USAID/INDONESIA ECONOMIC GROWTH SECTOR ASSESSMENT

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ADB	Asian Development Bank
AIPRD	Australia-Indonesia Partnership for Reconstruction and Development
AMARTA	Agribusiness Market and Support Activity
ANTARA	Nusa Tenggara Assistance for Regional Autonomy
APBD	Annual Local Budget
APKI	Indonesia Leather Association
APRISINDO	Indonesia Footwear Association
ASBEKINDO	Indonesia Service Station Association
ASEAN	Association of South East Asian Nations
ASITA	Yogyakarta Tourism Agency Association
ASMINDO	Indonesian Furniture Industry and Handicrafts Association
AUSAID	Australian Agency for International Development
BA	Business Angel
BAPEPAM & LK	Indonesian Capital Market and Financial Institution Supervisory Agency
BAPPENAS	National Development Planning Agency (Indonesia)
BEE	Business Enabling Environment
BGI	Business Growth Initiative
BIS	Bank for International Settlements
BPGT	Toll Road Regulator
BPN	National Land Agency
BPS	Indonesian Statistic Agency
BRI	Bank Rakyat Indonesia
BSD	Business Services Development
BSP	Business Service Provider
BTN	Bank Tabungan Negara
CAGR	Compound Annual Growth Rate
CBI	Centre for the Promotion of Imports from Developing Countries
CIDA	Canadian International Development Assistance
CIS	Collective Investment Schemes
CPIA	World Bank's Governance Matters and Country Policy and Institutional Assessment
CTO	Cognizant Technical Officer
DAI	Development Alternatives, Inc.

DCA	Development Credit Authority
DFID	UK Department for International Development
DSP	Danamon Simpan Pinjam
EGAT/EG	Bureau for Economic Growth Agriculture and Trade/Economic Growth
EGO	Economic Growth Office
EDP	Executive Development Program
EINRIS	Eastern Indonesia National Roads Improvement Project
EIU	Economist Intelligence Unit
EU	European Union
FIPF	Financial Institution Pension Fund
FSC	Forest Stewardship Council
FSA	Financial Services Authority of the United Kingdom
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GEM	Global Entrepreneurship Monitor
GIAMM	Indonesia Automotive Parts and Components Industries Association
GM	Genetically Modified
GOI	Government of Indonesia
GPI	Garment Partnership Indonesia
GTZ	German Agency for Technical Cooperation
HIVOS	Humanist Institute for Cooperation with Developing Countries
HRM	Human Resource Management
IAIS	International Association of Insurance Supervisors
IATO	Society of Automotive Engineers Indonesia
IAU	Infrastructure Advisory Unit
IBRD	International Bank for Reconstruction and Development
ICT	Information and Communications Technology
IDPL	Infrastructure Development Policy Loans
IEF	The Heritage Foundation’s Index of Economic Freedom
IFSC	Indonesia Footwear Service Center
IFC	International Finance Corporation
IFC-PENSA	Program for Eastern Indonesia SME Assistance
IGSC	Indonesian Global Sourcing Center

IGTC	International Garment Training Center
IMF	International Monetary Fund
IN-ACCE	Indonesia Anticorruption and Commercial Court Enhancement Project
IOSCO	International Organization of Securities Commissions
IPC	Indonesian Port Corporations
IPO	Initial Public Offering
IPR	Intellectual Property Rights
IRSDP	Infrastructure Reform Sector Development Program
IT	Information Technology
ITAP	Indonesia Trade Assistance Project
ITB	Institute of Technology of Bandung
IVC	Industrial Value Chain
Jamsostek	Social Insurance for Workers
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
KKPPI	The National Committee for the Acceleration of Infrastructure Provision
KPPOD	Regional Autonomy Watch
LED-NTT	Local Economic Development project in Nusa Tenggara Timur Province
LGSP	Local Governance Support Program
LPEM FEUI	Institute of Social and Economic Research Faculty of Economics University of Indonesia
M & E	Monitoring and Evaluation
MFI	Microfinance Institution
MICRA	Microfinance Research Center for Resources and Alternative
MOA	Ministry of Agriculture
MOF	Ministry of Finance
MOI	Ministry of Industry
MOT	Ministry of Trade
NAFED	National Agency for Export Development
NBFIs	Non-Bank Financial Institutions
NPL	Non-Performing Loans
NTB	Non-Tariff Barrier
OECD	Organization for Economic Cooperation and Development

OJK	Otoritas Jasa Keuangan -- Indonesian Financial Services Authority
OSS	One Stop Shop
PACA	Participatory Appraisals and Competitive Advantage
PADA	Papua Agribusiness Development Alliance
PDAMS	Local Government Water Authorities
PDF	Project Development Facility
PEAC	Promoting Enterprise Access to Credit
PEPI	National Team of Export and Investment Acceleration
PLN PSO	State Owned Electricity Company Public-Service Obligations
PPP	Public Private Partnership
PROMIS	Reducing Barriers to Market Entry and Business Operation
PSP	Private Sector Participation
QSEAL	Product of Seal of Quality for Automotive Components
RED	Regional Economic Development
REER	Real Effective Exchange Rate
RIA	Regulatory Impact Assessment
RMU	Risk Management Unit
RPH	Rupiah
RUU LKM	Microfinance Law
SBY	Susilo Bambang Yudhoyono, President of Indonesia
SCM	Supply Chain Management
SENADA	Indonesia Competitiveness Program
SEZ	Special Economic Zones
SME	Small and Medium Enterprise
SMEP	Small and Medium Enterprise Promotion
SOI	Center of Automotive Indonesia
SOW	Statement of Work
SRO	Self Regulatory Organization
STTA	Short-Term Technical Assistance
TA	Technical Assistance
Timnas Arus Barang	National Team for Trade Flow
Timnas KEKI	National Team for Special Economic Zones for Industry
Timnas Single Window	National Team for the Implementation of the National Single Window

USAID	United States Agency for International Development
USG	United States Government
VC	Venture Capital
VLO	Verification of Legal Origin
WCY	World Competitiveness Yearbook
WTO	World Trade Organization

EXECUTIVE SUMMARY

USAID/Indonesia contacted EGAT/EG to request an in-country assessment of the Mission's current economic growth (EG) programs and strategy as part of preparations for the development of their new 2009-2014 strategy. The two team members from USAID/Washington were William Butterfield, an economist in the office of technical support for the Asia and Middle East Bureaus, and Steve Silcox, Senior Enterprise Development Advisor in the EGAT/EG Office and CTO for the Business Growth Initiative (BGI) project. Dr. Butterfield focused on infrastructure and logistics while Mr. Silcox collaborated with the EGO Director, John A. Pennell, to provide initial supervision and guidance for the team. The other four team members, contracted through the BGI project, included Dr. Mohammed Chatib Basri as the Trade and Investment Specialist; Dr. John Mellor as the Agriculture/Agribusiness Specialist; Dr. John Thompson as the Finance Specialist; and Marialyce Mutchler, the Project Manager for BGI, as the Team Leader and Business Development Specialist.

The objective of the assessment team was to identify lessons learned from current EG interventions and develop detailed recommendations for future interventions in the EG area. The current USAID EG program focuses on assisting Indonesia to create jobs and generate income growth through an $80 million plus portfolio of activities aimed at improving the trade and investment climate, increasing agribusiness and industry competitiveness, and enhancing financial sector reform. All the current activities are expected to be completed in 2009.

Specific areas identified for assessment were based on current USAID programs and the findings of the USAID/Indonesia Economic Growth Stakeholders Workshop (July 2008). The assessment team addressed finance, trade and investment, business development and agriculture/agribusiness. Infrastructure was identified as a key cross cutting issue during the development of the work plan and was added as a section of the report.

The assessment team reviewed key documents from USAID, GOI and other donors, including project documents related to the USAID/Indonesia 2004-2008 Strategy, such as scopes of work, quarterly reports, workplans and deliverables for SENADA, AMARTA, ITAP, ATARP, and PROMIS.[1] Team members met with relevant stakeholders and met on a weekly basis with the USAID/EG team, presenting a workplan in week one, a discussion paper with initial findings in week two and a draft paper in week three.[2] The Assessment presented its finding to the mission in a formal presentation on August 26, 2008 and submitted the Final Report on September 2, 2008. All recommendations were made with particular regard to the new USAID Economic Growth Strategy: Securing the Future (April 2008).

USAID's (2008) Economic Growth Strategy states that economic growth occurs at the firm level. As firms find more efficient ways to organize production and distribution and improve the quality of their output, productivity increases. Firms do this by hiring more skilled workers, using better machinery, or using better management techniques. But unless the "driving" factors (macroeconomic and microeconomic policies and institutions) and "enabling" factors (e.g.,

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[1] In addition, the team reviewed the work of the USAID/Indonesia Economic Growth Stakeholders Workshop (July 2008), paper by Gustav Papanek "The Indonesian Economy and USAID's Comparative Advantage"

[2] Additional meetings were held with Terry Myers and Dave Heeson. Initial team meetings included Walter North, USAID Mission Director, the Economic Growth Office team, American Chamber of Commerce and BAPPENAS.

availability of finance, trained workforce and infrastructure) are in place, firms will not achieve the enhanced productivity necessary for broad based economic growth. In order to maximize USAID resources, programs should first seek to support large systemic impact, and where systemic reform cannot be achieved, programs should seek catalytic impacts.

Indonesia suffered more than any other country during the post-1997 Asian financial crisis as real GDP contracted 12% in 1998. Due to the political instability and the flight of foreign capital that accompanied the crisis, by 2000 GDP was only half its1997 level. The economy subsequently recovered, albeit more slowly than its peers in the region (i.e., Korea, Thailand, Philippines and Malaysia), with growth averaging 5.5% in the five year period ending in 2007. Key economic issues currently facing the GOI include poverty, unemployment, underemployment, corruption, poor infrastructure, rising food and energy prices, and regulatory burdens that manifest themselves clearly in indictors of the overall business environment.

USAID/Indonesia's economic growth resources are limited in comparison to other donors and relative to the size of the Indonesian economy. The assessment report presents recommendations that meet the objectives of the GOI that are aligned with USAID, needs expressed by stakeholders and USAID's comparative advantages in Indonesia. The assessment identified key cross cutting themes:

- *Workforce development and establishing linkages with universities;*
- *Programs should seek catalytic impacts when systemic impact opportunities are limited;*
- *Local ownership of concepts and processes;*
- *Focused and flexible program designs to meet changes in the global market; and*
- *Economic growth activities have a direct relationship to sustainable management of natural resources in Indonesia.*

Individual chapters present backgrounds detailing current activities, constraints, and other donor activities, as well as prioritized recommendations that seek to address these identified constraints in the most cost-effective and impactful manner possible.[3]

Finance Sector. Indonesia's financial system is considerably less advanced than those of its regional peers. In the next few years the country will be entering the ranks of middle income countries and thus it will need a more advanced financial sector that is supported by a sound legal and regulatory environment. Private sector bodies such as industry associations, self regulatory organizations (SROs) and private institutions will have to build capacity to meet increasing demand and the changing global economy.

The primary opportunities for USAID activities can be found in the Non Bank Financial Institution (NBFI) sector which is 1) less developed than the banking sector and 2) crucial for the next stage of Indonesia's development. BAPEPAM & LK, which is the natural counterpart for USAID, has worked with USAID in the past and would welcome the chance to resume cooperation. Assistance is requested in both capital markets and institutional investors (e.g., pension funds, insurance and collective investment schemes (CIS). Assistance can take several forms, including the provision of long-term advisors, training, regulatory assessments, and other types of capacity building. There may be opportunities to develop pilot projects designed to help

[3] While the assessment discusses various recommendations that indirectly support such key issues as improved macroeconomic stability and control of corruption, it does not address these issues specifically.

SMEs gain access to credit, which is now an area of priority for the government, and banks are seeking to sharpen their skills in relevant techniques. Such activities could build upon existing contacts with business associations and regional governments.

Trade and Investment. USAID objectives fit well with the government's programs for improving trade and investment. Nevertheless, there is a problem of implementation, enforcement and lack of priorities in the government program. Therefore, in implementing the current program or in the design of future programs, USAID should examine the effectiveness of the GOI investment policy packages and take into account the sustainability of reforms. USAID should also focus on the most binding constraints while remaining cognizant of the acceptability, support, and ownership of Indonesian stakeholders*.*

Some specific program recommendations include: 1) establishing a tariff team; 2) implementing a regulatory impact assessment (RIA) program in the Ministry of Trade (MOT); 3) creating a team to examine and support the development of Trade in Services Sector in the MOT; 4) designing a campaign that addresses Intellectual Property Rights (IPR) with concerns for both industry and consumers; 5) mapping the key problems in logistics and creating a blueprint for the logistics sector; 6) supporting the MOT on an early warning system for food prices by providing an information system for monitoring commodity prices; 7) conducting a study and a road map for special economic zones; 8) supporting the National Team of Export and Investment Acceleration (PEPI) by providing capacity building for the technical staff and providing consultants and senior advisers to develop strategies for improving the analytical and reporting capacities of PEPI.

Business Development. Current USAID/Indonesia programs have focused on business development through improving the business environment, integration of SMEs into industrial value chains through the development of business services, the application of international standards, and increased access to markets. Recommendations for future activities seek to leverage the most successful lessons of these projects and work through local partnerships.

Specific recommendations include an approach that focuses on local economic development. Projects should work with local governments to build dialogue between private sector leaders, associations, community leaders, and learning institutions/universities. Additional programs to consider are: 1) Global Development Alliance (GDA) partnerships with domestic and international private sector firms that will successfully support USAID EG activities and Indonesian business development as well as leverage additional resources to support capacity building and the sustainability of initiatives; 2) support the small but growing sector of business service providers (BSPs) by leveraging existing resources in an approach that works with local and national government entities to competitively contract out services to multiple providers; 3) support business education and the development of a network of entrepreneurship education institutions through partnerships with foundations and universities that are dedicating resources for this purpose; 4) capacity building for both the Ministry of Industry (MOI) and BAPPENAS to promote institutional change through the promotion of a better understanding of the role of government and the private sector in business services development.

