.

Chapter 8 critically assesses the Indonesian government's policies towards foreign investment, in the context of the country's industrial programme. The main argument is that these policies represent an understandable response to political pressures. Nevertheless, the economic rationale for many of these policies is weak, and the same ends could be achieved more effectively through alternative measures. Finally, Chapter 9 summarizes the main findings of the book, and considers future prospects for foreign investment in the subdued economic environment of the late 1980s and beyond.

It hardly needs to be emphasized that foreign investment data for Indonesia—or, for that matter, most countries—need to be interpreted with great care. The most widely accessible data on Indonesia are approved foreign investments for sectors within the jurisdiction of the BKPM. These data are frequently cited by researchers unfamiliar with Indonesian statistics, even though they give an entirely misleading impression concerning the magnitude and composition of these investment flows. Indonesian economic statistics, including those on foreign investment, have improved immeasurably since the mid-1960s. But important deficiencies remain. These are summarized briefly in Chapters 2 (on manufacturing) and 3 (on foreign investment); an Appendix sets out these limitations in more detail.

Abbreviations and Glossary

ABRI	(*Angkatan Bersenjata Republik Indonesia*) armed forces of the Republic of Indonesia
ASEAN	Association of South-East Asian Nations
BI	Bank Indonesia
BKPM	(*Badan Koordinasi Penanaman Modal*) Capital Investment Coordinating Board
BPS	(*Biro Pusat Statistik*) Central Bureau of Statistics
BRO	*Bedrijfs Reglemeenterings Ordannantie*
CKD	Completely Knocked Down
CSIS	Center for Strategic and International Studies
DAC	Development Assistance Committee (of the OECD)
DPR	(*Dewan Perwakilan Rakyat*) People's Representative Assembly
DSP	(*Daftar Skala Prioritas*) Investment Priority List
EPR	Effective rate of protection
EPZ	Export processing zone
ESCAP	Economic and Social Commission for Asia and the Pacific
GDP	Gross domestic product
Golongan ekonomi lemah	Weak economic groups
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
Kabupaten	Sub-provincial administrative district
KP	(*Keputusan Presiden*) Presidential Decree
Kretek	Indonesian clove cigarette
MITI	Ministry of International Trade and Industry, Japan
MVA	Manufacturing value added
NICs	Newly industrializing countries
Non-*pribumi*	Non-indigenous Indonesians (mostly Chinese)
NTB	Non-tariff barriers
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
Orde Baru	New Order (the period from 1966)
Orde Lama	Old Order (the period up to 1966)

Contents

Tables