Crosscutting programs recommended for consideration are 1) continued support for the ICT sector as a catalyst for business development in Indonesia; 2) tourism sector development; 3) increased linkages with natural resource management programs and activities.

Agriculture and Agribusiness. Employment growth and its twin, poverty reduction, is a central concern. While the urban formal economic sector is growing to dominant status in the economy, agriculture and its multipliers will have to respond to immediate needs of employment creation and poverty reduction. All commodity groups in agriculture will have to play a significant role if the desired five percent growth rate is to be achieved. However, the horticulture sector will play the single most important role, with the capacity for the highest growth rate of the major sub-sectors of agriculture already contributing significantly to production.

It is recommended that US foreign assistance strategy focus on a large commodity sub-sector and set in motion processes that will have major and lasting aggregate impacts. Horticulture, coffee and coca are proposed for the commodity focus on the basis of their current importance, potential for rapid growth, and past history of US effort. Components of the strategy should include: 1) strengthen the research staff with Ph.D. training in the US to push in the direction of applied research that diagnoses and treats the real problems of farmers and renews linkages with US land grant University systems; 2) address several large policy issues related to horticulture, such as the place of horticulture in the agricultural strategy and the need for a rural road policy that serves these key commodities; 3) strengthen the private sector horticultural seed industry through associations and farmers groups.

Infrastructure. USAID can have an indirect and catalytic impact in economic development through a program of providing technical assistance through an Infrastructure Advisory Unit (IAU) to either national or local government units that are identified as having the political will to improve their policies, effectiveness, and outcomes related to infrastructure, which is the most commonly identified constraint to growth in Indonesia. Improving the capacity and effectiveness of the Indonesian government in managing infrastructure policy can have the result of improved and expanded infrastructure across the nation without having to fund construction directly.

Specific recommendations include: 1) establish a local government IAU that will assist identified provincial and district governments with planning and logistics, regulatory efficiency, procurement and tendering, coordination, and financing; 2) establish an IAU for sea ports, railroads and logistics that will provide port management and regulatory training to the Port Authorities, the new regulatory port body as well as monitor implementation of the 2008 law on ports and 2007 law on railways and provide implementation oversight; 3) establish an IAU for public-private partnerships (PPPs) that will work directly with key government agencies to produce pre-feasibility studies and procurable, commercially viable, and bankable project documents; 4) build the capacity of the National Land Agency (BPN) by conducting specific work on public land appraisal and acquisition.

ACKNOWLEDGEMENTS

The assessment team would like to thank the USAID/Indonesia Economic Growth Office and staff members of the SENADA, AMARTA, and PROMIS projects for their help in providing background information for this assessment as well as the considerable time spent with the team to acquaint them with various project aspects and relationships. This assessment could not have been conducted without the able assistance of the current USAID/Indonesia projects. We would also like to thank USAID/Indonesia staff for their guidance on this assessment and their flexibility in arranging various meetings and handling some logistical issues as well.

The team would also like to thank Lauren Budnick and Carolyn Kirchhoff of Weidemann Associates, Inc. for their support and assistance to the team.

I. Background/Context

This assessment is part of a series of activities to formulate a new five-year strategy for economic growth by USAID/Indonesia.

The first activity was an "Economic Growth Stakeholders Workshop" held on July 8-10, 2008. Participants in that workshop included USAID staff and contractors/NGOs, Government of Indonesia (GOI) partners, and other interested parties. The Mission Director, Walter North, opened the workshop and highlighted a number of accomplishments by USAID in the economic growth area. Gustav Papanek, an economist at the Boston Institute for Developing Economies and a consultant with extensive experience in Indonesia, participated in the retreat and prepared a paper on his findings and recommendations for future activities by USAID/Indonesia in the economic growth area. Mohammed Chatib Basri, an economist at the Institute for Economic and Social Research at the University of Indonesia – a respected think tank in Indonesia – also participated in the workshop and is a member of this assessment team. Another key participant at the workshop was Pak Sidqy Suyitno, Director of Financial Service and Monetary Analysis at BAPPENAS who highlighted some of the GOI's plans in this economic growth area.

During this assessment, Walter North, the USAID Mission Director, requested that a former USAID/Indonesia Mission Director, Terry Myers, and another former USAID staff member who had previously served in Indonesia, Dave Heeson, conduct their own independent assessment of USAID's current programs and recommend potential areas for future activities as part of the Mission's next five-year strategy. Both of these former USAID/Indonesia staff members were in Indonesia for other business and contributed their reflections on how the USAID program might evolve over the next few years.

This assessment included two team members from USAID/Washington and four consultants contracted by Weidemann Associates, Inc., under the Business Growth Initiative (BGI) contract of the EGAT/EG Office in USAID/Washington. The assessment focused on the five key areas of finance, trade and investment, agriculture/agribusiness, business development, and infrastructure/logistics.

The two team members from USAID/Washington were William Butterfield, an economist in the technical office for the Asia and Middle East Bureaus, who focused on infrastructure and logistics, and Steve Silcox, Senior Enterprise Development Advisor in the EGAT/EG Office and CTO for the BGI project, who collaborated with the EGO Director, John A. Pennell, to provide initial supervision and guidance for the team.

The other four team members included Mohammed Chatib Basri (mentioned above as a participant in the workshop) as the Trade and Investment Specialist; John Mellor as the Agriculture/Agribusiness Specialist; John Thompson as the Finance Specialist; and Marialyce Mutchler, the Project Manager for BGI, as the Team Leader and Business Development Specialist.

The Economic Growth Office (EGO) of USAID/Indonesia will use this information in formulating a new five-year strategy for economic growth as part of the Mission's overall strategy development process for the 2009-2014 period. This new strategy will form the basis for the design of new projects in the economic growth area to begin in late 2009 when the rest of the portfolio of existing economic growth projects is projected to be complete.

II. Development Priorities

A. Economic Growth Transforms Societies and is a sine qua non for Poverty Alleviation

Economic growth is key to transforming the developing world. Economic growth enables countries to reduce and eventually eliminate extreme poverty. It is the surest way for countries to generate the resources they need to address illiteracy, poor health, and other development challenges on their own, and thus to emerge from dependence on foreign aid.

The consequences for ordinary people have been enormous. In 1950, South Korea's per capita income was roughly $770 in dollars of 1990 purchasing power; Ghana's was considerably higher, at $1,122. Over the next five decades, per capita income in South Korea rose dramatically to $14,343, while Ghana's crept upward to just $1,280. In 1950 life expectancy in South Korea exceeded that in Ghana by four years. The gap has since grown to 20 years. Most citizens of both countries lived on less than $2 per day in 1950. By 1998, 78 percent of Ghanaians, but less than 2 percent of South Koreans still lived in such poverty. Similar gaps emerged in education, health, and other measures of well-being. Due largely to their contrasting records in economic growth, Korea has achieved transformational development, whereas Ghana remains at a much earlier stage of this process.

South Korea has become a significant and constructive actor on the world stage as well as one of America's top trading partners, with two-way trade exceeding $70 billion in 2005. U.S. trade with Ghana remains less than $0.5 billion. Korea supports development in other countries through its own foreign aid program; Ghana remains dependent on assistance.

This example shows how economic growth increases incomes and improves livelihoods. While poverty alleviation measures can assist in short term income redistribution, unless they are coupled with economic growth, longer term prospects for poverty reduction are dim.

B. The Key to Economic Growth Is Rising Productivity

Economic growth occurs as societies accumulate and equip workers with more and better physical capital (e.g., factories and infrastructure) and human capital (skills and knowledge), and use these assets ever more productively to produce goods and services of increasing value. Among these sources of growth, *increases in productivity account for most of the differences in economic growth among countries.* Productivity grows as producers — entrepreneurs operating at all scales — find ways to squeeze more output from a given set of inputs. They do so by adopting more efficient production methods, applying technical knowledge to create better products, changing their product mix, etc. Capital accumulation and productivity growth both result from the independent efforts of millions of individual producers, constantly working to create new, better, and less costly goods and services through ingenuity and investment. Those efforts, in turn, are guided by the incentives that producers face — incentives strongly affected by public policy enforcement of contracts and property rights, the prevalence or absence of corruption, and other aspects of economic governance. (From "Securing the Future: A Strategy for Economic Growth, USAID, April 2008).

C. The Indonesian Economy and Key Development Issues

Key economic issues currently facing the GOI include poverty, unemployment, underemployment, corruption, poor infrastructure, rising food and energy prices, and regulatory burdens that manifest themselves clearly in indictors of the overall business environment. Employment, poverty alleviation and increased incomes were identified in discussions with BAPPENAS and were the top three issues in a nation-wide public opinion survey conducted by the International Republican Institute, as outlined in a presentation at USAID/Jakarta on August 13, 2008. Also cited as key constraints are the costs of corruption, and weak and deteriorating infrastructure, both of which have direct impact on the cost of doing business, production and the competitiveness of goods.

The effects of the 1997 Asian Financial crisis continue to have an impact on the Indonesian Economy. A number of studies have noted that Indonesia suffered more than any other country during the post-1997 Asian crisis. During the decade that preceded the crisis, annual GDP growth rates averaged 8% and major strides were made in economic diversification, employment creation and the expansion of manufactured exports. With the onset of the crisis, however, a large number of major firms became bankrupt and a major crisis in the domestic banking system occurred. The majority of banks became insolvent and foreign confidence evaporated. Real GDP contracted 12% in 1998. Due to political instability that accompanied the crisis and a cutoff in foreign financing, Indonesia was slower to recover than other crisis countries (i.e., Korea, Thailand, Philippines and Malaysia) and by 2000 GDP was only half its level of 1997. The economy subsequently recovered, albeit more slowly than its peers in the region, with growth averaging 5.5% in the five year period ending in 2007.

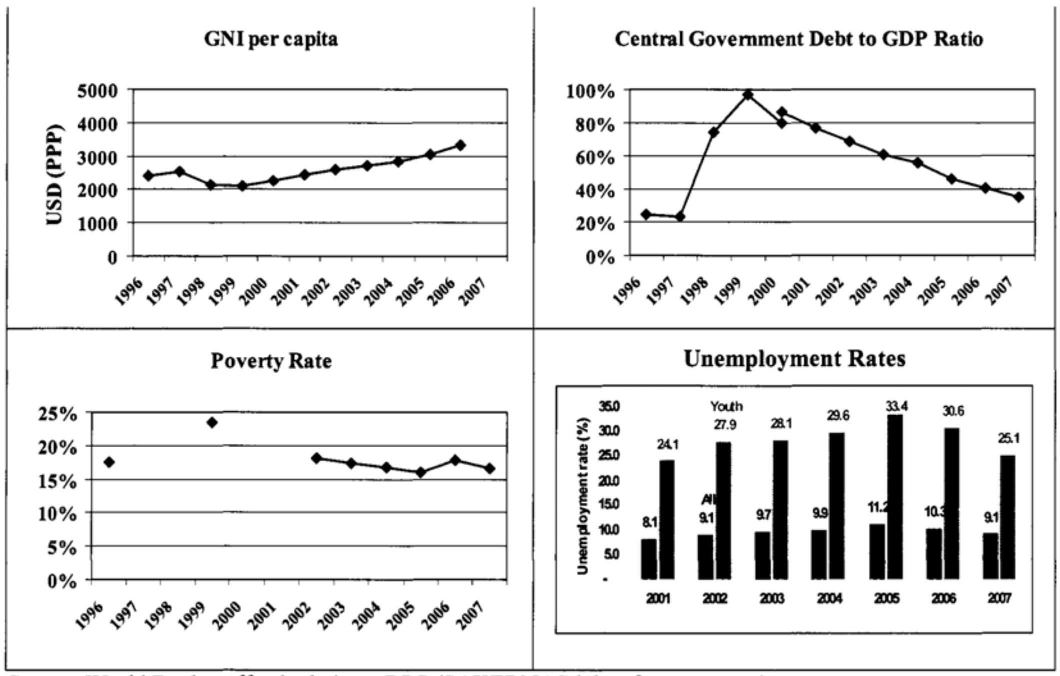
Despite the slow recovery from the crisis, there is a broad consensus that economic performance could and should improve significantly. The gap between Indonesia and the more dynamic Asian countries is widening. While the poverty rate has fallen one percentage point between 2003 and 2007, nearly half of Indonesia's population was still poor or had per-capita consumption levels of less than a third above the national poverty line.[4] Those living at and near the poverty level are most vulnerable to economic shocks. This was demonstrated in the recent upturn in the poverty rate which appears to have been caused primarily by a sharp increase in the price of rice between February 2005 and March 2006. This factor largely accounted for the increase in the poverty headcount rate to 17.75 percent.

The recovery in aggregate growth has not produced proportional gains in well-paid employment. The open unemployment rate rose from 9.1 percent in 2002 to 10.3 percent in 2006, and fell back to 9.1 percent in 2007. More than 60% of the labor force is employed in the informal sector while job creation in the higher-paying manufacturing and modern service sectors has been minimal. In agriculture and rural SMEs, which

[4] World Bank and the IFC, Indonesia Country Partnership Strategy (CPS) 2009-2012.

dominate the informal sector, productivity levels remain low and growth is stagnating. Youth unemployment and underemployment remains high with only about 30 percent of Indonesia's growing labor force making the transition to high-value added activities in the industrial and manufacturing sector.

Figure 1: Indonesia per capita income, government debt, poverty; unemployment



Source: World Bank staff calculations, BPS (SAKERNAS labor force surveys).
Note: Central Government Debt to GDP Ratio was recalculated in 2000. Poverty data were only available on an annual basis from 2002 onwards.

The paper by Gustav Papanek states that the key problem facing the Indonesian economy is limited job growth and growth based on commodity exports. He asserts that although Indonesia has had an impressive macro-economic performance in the last 3 years (growth of 6% and accelerating; investment at 25% of GDP; debt down by over half; exports since 2004 increasing at 18% a year), growth has been virtually without a significant increase in jobs. Since 1997, 20 million people have been added to the labor force, while only 3 million productive jobs have been generated.

The largest share for employment is in the agriculture sector, which is predominately in the informal sector. However, the employment growth in agriculture has been relatively slow and in some years experienced negative growth. Table 1 demonstrates that employment growth in the services (trade, transport etc.) sector has been relatively high compared to other sectors. However, its share is relatively small compared to both agriculture and manufacturing (which experienced slow growth in employment). While the stimulus from farm incomes to the rural non-farm sector will help growth in the agriculture sector it will not address the employment needs of the estimated 300,000 undergraduates that are entering the workforce each year, who are largely under and unemployed. The characteristic of the Indonesian workforce are changing. The characteristic of the unemployed and underemployed is more urban and educated resulting in an increase in demand for work in formal sectors such as services and manufacturing.

Table 1: Share of Employment by Sector
Share (%) Percent of Total Employment

Year	Agriculture	Manufacturing	Trade, Hotel and Resto.	Transport and Comm.	Finance
2000	45.28	12.96	20.58	5.07	0.98
2001	43.77	13.31	19.24	4.90	1.24
2002	44.34	13.21	19.42	5.10	1.08
2003	46.26	12.04	18.56	5.48	1.43
2004	43.33	11.81	20.40	5.85	1.20
2005	43.97	12.72	19.06	6.02	1.22
2006	42.05	12.46	20.13	5.93	1.41
2007	41.24	12.38	20.57	5.96	1.40

Indonesian Statistic Agency (BPS)-Statistics

Papanek asserts that regaining Indonesia's competitive position is crucial to providing productive jobs. This is consistent with the changing characteristic of the Indonesian workforce. However, other obstacles remain. Before the Crisis of 1997 high costs due to poor infrastructure, corruption and expensive labor regulations were compensated by low labor costs and lax labor law enforcement. Enforcement has been tightened and minimum wages have been increased and are better enforced. As the exchange rate has appreciated about 10% since 2005, it has further increased labor costs for exporters. Labor-intensive exports have been hit especially hard by higher labor costs and have lost market shares. The role of improved infrastructure and logistics as well as improved technology and innovation in Indonesia's agriculture/agribusiness industries and in its manufacturing and services sectors will be critical in improving Indonesia's economic prospects.

Team discussions with key private sector commodity export firms in Indonesia revealed a similar concern about the risk of commodity-led export growth. Commodities are notorious for being subject to global variables outside the control of commodity exporters and prices can easily decrease as quickly as they increase. Papanek observes that increased Indonesian earnings from commodity exports in recent years has resulted mainly from substantial price increases of the commodities while actual quantities of commodity exports have grown very slowly.

Higher investment in productive resources is only one of the elements in a strategy to accelerate development. At least equally important is the nurturing of an environment conducive to ongoing gains in productivity. In the past, the role of government was seen as directing the allocation of resources in order to accelerate growth while the lack of financial resources was seen as the main constraint. By contrast, the current environment markets are seen as the main drivers of economic performance, and the function of economic governance is to unlock the growth potential of markets by good regulation as well as by well-designed systems to extend positive support.

Increasingly, the creation of a business climate that stimulates businesses and individuals who seek to increase their income by producing higher quality outputs is a key challenge in development. In the past few years, considerable efforts by USAID and other donors have been devoted to measuring the degree to which the business environment favors productive activity and the quality of economic governance. Quantitative measures of the business environment are used to pinpoint where countries have particular vulnerabilities and to determine how countries perform compared to their peers.

Some major investment/business climate and economic governance indices used by the international development community are: the Global Competitiveness Index (GCI) of the World Economic Forum in Switzerland; the Doing Business Rankings of the World Bank; the Heritage Foundation's Index of Economic Freedom (IEF); the Economist Intelligence Unit's (EIU) Business Environment Rankings; and the Global Entrepreneurship Monitor (GEM) produced by Babson College and the London Business School. Other indicators include the World Bank's Governance Matters and Country Policy and Institutional Assessment (CPIA) scores, as well as the Cato and Fraser Institute rankings. While the methodology of these indices all differ in various aspects (See BGI paper comparing various business climate indices in ANNEX IV: Alternative Business Enabling Environment Rankings.), the overall rankings and scores of countries tend to be correlated in terms of the general business environment and per capita income.

On most of these indices, Indonesia generally ranks in the lower-middle overall. With respect to its neighbors, Singapore always comes in close to the top and Malaysia and Thailand in the upper-middle. Indonesia almost always beats Cambodia and Timor-Leste and normally clocks in just ahead of or just behind the Philippines and Vietnam (e.g., Indonesia is ahead of Vietnam and the Philippines in the GCI, but behind Vietnam in Doing Business and behind the Philippines in the IEF). While each index may have different rankings for specific areas, they tend to underline similar problems in Indonesia, namely regulatory burdens, inflexible labor laws, and corruption. These ranking systems are useful in identifying problems in the business environment, but they do not provide prescriptive analyses that will necessarily assist donors to determine the most effective means to address these problems. This must be done in conjunction with local stakeholders and deal with political realities on the ground.

III. Cross Cutting Themes

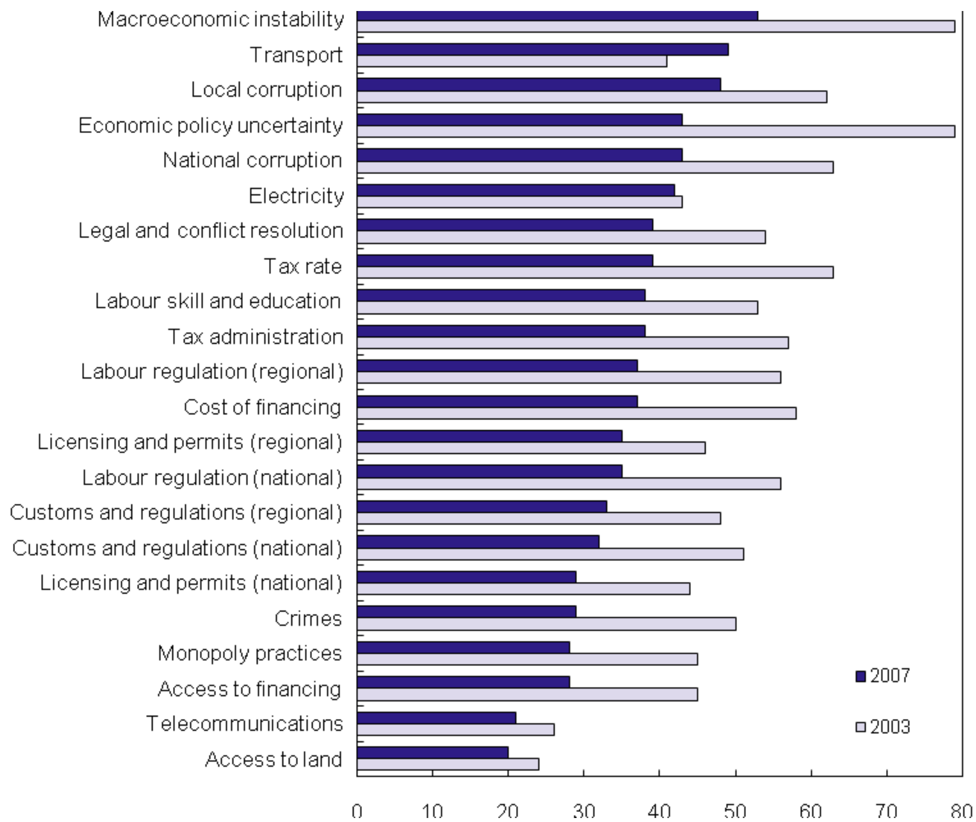
A. Corruption and Infrastructure

Public and private sector stakeholders cited corruption and infrastructure as the two leading constraints to economic growth at the national and local levels. Influenced in part by the devolution of regulatory authority and revenue raising function to the district and city levels, grafts and local corruption has erupted as a major issue. Prior to decentralization, a strong central government lead to the predictability of graft. Decentralization brought with it a shifting of responsibility for the provision of services. Most notable is the state of infrastructure and land ownership issues. Lack of clarity on roles and responsibilities of the central, provincial and district government has resulted in inaction. The impact on the cost of doing business has been significant.

However, decentralization also has brought with it opportunities in increased engagement by civil society, community leaders and private sector leaders in shaping their future. Improved access to information, increased public private sector dialogue and engagement in local political processes are improving local economic governance and development. USAID programs have had significant success working at the local level building public private sector dialogue, increasing transparency and promoting improved business climates at the local level.

Figure 2 Indonesia's main business constraints, 2003 and 2007

Per cent of firms reporting the issue as business constraints



Data for 2003 is available from Asian Development Bank (2003) and for 2007 from LPEM FEUI (2007a). Source: Asian Development Bank (2003) and LPEM FEUI (2007a).

B. Workforce Development/Institutional Linkages

Many of the persons interviewed by the assessment team indicated that capacity building, both in government ministries/agencies and in the private sector, is crucial to improved Indonesian economic performance and governance. While most individuals at the highest levels of government and business have excellent educational qualifications and many have received degrees from American and other foreign universities, it is unreasonable to expect that most mid-level company managers and civil servants will be able to afford an overseas degree. Thus it is important to build the capacity of Indonesian universities and other higher-level educational institutions to train the bulk of Indonesians working in those mid-level positions. USAID is in a good position to sponsor linkages between U.S. and Indonesian educational institutions, based on past relationships and evolving programs accessible to USAID. Some potential new linkages involve public-private partnerships between, for example, ICT companies and local training institutions. USAID/Washington has entered into agreements with a number of multinational companies that can help to develop training programs in specific countries, like Indonesia, and to share costs in program expenditures.

C. Catalytic Impacts when Systemic Impact Opportunities are Limited

The limited amount of USAID resources in Indonesia makes many systemic impacts on the Indonesian economy difficult without substantial resources from other sources, be they government, the private sector or other donors. In some cases, the lack of political will constrains improvement in economic growth despite the potential of adequate resources to address the problems. While USAID should look for opportunities for systemic impacts, it should also consider the options for catalytic impacts when those systemic impacts cannot be reasonably achieved. This includes focusing on specific government ministries or agencies that have demonstrated their interest in reform and improving the economic performance of specific sectors or geographic areas. This could include activities supporting champions in trade and investment or in local economic development. It could also include support of economic growth activities that are environmentally friendly and provide opportunities for better natural resource management. In these instances, it is critical that champions for change be identified and supported through resources, training and technical expertise.

D. Local Ownership of Concepts and Processes

As in almost all development contexts, it is important to focus on issues and activities that have local ownership, both on the part of government officials and private sector players. This is particularly true in Indonesia where both government and the private sector have dealt with donors for over three decades. Since USAID activities are tied to a Strategic Objective Agreement between USAID and the GOI that is reviewed annually by BAPPENAS, agreement between the two governments is crucial. Likewise, unless the key private sector players in any USAID activities are in agreement with the objectives of those activities, no amount of training or technical assistance can achieve the desired results of a project. This ties in with identifying local champions who are interested in the success of USAID activities as noted in Section C above. USAID's economic growth strategy and subsequent projects must build on the experience of previous projects by working with those individuals and entities that show the most promise and are committed to program or project objectives.

E. Focus and Flexibly in Program Design to meet Changes in the Global Market

The speed at which today's global markets operate, in terms of product quality tied to international standards, access to markets, finance and business services, and improved technology and innovation, present increased challenges to both governments and private firms to compete. This means that government must provide an enabling environment for firms through both a business friendly legal and policy environment and through the provision of infrastructure and other resources that allow companies to grow. Companies must improve the quality of their products and services as well as the efficiency of their operations in order to be competitive. A possible role for donors such as USAID is to provide assistance to both government and the private sector to help them address these needs.

A key objective in this assistance is the achievement of systemic or catalytic impacts through the design of intensive activities that utilize a more focused and narrow approach. This could mean working in a limited number of sectors in agriculture/agribusiness and in business development in order to achieve some quick wins while setting the basis for a higher level of impact in terms of long term economic growth and job creation. This might include working in a limited number of sectors in agriculture/agribusiness or in business development in order to achieve a higher level of impact than working with a broader or greater number of sectors. At the same time, programs should be flexible in order to take advantage of opportunities for change that were not contemplated during activity design, such as a newly found champion for change under a new government or an emerging sector with great potential that was not identified during the program design phase. The combination of greater focus with the flexibility to change program interventions or institutions/firms/associations as opportunities develop may seem contradictory, but is an important aspect of success in economic growth development in today's global marketplace.

F. Economic Growth, Energy and Sustainable Management of Natural Resources

Economic growth in Indonesia is linked directly and indirectly with activities and issues related to natural resources management and the environment. Lack of sufficient access to electrification, specifically in rural areas and for SMEs is a key issuing facing economic growth activities in Indonesia. This issue was cited among the top five constraints in meetings with stakeholders and identified at the USAID/Indonesia Economic Growth Stakeholders Workshop in July 2008. Assessment team meetings with USAID/Indonesia Mission Director Walter North and Alfred Nakatsuma, Director of the Office of Basic Human Services, expressed an interest in working with GOI on the development of clean technology and carbon trading systems. Opportunities may exist to work with the USG Clean Technology Fund, building linkages with Indonesia technology and research centers and private sector partners, through the newly established Business Innovation Center as well as public private partnerships with multinational companies.

The Indonesia economy is heavily dependent on its natural resources. An estimated 55 percent of the workforce relays on non-oil resources for employment making up 20 per cent of GNP. Two thirds of Indonesians live in rural areas and are directly or indirectly dependent on communal land, and coastal and environmental resources.[5] Current activities under the USAID AMARTA and SENADA projects have a direct relationship to sustainable management of natural resources. By collaborating on issues such as certification of community forests, work with fisheries and coffee and cocoa sectors programs can leverage mission resources and achieve more aggregate impact ensuring sustainability of USAID interventions.

IV. Methodology

The methodology for this assessment included the following:

- Review of written materials of GOI, USAID and other U.S. Government, USAID project implementers, international organizations and academic materials

[5] World Bank/IFC, Indonesia Country Partnership Strategy (CPS) 2009-2012.

- Interviews and discussions with:
    - USAID officials
    - Other U.S. officials
    - Indonesian officials
    - USAID program/project implementers
    - Representatives of other donor organizations
    - Private market actors
    - Independent analysts
- Periodic consultations among team members
- Field trips outside Jakarta as needed
- Preliminary conclusions of each team member with respect to their sector
- Identification of "overarching themes" by discussion among team members
- Feedback from USAID personnel
- Development of final report

A. Key dates

August 4 – In-briefing with Mission Director and EGO staff
August 11 – Meeting with USAID EGO staff to review team progress
August 19 – Meeting with USAID EGO staff to discuss preliminary key findings and conclusions (A Discussion Paper on these points was submitted at this meeting)
August 25 – Submission of draft team report
August 26 – Debriefing on draft team report with USAID Jakarta
September 1 – Submission of final team report based on comments received from USAID staff

B. Format of Report

The following sections of this report address the five areas of finance, trade and investment, agriculture/agribusiness, business development and infrastructure/logistics. Each section reviews the current status of the area, a discussion of the strengths and weaknesses of existing USAID programs/projects in the area, and recommendations for future activities for USAID. Annexes are provided that explain in more detail specific issues that arose in the body of the report.

V. Financial Sector

A. Background

If Indonesia is to achieve faster growth through increased investment in capital equipment and infrastructure, the capability of the system to provide finance will have to increase. As the USAID Economic Growth Strategy[6] observed, economic progress occurs as firms find more efficient ways to organize production and distribution or to improve the quality of their output by hiring more skilled workers, using better machinery, or improving management techniques. In an economic environment conducive to growth, financial intermediaries seek out firms with good records of financial strength and/or credible growth prospects, work with those firms and provide them with the financial resources to conduct and expand their business.

The stability of the financial system is also an important objective. The country was traumatized by the 1997 Asian crisis. During the past decade huge amounts of money and much of the energy of key officials had to be expended on dealing with the repercussions of the crisis.

Table 2: Indicators of Financial Development in S.E. Asia
Financial Assets as a Share (%) Percent of GDP in 2005

	Bank	Insurance	Pension Funds	Mutual Funds	Bonds	Equity
INDONESIA	54	3	4	1	6	29
Thailand	115	3	5	12	12	79
Malaysia	160	20	56	20	38	162
Singapore	233	50	66	20	32	162

Source: World Bank, 2006.

1. Comparatively Underdeveloped and Bank-Dominated Financial System

As Table 2: Indicators of Financial Development in S.E. Asia demonstrates, the Indonesian financial system has a relatively low level of overall development. Holdings of all categories of financial assets account for lower shares of national income than in comparable Asian countries, such as India, Malaysia and Thailand. Much of the population has little access to banking services with the ratio of bank loans to GDP at around 20% compared to 95% in Thailand and about 120% in Malaysia and Singapore. Although the banking sector is small by international comparison, it is by far the dominant component of the financial system, with bank deposits accounting for some 80% of all financial assets. Because banks mainly deal in short-term operations, reliance on bank finance has lessened the capability of the system to provide long-term financing to high priority sectors such as industrial development, infrastructure and housing.

With the country now emerging from the aftermath of the crisis, the top priorities of the government are: 1) to continue restructuring the banking system in order to make it more prudentially sound and better able to support economic growth; and 2) to accelerate the

[6] USAID Economic Growth Strategy: Securing the Future. April, 2008.

development of non-bank financial institutions (NBFIs) which are considerably less advanced than the banks.

The past decade has witnessed a sizeable expansion of Islamic financial products; i.e., instruments that are similar to conventional financial instruments but structured so as to conform to restrictions in the Koran concerning the payment of interest. While still a rather small part of the financial system, these instruments have become well established in several sectors. Many banks are targeting Islamic banking. As of August 2007, only 1.3% of bank assets were in Shariah-compliant products but Bank Indonesia (perhaps over-optimistically) projects the proportion to grow to 5% by end-2008. There are three pure Shariah banks, while 24 conventional banks have opened Shariah units. The government recently issued its first Shariah–compliant bond-like product (sukok) in the domestic market and further issues are planned. Sukok have also been issued in foreign currency for placement with foreign investors. Islamic financial products are also found in the mutual fund and insurance sectors.

a. The Banking System

When discussing banking it is essential to highlight the pivotal role of Bank Indonesia, which is both the central bank and the banking supervisor. Partly owing to its leading role in guiding the resolution of the banking crisis, Bank Indonesia has emerged as a powerful institutional force guiding the transformation of the banking system.

Prior to the 1997 crisis, the banking system was comprised of state-owned banks as well as large domestic banks, which were often linked to industrial conglomerates and usually under the control of a wealthy family. Due to practices such as connected lending within conglomerates and borrowing in dollars for lending in local currency, the system proved highly vulnerable during the crisis when the evaporation of foreign credit and the sharp fall in the currency drove many corporate entities and banks into bankruptcy. The major banks became insolvent and outstanding credit contracted sharply, aggravating the decline in real income. The recapitalization of the banks entailed expenditures of $45 billion (about 50% of 1997 GDP) and incapacitated the financial system for much of the ensuing decade.

Working closely with the IMF, the international development banks (the World Bank and the Asian Development Bank (ADB) and the Bank for International Settlements), the authorities, led by Bank Indonesia, engineered a recovery in the banking system. In the case of banks that had become insolvent, the government became the majority owner while acquiring large portfolios of non-performing loans (NPLs). In the course of the rehabilitation, the insolvent banks acquired by the government were sold to foreign strategic investors, mostly from other Asian countries (e.g., Malaysia, Singapore, India and Korea). The government also sold minority stakes in the major state-owned banks. With stronger ownership and governance structures, bank managements are under strong pressure to adhere to strict norms of internal risk management and earnings.

Bank balance sheets have been strengthened; NPL ratios were reduced steadily -- from 35% of total assets at the time of the crisis to less than 3% at present. Bank capitalization ratios now average 20%, well in excess of the international norm of 8%.

Most banks are comparatively well rated by agencies such as Moody's and Standard and Poor's.[7]

There are over 130 national commercial banks in the country, a reduction from 220 at the time of the 1997 crisis. There are also thousands of small regional banks and credit cooperatives. Although there are many small credit institutions, the system is rather concentrated. The four largest banks, of which three are state-owned (Mandiri, Negara and BRI), control nearly half of total bank assets while the ten largest hold 60% of total assets. At the same time, some analysts believe that the state-owned banks have not fully resolved their problems of balance sheet quality.

As the recovery from the 1997 banking crisis gained traction, Bank Indonesia in 2004 articulated its Banking Architecture Plan, a sweeping strategy aimed at developing a core of prudentially sound market-oriented banks capable of providing a broader range of financial services with more competition and reduced systemic risk (McKinsey, the international consulting firm, played a major role in developing the Plan). The Plan aims to consolidate the industry into 58 national banks through mergers and acquisitions over a period of 10-15 years. In order to encourage consolidation, the minimum capital required to maintain a banking license for a national bank was raised from 3 trillion RPH to 80 trillion RPH in 2007. Bank Indonesia envisages that banks will be stratified by size into categories such as international-class banks, national banks and specialized or rural banks.

As part of the transformation of the banking landscape, banks will be expected to move from their earlier business model which stressed lending to large corporate entities (often in affiliated groups) to lending to consumers and SMEs, while larger corporate entities are expected to rely more heavily on capital markets. As the banking transformation proceeds, banks will seek to expand lending to SMEs. This will probably mean that banks will be seeking to overcome traditional structural obstacles in SME lending such as lack of collateral, opaque accounts and ambiguity about the legal position of creditors.

B. Prospects for USAID Collaboration in the Banking Sector

Bank Indonesia has gained considerable institutional strength and is now a highly respected institution that is fully integrated into the international financial network, benefiting from its working relations with other central banks and bank supervisors. To the degree that Bank Indonesia needs to work with foreign partners, it is likely to call first on the IMF, the Basel Committee or other central banks and banking supervisors. Therefore, the margin for USAID participation is small.

At the same time, there may be some opportunities to participate in the development of the banking system by well targeted programs to support SME finance, which is now a priority sector for expansion. Since banks will be deliberately seeking to develop this market sector, USAID could conceivably use its expertise in microfinance and business environment development to assist SMEs, especially those that are trying to expand, in gaining access to bank credit. While some surveys do not indicate that lack of external

[7] Indonesian banks are rated below investment grade, but this is due mainly to the sub-investment grade sovereign rating of Indonesia.

finance is a critical barrier to the growth of SMEs, limited access to finance is a constraint for growth. Part of this process would be to seek out firms with good growth prospects that are ready to progress to the stage of seeking credit through the formal banking system. Such firms can be identified through micro-finance institutions or through local business support networks. Assistance can take the form of "coaching" or the provision of business services. USAID's current DCA loan guarantee fund, addressed in section VII Business Development, could be modified to address these needs, which can be helpful as firms and banks develop risk sharing formulas in order to mitigate the risks of SME lending. The logical partners for such an activity would be major national banks that are seeking to expand into new areas, smaller regional banks (and other depositary institutions), regional governments and regional business associations. Other donors, especially the IFC, have small scale programs in this sector as well (see below).

1. The Non-Bank Financial Sector

In all likelihood, the non-bank financial institution (NBFI) sector will offer more opportunities for USAID activity than the banking sector, simply because NBFIs are increasingly seen as crucial for the next phase of development and because their starting point is very low. For example, the assets of all institutional investors amount to only 7% of GDP in Indonesia compared to 20% in Thailand and over 100% in Malaysia and Singapore.

The development of NBFIs is crucial for Indonesia in its next phase of development. Since the system is overly dependent on bank finance it has limited capability to engage in long-term finance, which is usually provided by the capital market rather than through the banking system. The lack of depth in the capital market is a structural impediment to growth in high priority sectors such as industrial expansion, housing infrastructure and local government finance.

Since institutional investors, especially pensions, insurance and mutual funds, usually are the main investors in capital markets, the absence of such investors imposes a severe constraint on the potential growth of the capital markets. In addition to their role in supporting capital market development, pensions and insurance are important in themselves inasmuch as they enable citizens to deal with many risks and uncertainties inherent in a modern economy. Pensions and insurance also form part of a broader "social safety net." The social safety net consists of public and private systems which enable the population to mitigate the financial shock of events such as untimely death, disability and unemployment and also provide retirement income for a population in which life expectancy is rising. At present less than 10% of the Indonesian population is covered by any form of pension or insurance. If as is hoped, the level of income rises in coming decades, demand for pensions and insurance and other forms of institutional savings will rise.

The challenge is much more fundamental in the NBFI sector than in banking. In some sub-sectors, basic laws and regulations will have to be enacted or revamped. The capability of the supervisors to provide effective oversight to the market will have to be strengthened, in some cases starting from very low levels. The officials responsible for the legislative and regulatory framework will have to work closely with self regulatory organizations (SROs), private industry associations and individual firms, all of which will need to acquire new capabilities. Finally, there is a task of educating legislators and the general public about how NBFIs can help the country and its citizens to attain their basic objectives, a task that is made more difficult by some negative experiences with insurance, pensions and mutual funds.

Despite the difficulties ahead, it is an observed trend in all markets that as the financial system becomes more advanced, the capital market grows relative to the banking sector while the holdings of the public shift from bank deposits to the assets of institutional investors. Moreover, demand will rise for instruments such as pensions, insurance and mutual funds as the country begins to construct a social safety net — almost from scratch. As Indonesia moves into its next stage of financial development, the NBFI sector will be called upon to shoulder a larger part of the burden of financing.

The priority of developing the NBFI sector is now recognized at high policy levels. Thus in a speech in 2006, Finance Minister Sri Mulyani Indrawati outlined the urgency of moving away from excessive reliance on bank finance and committed her ministry to accelerate support for the NBFI sector. The Finance Minister noted that development of a vibrant non-bank sector is particularly important for the development of longer-term finance. The banking system basically receives short-term deposits and extends short-term loans. Some 90% of deposits have less than one month maturity. In view of the need to avoid maturity mismatches, banks simply cannot supply long-term funds on the scale required. However, the private sector needs longer-term financing in order to increase expenditure on plant and equipment, while expenditure on public infrastructure will have to grow significantly in order to raise growth and increase living standards. Housing finance, another important priority, also requires long-term funding. The Finance Minister also alluded to the challenge facing NBFIs because the vast majority of the population does not have pensions or insurance coverage, instruments that are basic characteristics of every advanced economy.

A group of market participants have taken the initiative in creating a “Blue Ribbon Commission” of former office holders, academics and market practitioners to identify key problems in the NBFI sector and make recommendations for policy remedies. So far the commission has begun working on insurance issues, but it is expected to broaden its work into other parts of the NBFI sector.

2. Prospects for USAID Collaboration in the NBFI Sector

While the situation varies among sub-sectors, there are generally very good prospects for collaboration throughout the NBFI sector. There is a broad expectation that this sector will grow faster than the banking sector and that fundamental improvements in the environment will be needed to facilitate the transition. In some cases it is necessary to reconsider the basic laws governing the sector and to create regulatory capacity from very low starting points. The demand is for high quality technical assistance with only a small element of financial assistance and little conditionality, precisely the kind of support that USAID is equipped to supply. The willingness of the responsible officials to work with foreign advisers is strong, and in some cases there is a history of positive experience to draw upon.

3. Regulation of NBFIs: BAPEPAM & LK

The agency responsible for regulation of NBFIs was created by merging BAPEPAM, the existing regulatory authority for capital markets with bodies responsible for other NBFIs, to produce BAPEPAM & LK. BAPEPAM & LK is currently organized as a directorate general inside the finance ministry. It is generally considered more desirable to organize the financial regulator as an independent body rather than subordinate to the minister. In theory all financial supervision (i.e., supervision by Bank Indonesia and BAPEPAM & LK) will by 2010 be merged into Otoritas Jasa Keuangan (OJK,) a unified financial supervisor along the lines of the FSA of the United Kingdom. Bank Indonesia is slated to cede responsibility for banking supervision to the OJK. However, senior officials in all of the agencies involved oppose the concept of the single regulator and it is doubtful whether the merger will actually take place.

BAPEPAM & LK is the natural counterpart for USAID in a program of technical assistance in the NBFI sector.

4. Capital Markets

For expositional purposes, it is useful to divide the NBFIs into 1) capital markets and 2) institutional investors, but there are close linkages between these two segments of the market. Since institutional investors are the main owners of financial assets in advanced markets, expanded capability of the capital market to provide finance goes hand in hand with the growth of institutional investors.

5. Equity Markets

The Indonesian equity market has relatively advanced physical and technological infrastructures with an automated stock trading platform as well as custody and clearing and settlement systems that are in line with international norms. The country recently formed the Indonesian Stock Exchange by merging the two exchanges in Jakarta and Surabaya. Several equity derivative products are traded. The staffs of the major investment houses that are active in the market have a level of skill commensurate with the level of development of the market.

The equity market makes a relatively small contribution to raising capital for business. Total market capitalization as a share of GDP (29%) is the lowest among middle income Asian countries. The comparable figures were 40% in the Philippines, 65% in Thailand 100% in India and 150% in Malaysia. The exchange has attracted a relatively small number of new listings in recent years. There were 335 companies listed in 2005 compared to 288 ten years earlier. The market has one of the highest rates of concentration in Asia, with the ten largest firms accounting for more than half of market capitalization. Most listed companies are family-owned conglomerates in which the inside group maintains control. The “free float” (i.e., the tradable share of equity) is generally about 35-40% of the total. In many countries one of the major sources of new listings has been privatization of state assets, but due to its slow progress in Indonesia, privatization has not been a strong stimulus to expanding the volume of tradable equity.

Domestic institutions do not invest heavily in equity and individual investors have also been largely absent. This can be contrasted with some other Asian countries with strong equity cultures where the general population often invests heavily in stock markets. As a result, trading has been dominated by foreign institutions. At the end of 2004, foreign investors held about 75% of tradable equity, domestic institutions held 20% and domestic retail investors only 5%. While the presence of foreign investors is basically positive, excessive reliance on foreign investors plainly increases the risk of volatility. When foreign investors change their exposure to the market the impact is more severe than when there is a steady core of domestic investors with asset allocations weighted to the home market. In this context, it is a positive sign that domestic investors have increased their activity somewhat in recent years.

6. Bond market

It is generally recognized that the government bond market is the foundation of the fixed income market. By providing a base of risk free and liquid assets, the government bond market usually serves as a basis for pricing and trading other bonds with higher risk and less liquidity. Prior to the crisis, the government had been legally prohibited from issuing domestic debt, but with the banking crisis a large volume of bank recapitalization bonds were issued. The sharp rise in the outstanding stock of debt enabled the authorities to engage in large scale operations to restructure the debt.

Although the bond market is still in early stages of development, substantial strides have been made in modernizing the government bond sector by issuing paper with longer maturities and by introducing regular issuance calendars. Foreign advisers have helped in the development of the government bond market, which now has a level of technical capability that is adequate. A system of primary dealers with access to special central bank facilities has helped add liquidity. Banks are the largest holders of government debt, but much of the trading is dominated by foreign institutions. Still, trading remains very thin. The expansion market is hampered by the scarcity of institutional investors who are normally the natural buyers of longer-term fixed income assets (see below).

Outside of the government debt sector, the fixed income market is very shallow. Outstanding corporate bonds amount to only 2% of GDP, as against some 20% in the rest of the region. Domestic institutional investors are the main holders of corporate bonds. An attempt was made to launch a market in local government debt in 2001, but few issues of local government debt have actually taken place.

There is no market in housing related debt. Outstanding housing loans amount to 2% of GDP (28% in Malaysia). One institution, Bank Tabungan Negara (BTN), is mandated to extend credit to middle and low income families. BTN depends upon deposits and government funds for its operation and its business remains limited. The government created a specialized institution (Sarana Multigriya Finansial) to purchase mortgages from banks in order to build a secondary market in housing related assets. This institution has received some support from the ADB. Results have been meager to date.

7. Supervision and Regulation of the Capital Market

BAPEPAM (Capital Market and Financial Institution Supervisory Agency), which has a long history as the capital markets regulator, is probably the strongest official institution in the NBFI sector. BAPEPAM has the basic organizational structure that is common to all capital market supervisors with departments responsible for intermediary’s market conduct and investment management. Unlike other parts of the NBFI market which are still creating their basic legislative frameworks, BAPEPAM already has enacted the basic laws defining the capital market, the status of the regulator, insider trading and market manipulation and the status of the stock exchange. Institutional capability is adequate for a market at Indonesia's relatively incipient stage, but if as is hoped the capital market begins to assume an increasing share of financing, ongoing strengthening of capability will be necessary.

C. Prospects for USAID Collaboration in Capital Markets

There are very good prospects for collaboration in capital markets. BAPEPAM is planning a major expansion of institutional capability to supervise markets and the demand for foreign expertise is expected to be high. BAPEPAM would like to have access to assistance in several forms, including resident advisors who operate inside BAPEPAM as well as training seminars and the possibility to send BAPEPAM personnel for several months as capital market supervisors in major markets abroad. A program of regular exchanges already exists with the Australian regulatory agency. The capacity building exercise should encompass not only BAPEPAM, but also the self regulatory organizations (SROs) that will assist in market oversight.

Concerning resident advisors, BAPEPAM would prefer advisors to remain for relatively long periods. It was observed that advisors who spend short periods observing the capital markets tend to make recommendations on a rather general level and then leave. What is needed is to carry recommendations through to the stage of implementation and adapt initial recommendations to the concrete conditions in Indonesia. BAPEPAM states that it has had very positive experiences with USAID sponsored advisors in past years and would like to resume cooperation of this kind.

Technical assistance offered by USAID should be coordinated with other donors as well as with the IOSCO (International Organization of Securities Commissions), the body which is charged with international coordination of capital markets supervision and the establishment of international norms in capital market oversight. Indonesia is an active member of the IOSCO.

1. Institutional Investors

Institutional investors serve two functions in a modern economy. First, as capital markets mature institutional investors tend to become the main owners of securities. A market without institutional investors faces inherent limits on its development. Second, institutional investors serve socially necessary functions. Institutional investors are necessary to the development of a "social safety net" in which citizens acquire the means to alleviate risk (such as those mitigated in an insurance market) or to provide income security for retirement or disability. At this time only about 8% of the Indonesian population has access to a social safety net of any kind. In most countries the social safety net consists of several various "pillars." A government "pay-as-you-go" system to assure provision of minimal benefits is usually complemented by funded occupational or personal pensions that provide for a more resilient system of income security. Indonesia does not have a public social security system although a law establishing such a system was recently passed.

Because pension funds and insurance companies have long-term liabilities, they are the “natural” buyers of long-term fixed income securities. Institutional investors invest on behalf of their ultimate beneficiaries, such as policyholders or retirees, and compete on the basis of performance. Their presence raises the level of professionalism of the market. Thus, institutional investors demand that investment banks and dealers provide a full range of services to investors and that exchanges offer transparent trading systems. Institutional investors also hold issuers of securities to high standards of transparency and disclosure and encourage the production of unbiased research. As institutional investors become the predominant holders of corporate equity they press for higher standards of corporate governance.

2. Pension Funds

Pension funds play a crucial role in assuring an adequate retirement income for the population in advanced economies. In Indonesia, however, an estimated 92% of the labor force are not covered by any pension plan and thus depend upon their personal savings or upon their families.

At present there are unfunded pension plans for civilian government employees and for the armed forces. Both of these schemes represent a drain on the public finances, a drain that is projected to grow over time.

All private companies are required by law to provide coverage to their employees through Jamsostek, a scheme that provides pensions as well as health, accident and life insurance. The employer contributes to funds for all purposes but the worker contributes only to the retirement portion of Jamsostek. Jamsostek makes lump sum payments at retirement or upon earlier termination of employment.

Despite the fact that the law mandates coverage for all private sector employees, only 21% of formal sector employees are actually covered. Since most workers are outside the formal sector, coverage is very narrow indeed. Jamsostek has very high administrative expenses, and more than 40% of its assets are in bank deposits. The World Bank concluded that owing to its poor results Jamsostek has tarnished the image of pension funds in the eyes of the public and led to widespread evasion.

In addition to the mandatory plans offered by employers through Jamsostek, some employers voluntarily offer funded pension plans to their employees through special plans, which can be defined benefit or defined contribution. One final category of pensions is Financial Institution Pension Funds (FIPFs) which are offered by banks and insurance companies. These plans can be purchased by employers or individuals can provide for their own retirement through voluntary subscription. Over half of all pension fund assets are in these two categories of private plans, although the number of individuals covered is much smaller than in Jamsostek. Private plans also have a better investment record.

3. Regulation of Pension Funds

The legal, regulatory and tax framework inside which pension funds operate is complex and leads to an uneven playing field for various forms of institutional savings. Jamsostek operates outside the pension law and the insurance law under a set of ad hoc regulations. In 2004 measures were taken to bring Jamsostek under the supervision of the Ministry of Finance, where it is regulated in the insurance section. Employer pension plans and FIPFs are supervised by a special unit of BAPEPAM & LK. The regulator lacks the legal mandate and the technical capacity to permit large-scale investment in capital markets Present rules limit investment in equities and long term bonds. A large share of assets invested in bank deposits and hence the contribution of the pension fund sector to long-term capital market development is negligible.

The reform of the pension regime will take many years of concerted efforts, a task complicated by the wide number of interests involved. Laws have to be modified; regulatory capacity has to be upgraded and tax policy has to be modified to remove the distortions. Basic capacity building inside the industry and its regulators as well as education of the public and legislators are serious challenges. In 2005, BAPEPAM L&K produced a “Road Map” for the comprehensive reform of the pension sector. A number of objectives were set forth, but no rigorous timeframe was adopted.

4. Insurance Sector

As in other forms of institutional investment, the insurance coverage of the Indonesian population is low by international comparison. One of the common measures of coverage is the penetration ratio (the ratio of insurance premiums to GDP.) The figure was 1.4% in Indonesia against an average of 2.2% among ASEAN countries and 9% in OECD countries. In addition to the low level of participation, low net earnings on investment by insurance companies have meant that the insurance industry has not generated a pool of long-term savings suitable for purchasing long-term assets.

Despite the small market, there are 162 companies offering insurance, many of the companies being too small to be economically viable. There apparently are a number of companies that are insolvent, but no action has been taken to close or consolidate marginal companies. There have also been many instances in which insurance agents have engaged in deceptive marketing practices.

BAPEPAM & LK is responsible for the supervision of the insurance sector. Indonesia was the first country in Asia to implement a system of risk-based capital in insurance supervision.

5. Collective Investment Schemes

Collective Investment Schemes (CIS) is the generic term for mutual funds and similar instruments under which small investors pool their funds in a vehicle which invests in a portfolio of securities. The CIS contains a legal structure that provides safeguards to the investor as well as offering professional portfolio management. CIS typically have explicit rules governing valuation and calling for a clear statement of investment policy as well as regular reporting requirements. CIS can be used in conjunction with other forms of institutional investment such as pension funds, where CIS are one of the vehicles typically used in a defined contribution pension plan, as well as in insurance where a CIS is packaged as an insurance product with tax advantages and marketed as a “unit linked” product.

Owing to its great flexibility, the CIS industry has attained huge proportions in North America and Europe. Some analysts describe the CIS sector as the "democratization of finance," putting relatively sophisticated investment strategies and professional portfolio management within the reach of ordinary citizens. Moreover, as countries introduce funded pensions CIS will probably be used as the main vehicles in defined contribution plans. For all these reasons it is essential to strengthen the framework for CIS.

The CIS industry is very small in Indonesia, although it has expanded since its inception in 1995. Even in its current embryonic form, however, the industry has already experienced substantial problems. With the resolution of the banking crisis after 2000, the government began to issue special bonds to recapitalize banks. CIS managers bought heavily for their portfolios. As a result, the assets of fixed income funds surged from 4.6 trillion RPH in 2001 to 37 trillion one year later. The domestic CIS industry was ill-equipped to absorb this sharp rise in inflows. Valuation procedures were inappropriate. Many of the funds were marketed without adequate explanation of the risks in fixed income investments. Disclosure practices were inadequate. The highly publicized surge in investment in 2000-2005 was followed by a collapse which led to a major loss in confidence in the CIS industry. In 2003 and again in 2005, price corrections in the bond market induced a panic among investors which led to a wave of redemptions and widespread allegations that improper methods of valuations were used. Net liquidations were especially high during 2005, when assets in fixed income funds fell from 88 trillion RPH at the end of 2004 to only 14 trillion a year later.

It is widely agreed that much improvement is needed if the industry is to expand its role in finance. As in the rest of the institutional investor sector, CIS are characterized by the need for basic improvement in the legal, regulatory and tax framework. Private industry, SROs and the regulators need to make major advances in order to remove the distortions that are found in the sector and to forestall recurrences of the shocks in various segments of the institutional investor market.

D. Prospects for Collaboration with USAID in the Institutional Investor Sector

As in the remainder of the NBFI sector, the staff of BAPEPAM & LK charged with regulation of the insurance, pension and CIS industries would be eager to expand cooperation with USAID in various forms. It is realized that building the institutional investor sector will last a long time and that the process can be sped up through adapting foreign experiences. Fortunately, there is a wealth of experience upon which the country can draw. Cooperation can take many forms, such as resident advisers, assistance in drafting basic laws and regulations and capacity building.

E. Other NBFIs

1. Multi-finance Companies and Microfinance

One significant category of NBFIs is “multi-finance” companies that engage in a range of “near banking activities,” such as credit cards, leasing, consumer finance and factoring. There are about 130 multi-finance companies. Originally multi-finance companies were engaged in leasing but in 2005 nearly 70% of their activity was in consumer finance, with leasing accounting for most of the remainder. Automobile and motorcycle credits and leases, often to low income segments of the population, are the most common operation. Multi-finance companies often engage in consumer finance operations. Multi-finance companies receive a considerable amount of their funds from commercial banks; the largest multi-finance companies are bank affiliated. It should be noted that finance companies of this kind have encountered serious problems in a number of Asian countries such as Thailand and Korea.

One issue that was mentioned by BAPPENAS and other donors is the limitation on sources of capital for non-bank microfinance institutions (MFIs). USAID could assist in this area through the provision of technical assistance to help encourage the passage of legislation that would permit MFIs that do not intermediate funds to receive funds from donors and private sources other than banks. The World Bank CGAP unit has written a number of documents on the regulation of MFIs. Their expertise could be tapped on this issue as well.

The Bapak Sahala Lumban-Gaol, Deputy Coordinating Ministry for Macroeconomics and Financial Sector express interest in receiving support for the development of this sector. Specific needs are regulatory frameworks, capacity building and public outreach and consumer education.

F. Equity Finance for SME: Business Angels and Venture Capital

The Economic Growth Stakeholder Workshop expressed the need for venture capital as a means of providing finance to newer companies with high growth potential, and notes that this market sector is seriously underdeveloped in Indonesia. An interview with University business school programs and private sector leaders including KADIN, the Indonesia Chamber of Commerce also indicate a growing demand for and interest in the development of VC networks.

Venture capital is a technique to provide unlisted equity finance to smaller companies with high potential growth and high risk. Such firms are not typically suitable for bank finance or for stock exchange listing. Venture capital finance usually occurs in several rounds (start-up, expansion and late stage). At the end of the venture capital cycle, investors exit through an IPO (public offering) or a “trade sale” to strategic investors. Many VC-suitable companies are found in innovative or high technology sectors. In the Business Development section of this report, it is noted that one subsector of SMEs in which the absence of finance is perceived as a constraint on growth is in technology oriented SMEs.

In 1995 the Ministry of Finance issued a regulation recognizing venture capital as a special field of activity in the financial sector. Subsequently there are a number of venture capital companies with both domestic and foreign participation. Nevertheless the industry remains, although it has not progressed beyond a nascent stage with less than 0.1 per of total assets of the financial system.

Venture capital tends to be highly concentrated geographically. This industry is very significant in the United States and Israel, but most European countries and Japan have not succeeded in creating dynamic venture capital industries despite the fact that they have mature capital markets. On the other hand, several Asian countries (i.e., Korea, Taiwan, China and India) have developed vibrant VC markets although in many cases they do not appear to have a regulatory and investment climate that would favor the growth of such a sector. The main advantage that such markets enjoy is an environment in which there are strong linkages among research, innovation, entrepreneurship and production, especially in technology-related industries. Venture capital tends to migrate to narrow geographic areas (e.g., Silicon Valley or Bangalore) where there are environments supportive of venture capital investment. Such an environment includes critical masses of universities, other research centers, high tech companies and entrepreneurs with talent for combining technical skill, practical application and willingness to take risk. The access to “seed money” in the form of grants from universities, companies or governments is also helpful. Venture capitalists seek out promising deals in such environments.

There is a considerable body of experience in the United States and in other Asian countries about how governments can work with universities and other research centers to build science parks and technology corridors in which venture capitalists can remain in touch with entrepreneurs and providers of business services in order to be able to be exposed to a constant deal flow from potentially innovative companies.

Clearly, the starting point for a country seeking to replicate other success stories in Asia is to introduce policies to attract high technology industry and to promote domestic research that is closely related to production so as to create an environment conducive to entrepreneurship in innovative companies. ITB University and the Ciputra University programs on Entrepreneurship are seeking to develop VC capacity as part of their degree program, capitalizing on local talent from universities and the growing ICT sector.

The Business Development section discusses that the Ministry of Research and Technology has initiated the Business Innovation Center as a public lead initiative to improve linkages between research centers and universities and the private sector. This section also discusses the work of local ICT firms and partnerships with CISCO and Microsoft.

A concept that is close to that of venture capital is that of “business angels” (BAs), informal equity investment, by “cashed out” entrepreneurs who have retired as active owners, but who would like to invest in newer companies. BAs contribute not only money but their own expertise in launching and nurturing a business. In the United States, more innovative firms are financed though BAs than through formal venture capital while VC firms are increasingly specializing in later stage deals and buyouts. BAs operate in high growth and innovative companies as well as in traditional SMEs. BAs typically form “networks” that provide information about potential investors and projects and allow BAs to form syndicates to finance promising projects. BAs also use their experience in helping entrepreneurs gain access to finance, while “coaching” prospective entrepreneurs, for example, in the preparation of business plans. BAs are often the first stage in a “financing ladder” in which high growth technology companies eventually gain access to formal venture capital.

The BA approach can be integrated into existing programs to strengthen the business environment. There are examples of support extended by regional governments to BA networks. Support usually consists of meeting facilities data bases about prospective seekers of capital, as well as access for business services such as accountants and lawyers.

USAID could consider launching small scale venture capital and business angels' projects that could have significant impact through their demonstration effect. These activities should be linked with projects described in the Business Development section that relate to the expansion and support of University entrepreneurship networks and local research institutions.

G. Activities of Other Donors in the Financial Sector

Concerning the banking sector it was noted above that Bank Indonesia has well established connections with the IMF, the World Bank, the BIS and the Basel Committee. If USAID wanted to work with Bank Indonesia on banking, it could for example offer to fund experts to assist in the implementation of Basel II risk capital norms which are scheduled to take effect in 2009.

USAID could probably carve out a more distinctive role through a project to enlarge access of SMEs to bank finance. The IFC is currently working on similar projects in this sub sector, in a program of downscaling under which banks and NBFIs enlarge access to finance for previously underserved market segments. The German Agency for Technical Cooperation (GTZ) also has a few small projects designed to foster the expansion of SME credit and microfinance. It also has a project to assist small banks and credit cooperatives to expand their range of services. Since these are essentially demonstration projects, there is little risk of duplication, and considerable benefit to be had by comparison of experience.

Although there are a number of active donors in various parts of the NBFI sector, USAID has a better opportunity to develop a distinctive role in NBFIs than in banking. There is little risk of any donor monopolizing assistance, given the low level of development in NBFIs and the wide variety of activity undertaken.

The largest single donor is AusAID, which has several advisors in the Ministry of Finance, including an advisor to the head of BAPEPAM & LK. AusAID regularly sends Indonesian capital market regulators from BAPEPAM & LK for extended stays inside the Australian Prudential Regulatory Agency (APRA), which supervises capital markets. AusAID also sends Indonesian supervisory officials for training at Australian technical schools and universities.

The World Bank Study of 2006 provided a basic store of information about the NBFI sector. The World Bank also has an ongoing policy dialogue with the officials of BAPEPAM & LK and frequently provides ongoing technical advice. The Asian Development Bank recently produced a basic study of the Social Security System of Indonesia that is a basic reference about insurance pensions and the social safety net. The ADB also has sponsored a feasibility studies to consider the possibility of developing housing finance, asset-backed securities and corporate bonds. Neither the World Bank nor the ADB has advisers inside government agencies, or a program for comprehensive reform for the sector.

In addition to technical assistance narrowly defined, BAPEPAM & LK participates with other securities supervisors through IOSCO (International Organization of Securities Commissions), the body which is charged with international coordination of capital markets supervision and the establishment of international norms in capital market oversight. It would also be desirable for BAPEPAM & LK to take part in the work of the International Association of Insurance Supervisors (IAIS) which does comparable work for insurance. USAID work should be coordinated with activities undertaken through these bodes as well.

H. Recommendations

Indonesia's financial system is less advanced than those of its regional peers. In order to support its advance into the ranks of middle income countries during the next few years the country will need a more developed financial system that operates in a robust legal and regulatory environment. Consistent with other sectors and findings of this assessment, capacity building is a critical issue. Private sector bodies such as industry associations, self regulatory organizations (SROs) and private institutions will have to build their capacity to operate in a more sophisticated and competitive environment as well.

Bank Indonesia, which is responsible for banking, and BAPEPAM & LK, which is responsible for NBFIs, would like to enlist foreign donors in their reform efforts. Potential donors, such as USAID, will have to consider carefully where their efforts are best concentrated. Accordingly, the following paragraphs propose some activities in which USAID could focus its activities in order of their priority. Among the factors that influenced the assignment of priorities were: 1) the importance of the issue to economic development; 2) the prospects of success; and 3) the capacity of USAID to make a unique contribution.

1. The biggest opportunity for USAID will be in the NBFI sector which is: 1) more backward than the banking sector; and 2) crucial for the next stage of development. This sector is critical because capital markets are necessary to provide long term finance in critical sectors. Additionally the expansion of institutional investors will permit the country to attenuate risk, enhance income security and generally build a social safety net. BAPEPAM & LK, which is the natural counterpart for USAID has worked with USAID in the past and would welcome the chance to resume cooperation. Assistance is requested in capital markets and institutional investors (pension funds, insurance and CIS). This work could include the development of a regulatory framework for microfinance, assuming that the necessary laws are enacted. Assistance can take several forms, including the form of long term-advisors, training and other forms of capacity building.

2. Support can be extended to programs designed to enlarge the access of SMEs to finance. The authorities have targeted the SME sector as an important priority, not only because of their importance in maintaining a high aggregate rate of growth, but also because of their social importance in achieving balanced and equitable growth. Many banks have also targeted the SME sector as one with promising growth prospects, but they are also concerned due to the special risks of SME lending and banks are seeking to sharpen their relevant skills. USAID activity could build upon existing contacts with business associations and regional governments. Also, the current DCA mechanism should be reviewed and revised. Unlike the work with BAPEPAM & LK, which would provide direct

support to systemic transformation, these activities would seek to have a catalytic effect. By working on smaller projects in unfamiliar territory, they would help to uncover some practical techniques and methods that might eventually have wider applicability in helping underserved market segments gain access to formal finance. Since other donors, such as IFC, are also active in this field, there is a possibility that different experiments using somewhat different approaches might increase the chances of finding techniques that work.

3. Support of venture capital as well as informal equity finance (business angels) is also a worthwhile concept. High technology SMEs, which can make a strong contribution to economic progress, have a recognized need for finance and there are reasons to believe that Indonesia has some of the elements of a successful technology-based industry. At the same time, there are reasons to be cautious. It is not obvious whether any official agency is able to make a decisive contribution to the development of this sector and hence there is an argument for leaving this task to the private sector. Silicon Valley developed without very much positive help from the US government while many European countries have been trying for years to develop their domestic markets without success. That being said, there are cases of successful venture capital sectors in Asia and many Asian governments have developed venture capital with approaches that involve higher doses of government intervention that is found in the United States.

4. USAID could assist Bank Indonesia in upgrading banking supervision. The banking system is relatively advanced (though still backward by international comparison) and has been restructured following a nearly complete collapse during the 1997 crisis. Under the Bank Architecture Plan, banks will be applying more sophisticated risk management systems and will be subjected to global norms of supervision under Basel II. In promoting the further modernization of banking Bank Indonesia will utilize external expertise. However, it is well to be cognizant that Bank Indonesia will probably call on its contacts in the IMF and the BIS as its primary source of technical assistance. Thus, the role of USAID would be simply to provide funding, funding which would probably still be forthcoming if USAID were not to supply any resources.

VI. Trade and Investment

A. Background and Future Trends

1. Performance

Indonesia's export performance has been relatively slow compared to its neighbors. This has related to problems in Indonesia's labor intensive manufacturing sector. In fact, Indonesia's manufacturing export growth is one of the lowest in Asia (Basri and Papanek, forthcoming). It is far slower than India and China and is still behind Malaysia and Thailand. The decomposition of Indonesia's non-oil export growth shows that the price effect of oil, rubber, and minerals were positive during 1996-2006 but negative for labor intensive sectors (Annex VI, Table 1). In terms of volume, the export growth of labor intensive manufactured goods (textiles, footwear and furniture) declined significantly from 23.5% in 1990-1996 to only 5% in 1996-2006. In dollar value it dropped from 23% to 2%.

2. Trend of Trade Protection

Indonesia has been making efforts to increase its efficiency by removing restrictions on trade, investment, and production, as well as streamlining procedures at border areas. As a consequence, it has been able to afford tariff reductions to an average of below 10%. While tariff rates have gone down (or at least been maintained), non-tariff barriers have flourished. Sensitive agricultural products, such as rice, cloves, sugar, corn, and soy beans, have been subject to special import licensing; with the former three also having been exposed to exclusive import rights granted to domestic producers (World Bank 2004; WTO, 2007).

3. Future Trends

a. Production Network

For Indonesia, interaction with the international market is very important for the future. East Asia's trade, for example, has expanded rapidly during the last 20 years, and now around two-thirds of the increase in world trade volume is taking place in East Asia. In addition, one-fifth of East Asia's current trade is in the form of a regional production network. In the future, countries in East Asia should take part in increased regional production networks. However, as argued by Kimura (2005), Indonesia is behind other countries in participating in production and distribution networks. In the future, Indonesia should become more involved in production networks, which will require an efficient logistics system.

b. Trade and Investment in the Era of High Commodity and Energy Prices

The impact of high commodity and energy prices can affect trade and investment in two ways:

First, while it is true that the commodity boom and high energy prices have boosted Indonesian exports, these also create a potential problem for mild Dutch Disease (Basri and Papanek, forthcoming). The commodity boom could contribute to a real appreciation of the real effective exchange rate (REER). The combination of the appreciation of REER and the "high cost economy," including investment climate problems such as the poor quality of infrastructure, bribery, and logistics costs, have resulted in a shift in the pattern of investment away from tradable into non-tradable goods (Basri and Hill, forthcoming). Thus, in the short and medium term we need to anticipate the shift of the labor-intensive sector into non-tradable goods, including the services sector. In this particular case, it is important to explore the future potential of trade services.

Secondly, the high energy prices in the medium-term may also have an impact on transportation costs. This may shift Indonesia's export destinations from far distant countries, including the US and Europe, to nearer countries such as in East Asia. In addition, the high transportation costs may cause the non-tradable sector, including services, to become more important in the future. In addition, the relatively high transportation costs will make the role of efficient logistics become extremely important. It is true, that in the long-term, technology may overcome this problem and there will be new inventions in terms of more efficient modes of transportation, but this is less likely in the short- and medium-term.

c. The Importance of the Services Sector

Dee (2008) shows that the services sector now accounts for almost half of the Indonesian economy. Almost by definition, the sector has dense linkages to the sectors it serves. It is therefore critical for Indonesian incomes and for economic growth that the sector performs efficiently. One key factor affecting its performance that is within the government's control is the quality of its regulatory regimes.

The role of the services sector will become more important in the future for tackling the unemployment problem. Annex V, Figure 2 shows the characteristics of unemployed people in Indonesia. Most of them are young and highly educated (more than 60% of them have been educated at senior high school level or higher). One cannot expect that these young unemployed will work as blue collar workers. They will seek jobs in the formal and services sectors. Thus, in the future, the role of services will become important for job creation especially for educated people.

However, Indonesia is still facing a problem in the efficiency of the services sector and some related sectors remain underdeveloped. Dee (2008) points out that Indonesia scores well and is relatively liberal in road, rail transport, telecommunications, and maritime transport. Nevertheless, Indonesia scores relatively poor in post and courier services, air passenger transport, retail trade and higher education services. Therefore some policy measures should be undertaken in these particular sectors.

B. Trade and Investment Impediments

1. Investment Climate

The sluggish performance of the manufacturing sector, particularly manufacturing labor intensive exports, has been largely caused by relatively low investment. The investment ratio to GDP dropped from 28% during the period of 1990-1996 to 22% in 1996-2006, resulting in the labor intensive manufactured goods to have declined significantly from 23.5% in 1990-1996 to 5% in 1996-2006. The ability of the government to attract foreign investment to Indonesia is highly dependent on political stability and the ease of doing business in the country. Basri (2004) argues that political instability, labor problems and local taxes can increase the cost of doing business in Indonesia; for example, bribery is no longer an efficient means to cut transaction costs in connection with bureaucracy. Furthermore, parallel with the distribution of power in bureaucracy through the policy of autonomy, corruption has also been decentralized.

As pointed out by Bardhan (1997), in decentralized corruption, the bribe per unit of transaction may be higher than in centralized or “one stop” corruption. As a result, business uncertainty increases, the investment climate becomes less predictable and is far from conducive. According to the World Bank/IFC’s Doing Business Report 2008, Indonesia’s investment climate ranking is 123rd, although this is beginning to improve under the current SBY administration. The results from the survey on Monitoring Investment Climate in Indonesia by LPEM FEUI (2007) and the World Bank (2008) also showed that despite an improvement of companies” overall perceptions on investment climate in Indonesia during the 2005-2007 period, Indonesia still remains behind its competitors in many important investment climate indicators. These include: amount of days to start up a business, import clearances and tax complexities. Even with reforms being implemented, persistent problems have been bureaucratic red tape and onerous regulations for businesses. Perceptions of infrastructure quality (transportation and electricity), financial access, and land procurement worsened relatively to the end of 2005.

Despite the importance of the investment climate, one should not overemphasize its role in explaining industrial performance industry in Indonesia. We believe that improving the investment climate is necessary but that the situation is not sufficiently conducive. A study done by LPEM (2005a) shows that although the Japanese and Korean electronic companies were facing the same problems of poor quality of infrastructure, labor issues, a high-cost economy and corruption, some Korean companies performed better than Japanese. This leads to a question of why some companies performed better than others despite facing similar problems of a bad investment climate. LPEM-FEUI (2005a) argues that efficient Supply Chain Management (SCM) has provided some Korean companies with good value in terms of marginal productivity of labor, constant manufacturing chain improvement relying on close inter-department self-seeking problem solutions, and a common real understanding and awareness of the company vision-mission-goals-objectives interrelationship and its relation to their companies” policy.

2. Inefficiency in the Logistics of the Export Industry in Indonesia[8].

As discussed earlier Indonesian exports have been suffering from low competitiveness. This is due to low productivity and other problems at the factory or firm levels, as has been shown in many empirical studies. In addition, logistics inefficiencies have increased transaction costs that in turn place a more downward pressure on the degree of competitiveness.

The inefficiency in logistics costs – i.e., transportation cost for cargo – has forced companies to pass on the burden to consumers in the form of higher prices. LPEM-FEUI (2005b) found that the share of Indonesia’s total logistics costs was around 14% of total production costs, while the best practice in Japan was only 4.88%. The survey divided logistics costs into three types: input logistics costs (from vendor – which can also involve ports – to manufacturer), in-house logistics costs (in the manufacturer), and output logistics costs (from manufacture to port). The study found that the highest costs are input logistics costs (Annex VI, Figure 1).

The study also found that the key sources of inefficiency as perceived by respondents in the input logistics are poor road infrastructure, informal collections, and government policies (such as local taxes). In the case of in-house logistics costs, government policies such as the minimum wage are perceived as the main source of inefficiency. Finally, the study also found that informal payments at roads and ports contributed about 22.12% to the total inefficiency in

[8] This section has been heavily drawn upon from LPEM Logistics.

output logistics cost. As discussed in Patunru *et al* (2007), inefficiency in ports directly leads to higher transport costs, in particular for export-oriented and import-based industries. Therefore the physical condition of roads and ports, as well as administrative procedures and informal payments, are key sources of inefficiency. Of course these factors are not independent of one another.

3. Intellectual Property Rights (IPR)

LPEM and EU (2006) argue that counterfeiting has becoming a well-known issue in Indonesia, particularly in recent years when counterfeiting practices have reached a point of seriously threatening the trademark value of major companies whose brand names are well-known internationally. While the qualitative impact of counterfeiting is very clear and unambiguous for the producers of the original products, such as loss of potential sales revenue and the erosion of the product trademark value, the qualitative impact of counterfeiting for consumers may be more debatable and, often, contains conflicting arguments. As an example, in the specific case of pure piracy, such as the selling of illegal copies of computer software, where consumers are able to reap almost the full benefit of the products by paying much less than the originals, such Intellectual Property Right violations are very often perceived to be associated with a more noble cause, i.e., providing a built-in mechanism for fostering information technology (IT) education in a much less expensive manner for the masses who are mostly unable to afford such luxuries, than if IT education had been undertaken in another way[9]. This argument may, however, undermine the full economic losses suffered by the country, including slow technological transfer and potential threat of international economic sanctions due to Intellectual Property Right violations. The fact that no software related industry would ever decide to invest in Indonesia may attest to this. In some other cases, particularly related to food, healthcare, and cosmetics, most people may be strongly against any form of counterfeit products; while in others, such as home appliances and other similar products which are neither directly consumed nor applied to the skin, people may try to balance between benefits received and payment made.

C. Institutional Aspects

Central to the problem of institutions in Indonesia is the lack of capable human resources[10]. Basri and Patunru (2008) point out that the GOI issues many policy packages and also forms many *ad hoc* teams or agencies to help implement or to monitor their implementation. For example, the government has formed the national team for export acceleration and investment acceleration (Tim Nasional PEPI),[11] the national team for special economic zones for industry (Timnas KEKI), the national team for trade flow (Timnas Arus Barang), and the national team for the implementation of the national single window (Timnas Single Window). These teams consist of members from outside the government such as academics and consultants as well as those from within the government. While the formation of these many "teams" might seem useful in speeding up the whole reform process in a more focused way, while guarding against strong

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[9] Note that this argument may only apply to the case of computer software piracy.

[10] This issue was also raised by Kevin Thompson from PT Aneka Search Indonesia at the team meeting with American Chamber of Commerce in Indonesia.

[11] Timnas PEPI is responsible for the improvement of the otherwise controversial negative list for investment. This team consists of four working groups that are responsible for the issue of regulation, implementation, promotion, and fiscal incentives, respectively. Each working group has representatives at the level of "echelon one" (one level under minister) from all related departments, in addition to members from outside the government. The working groups hold a meeting at least once a month.

conflict of interests (compared to cases where everything is handled by the existing bureaucracy), it nevertheless raises one question. That is, whether this is merely a reflection of the incompetence of government officials (at the levels lower than ministers); or whether this is in fact a clever way to get around high coordination costs in the midst of conflicting interests across line ministries. Despite many good professionals that are available outside government, a law that does not allow private sector employees to work as officers in the government makes them unable to work as government officials. Professionals can only support the government as advisers and do not have authority to make decisions. In addition, their number is also limited. Thus, the fact that there are many teams consisting of members from outside government may reflect the problem of a lack of capacity of human resources in government agencies. In Indonesia, regulations are developed and enforced by line ministries, while laws require the approval of the national parliament. Too often, the regulatory review of crucial laws is hindered by the inability of ministerial staff to solicit relevant stakeholder inputs and conduct cost and benefit analyses. There are only a few young, well trained staff available for setting up trade and investment policies. Thus, there is a need in Indonesia for more resources to support regulatory reform efforts. Many countries' governments have access to internal policy analysis teams, independent commissions, and other types of research groups that provide comprehensive, non-partisan assessments of public policy options. Without similar resources, the Indonesian government will continue to struggle to make timely, informed decisions on a vast array of economic regulations that will guide the development of the country in the coming years.

1. Tim Tariff (Tariff Team)

While it is true that the training and performance of professionals in Indonesia is generally high compared to other LDCs,[12] the capacity of human resources in some government institutions, including Team Tariff, is relatively weak. Central to tariff policies is an inter-ministerial committee, the Tariff Team, chaired by the Ministry of Finance (MOF). The members of the Tariff Team consist of representatives from various ministries including the MOF, the Ministry of Trade (MOT) and the Ministry of Agriculture (MOA), which provide recommendations to the Minister of Finance on setting up the tariff policies. By having an inter-ministerial team composition, the team is expected to have a comprehensive view on tariff policies. However this approach is informal and not disciplined by externally imposed guidelines (Bird, Hill and Cuthberson, 2006). In some cases information is provided by an industry association which obviously has a conflict of interest with tariff policy. World Bank (2004) and Bird, Hill and Cuthberson (2006) point out that capacity building in team tariff is weak. Team Tariff also suffers from a limited budget. Throughout the 1990s Team Tariff members participated in short training courses in various countries including Australia. However, most of the people have moved on. In addition Team Tariff also lack a comprehensive view and are not much informed about an economy wide view. The World Bank (2004) pointed out that members of Team Tariff lack a career structure so that an assignment to Team Tariff by a sectoral agency does not reward an opportunity to establish a career in TeamTariff.

Bird, Hill and Cuthberson (2006:4) point out some other handicaps:

- The team's approach is not well supported by analysis or information.
- Staff members are not assigned on a permanent basis and incentives to build up and apply a consistent methodology for appreciating and explaining the effects of various policies are weak.

[12] We thank John Pennell from USAID for this point.

- There are few well trained staff members available for Tariff Team work.
- Members from sectoral ministries sometimes break away from team membership loyalties to think in terms of public interests and instead push for sector specific policies.
- The Tariff Team deals only with tariffs while NTBs are managed by sectoral ministries. These burdens are likely to become more significant as policies shift from technical matters (matters that are related to technicalities), within government track to a political track, where parliament and the public at large demand to be involved and be persuaded about the benefits of continued trade reform.

Capacity building for team tariff could be strengthened in the following ways:

a. training for staff in techniques of policy evaluation and economy-wide modeling;
b. enhancing development of transparent processes; and
c. improving the knowledge of domestic and international trade laws and of the effect of environmental issues in relation to international trade practices and WTO (World Bank 2004).

2. Inter-regional Commerce

Parallel with decentralization programs, there has been a proliferation of sub-national taxes and restraints on trade. Many of these regulations are not consistent with competition and competitiveness. In addition, there is limited consultation with stakeholders before issuing licenses and new regulations. As a result, many regional regulations (*Peraturan daerah*) create obstacles for investment and trade flows in the region. Some of the weaknesses of the decision making process of regional regulations include: little transparency in the process; no assessment of the likely benefits and costs, including some test of public interest; and “winners and losers” are rarely identified (Bird, Hill and Cuthberson, 2006). These problems also reflect the lack of capacity of local government officials in producing regulation that is in pace with the effort of improving investment climate. The section on Business Development further addresses the issue of local economic development, and providing support for enabling business environments.

3. Government Program to Improve Trade and Investment

In its attempt to encourage more investment, GOI issued three policy packages in 2006: an infrastructure package (Ministerial Decree No. 38/PMK.01/2006), an investment package (Presidential Instruction No. 3/2006), and a financial sector package (Joint Ministerial Decree between the Coordinating Economic Minister, Minister of Finance, the Minister of State-Owned Enterprises and Bank Indonesia, 5 July 2006). The 2006 investment package addresses general investment policies, customs, taxation, labor regulations, and policy towards small and medium enterprises. This package includes the plan to enact a new law on investment (see Annex VI). All the attempts in the Annex VI are to be commended. Nevertheless, as Basri and Patunru (2008) show, problems and complaints have been noted. Key among these is rooted in the issues of implementation, enforcement and lack of priorities. One common feature across the many packages (most notably the 2006 and 2007 investment packages) is the use of ‘task matrices’ that explicitly state the policies, programs, needed actions, expected outputs and outcomes, time line, and the corresponding line ministries that are responsible for their implementation. A careful look on the matrices however reveals that the degree of importance of different targets and the degree of difficulty in achieving them can easily be ignored (Basri and

Patunru 2006). The matrices also contain some very general and loosely-defined terms, or simply confusing terms; while at the same time lacks measurable performance indicators. As a result, a particular action by a ministry can be regarded as a 'completed' task of one measure by GOI while its contribution to improving the investment climate is vague.[13] In fact, GOI seems to be trapped in merely reporting quantity achievements (or lack thereof) with less emphasis on the quality. Finally, while the office of Coordinating Economic Minister holds regular evaluations on the implementation of the investment packages, the reform momentum seems to have subsided. One indication is the reduced attention paid by line ministries and government agencies to the investment package coordination meetings. Such meetings were first attended by high-level officials with decision-making authority, but recently they are only attended by lower level officials without such authorities and many times some ministries/agencies are simply not represented. In addition, Basri and Patunru (2006) argue that the real problem lies deeper. In fact, many of the targets in the packages are in direct conflict with the interests of government officials. It is of no surprise, therefore, that the packages are hard to implement due to strong resistance from even within the government itself. This in turns cries out for a major overhaul: civil service reform. Moreover, such reform will not only necessary for the government, but also for legislatures.

D. Work of other Donor Agencies

1. AusAID

AusAID through the Technical Assistance Management Facility undertakes various activities within its core policy such as fiscal and financial sector. The Indonesian counterpart agency for the Facility is the Coordinating Ministry for Economic Affairs. AusAID also provides support capacity building for MOT by involving in development study training need assessment and trade policy analysis for enhancing the international cooperation. In addition, for capacity building, AusAID provides scholarship for master degree's program in Australia through Australia Partnership Scholarship. In addition, the AusAID also involves in Trade in services i.e., study for request and for some particular services sector.

2. The World Bank

The World Bank provides resources for the PEPI secretariat to do an analytical work. As for MOT, the World Bank hires some consultants to work with the MOT. In addition the World Bank also conducts studies related to export performance of some key export products and market access for agriculture product. The World Bank also supports MOT by providing policy memos and rapid response activities which is provided by trade advisor. Trade advisors provide various inputs including multilateral trade negotiations, stabilizing price of palm oil and issues of East Asia economic integration.

3. JICA

JICA provides capacity building for enhancing trade cooperation to support Indonesia-Japan Economic Partnership Agreement. In addition, JICA is involved in WTO-related cooperation by providing capacity building of the MOT's staff for improving their analytical skill on antidumping, safeguard and countervailing duty. To support export promotion, JICA supports the MOT in

[13] For example, 'holding a dialogue with the business community' is regarded as completion of one measure (Basri and Patunru 2006).

establishing Regional Export Training and Promotion in four cities: Surabaya, Medan, Makasar and Banjarmasin.

E. Assessment of Current USAID Program on Trade and Investment

1. General Program

USAID has stated that one of its strategic objectives is supporting Indonesia's economic stabilization efforts. This assistance aims to strengthen economic growth and employment creation (USAID, 2004).This objective aims to have two intermediate results:

- *Increased certainty in the business operating environment lowers trade and investment risks*. To increase certainty in the business environment programs are focused on areas including property rights, economic policy design, regulatory and self-regulatory capacities as well as an increase of civil society in economic policy and decision making in order to reduce trade and investment risks. These programs are aimed to create rational economic rights and responsibilities through effective policies by providing inputs for more effective legislation for administrative procedures, tax administration, labor, investment, and fiscal management.

- *Improvements in critical public services increase investment and trade efficiency.* To achieve this objective USAID has emphasized efforts to: increase the effectiveness of independent regulators and commissions; improve the efficiency and accountability of the government using participatory approaches that integrate private actors into the design and decision-making process; and increase Indonesia's domestic, regional and international trade volume (USAID, 2004). In addition, as regards trade and investment, USAID (2004) focused its program on how to lower barriers to investment and trade at the border, and behind the border, but USAID did not implement any programs on customs. Moreover, it prioritized: service sector barriers; import licensing; government procurement systems; non-tariff barriers to agricultural and food imports; foreign investment rules; and effective participation in international trade negotiations (WTO and ASEAN).

2. The Indonesia Trade Assistance Project (ITAP) Program

The Indonesia Trade Assistance Project (ITAP) is the key program to enhance Indonesia's competitiveness by providing assistance to the Ministry of Trade (MOT) to build its institutional capacity (USAID 2008). ITAP helps the MOT in increasing the capacity of its staff members to plan, analyze, implement and manage various agenda of domestic and international trade programs and reforms. This program supports the MOT in designing policies that can expand the country's exports, improve the investment climate and create new employment opportunities.

Some of the key programs are in Annex VII:

3. General Assessment

By and large these USAID objectives fit well with the government's programs on improving trade and investment (see Annex 1). Nevertheless, there is a problem of implementation, enforcement and lack of priorities in the government program, therefore in implementing the current program or in the design of future programs, USAID should also examine the effectiveness of the GOI investment policy packages and take into account the following issues:

Sustainability of the reforms must be examined. It is important to bear in mind that reforming the bureaucracy through policies, such as deregulation aiming to reduce the high-cost economy, is very likely to be more difficult than mere policy reform because it might encounter strong political challenges from various interests and groups. The benefits of reform most likely will be felt in the medium- or long-term, while the sacrifices are immediate. In addition, there is always a lag of time between the implementation of the reform and the results. Therefore, the most difficult task is not only to assure the continuity of the reform, but also to generate support for the changes. The opportunity cost of carrying out gradual reform must be considered, compared to making the greatest benefits of the reform momentum. Therefore it is also important to create a "quick wins" program.

Focus on the most binding constraints. The scale of the country and its administration does matter. In a country as complex as Indonesia, it is more difficult to carry out wholesale reform (i.e., to simultaneously eliminate all distortions). It is much more sensible to apply a piece-meal approach by focusing on the most binding constraints.[14] The reform can start in one particular agency, focusing on one particular project. Once it has been successful, then this can be replicated in another agency and similar projects in different areas.

Acceptability and support are also important. Two of the keys to success of any program are acceptability and support from institutions. Lessons from various multilateral programs in Indonesia show that many programs failed to be implemented not from poor design, but due to them receiving little support from the public, the press or government agencies. Therefore, it is important to design programs that can generate support from various institutions in Indonesia. One of the possible mechanisms is designing a program that involves local institutions (universities, research institutes, and business associations).

Considering the nature of the problem and also some caveats, we recommend USAID to consider some general strategies, presented in priority order:

1. Looking at the severity of the problem, it is less likely that the wholesale reform or big bang approach will be successful. Focusing on programs and activities that are catalytic and can have a demonstration effect is recommended. Rather than having comprehensive and wide ranging programs, it is better to focus on some programs and find the champions of these programs. Of course there are risks with this type of approach. Identifying champions is not an easy task. In addition, there are risks regarding the sustainability of the programs if there is a change in the leadership of one particular champion institution. These risks can be minimized by institutionalizing the programs in the particular champion agency. In this particular case we recommend USAID find the champions in order to continue trade and investment reform. The possible candidates are the Ministry of Trade and Export and Investment Acceleration Organization (PEPI). There are three reasons for choosing the MOT and PEPI. First, officially MOT and PEPI are the agencies who are responsible for Trade and Investment, and play important roles in designing policy reform in trade and investment. Second,

[14] See a good discussion on various reform strategies in Rodrik, D, One Economics. Many Recipes. New Jersey: (Princeton University Press) 2007.

most of the binding constraints lie within the authority of MOT and PEPI. Third, MOT and PEPI are champions for economic reform, thus they are more accessible and would be easy to work with.

2. Implementing reforms should be carefully sequenced in order to obtain the optimal conditioning and in order to achieve wide support for the maximum benefits of the reform implementation. However, this can only be done in normal times. Therefore, it is very important for the reformers to make some quick wins without harming macroeconomic stability. If these quick wins fail to materialize, there will be risks that populist pressure will accumulate, endangering the continuation of economic reforms. So, the most difficult task is not only to assure the continuity of the reform, but also to generate support for changes. As a result of generating support for changes and also to assure the sustainability of the reforms, some of the USAID programs should also put an emphasis on quick win programs or creating success stories.

3. In establishing technical teams, it is important to work closely with local institutions (local universities, research institutes, and business associations).

4. Since a lack of institutional capacity is central to the problem, we recommend USAID to continue to work on capacity building programs. ITAP's program on capacity building has been successful and useful in improving the capacity of human resources in MOT.

As regards specific areas in MOT and PEPI we recommend USAID to prioritize on two areas: Logistics and Services sector. In fact, there are several potential programs that can be undertaken:

a. Tariff Team:

- ✓ Establish a small permanent technical staff within the Tariff Team agency.
- ✓ Develop strategies for improving analytical and reporting capacities of the Tariff Team.
- ✓ Establish principles and guidelines for assessing trade policies, including the mandating of a "public interests" test.[15]

b. Regulatory Impact Assessment (RIA) Program

The Indonesian government, both at the national and local level, has shown a keen interest in introducing Regulatory Impact Assessment (RIA)[16] as a regular part of policymaking. The Asia Foundation, with support from USAID and Canadian International Development Assistance (CIDA), has introduced a RIA program in 25 local districts. In addition the Asia Foundation has also introduced RIA to the Ministries of Trade and Finance, which both have shown a particular

[15] Public interest test means an analysis of the economy-wide benefits and costs of protection, along with the dissemination of that analysis to the public and the parliament.

[16] RIA is an internationally recognized practice that uses public consultation and cost and benefits analysis to break down complex policy problems and highlight the most advantageous options. RIA has been institutionalized for many for many years in OECD countries, and more recently used as part of successful economic reform campaigns in emerging market countries.

interest in building their capacity to use RIA to assess national regulations. Other areas where this intervention can also be undertaken include establishing RIA units at some universities in Indonesia, consisting of a few trained RIA experts (from universities and other institutions). These units are expected to provide short-term intensive RIA training for MOT and MOF. Eventually, there could also be RIA teams in the MOT and MOF, which would review national regulations using RIA methodology under the assistance of some universities in Indonesia. We argue that extending the RIA program in collaboration with universities or research institutions such as has been undertaken by the Asia Foundation and the University of Indonesia will be useful in addressing inter-regional commerce problems.

c. Services Team

Considering the importance of the services sector for Indonesia's trade in the future it is important to support MOT in the issue of Trade Services through: establishing a small technical staff within the Services team; developing a strategy for improving analytical and reporting capacities of the Services Team; and establishing the principles and guidelines for assessing the trade services sector in Indonesia. In the initial stages, the assessment can be focused on courier services, air passenger transport, retail trade and higher education services. USAID can provide analytical support to underpin policy decisions in these key sectors. This core can be comprised of long term advisers, a few MOT staff and short-term consultants. Looking at the potential of the services sector in terms of creating jobs, especially for young and educated people, this team can also help the GOI in providing a road map for expanding the services sector.

d. Intellectual Property Rights (IPR)

A successful campaign against piracy requires strong support from both producers and consumers. Gaining support from producers is not a difficult job, but gaining support from consumers is not easy. As we discussed earlier, consumers are able to reap almost the full benefit of products by paying much less than the originals. Therefore there is a need for a strategy of creating awareness. The best strategy is to find a case in which both producers and consumers both suffer from IPR violations. One such case is counterfeiting. The LPEM and EU 2006 study shows that consumers are much more reluctant to buy counterfeit products if the products are applied to skin or swallowed, that is if such products directly involve health. On the contrary however, consumers will be much more willing to buy counterfeit products if the products do not have any association with health. Therefore a campaign against IPR violations can start with products related to health such as pharmaceuticals, cosmetics, etc. USAID can support the campaign by hiring consultants (in collaboration with local institutions, business associations or universities) to conduct a study to disseminate the results. This strategy can build a path for raising awareness about the importance of IPR. Once the awareness is there, the campaign can be followed up by focusing on piracy or other IPR violation issues.

e. Logistics

The important role of production networks and the impact of high transportation costs due to the high energy prices requires an efficient logistics system. Efficient logistics is a prerequisite for export success and for the ability of domestic producers to be able to maintain international competitiveness. Mapping the key problems in logistics and creating a blueprint for the logistics sector will be needed by the government. A large survey can be designed to provide specific policy recommendations. A small technical staff within the Logistics team should be established, as well as developing a strategy for improving the analytical and reporting capacities of the Logistics Team.

f. Information System for Monitoring Commodity Prices

One of the important issues in domestic trade is price stabilization for food and production factors of foods (e.g., seed, fertilizer). USAID can support the MOT on an early warning system for food prices by providing an information system for monitoring commodity prices. This information can be used by the rapid response team of the MOT for anticipating any such situations.

g. Special Economic Zones

It is better to focus on one particular area or region by creating a beachhead or “land of integrity”. This means focusing on one particular area in which there is a good investment climate, free trade regime and less distorted economy. This objective can be achieved if we focus on one Special Economic Zone (Batam, Bintan and Karimun). Therefore one of the potential areas that USAID can provide support to the GOI is on the issue of Special Economic Zones. USAID can work together with the GOI (MOT and PEPI) in collaboration with universities or research institutes to conduct a study and a road map for Special Economic Zones. Once we have one successful SEZ, then it can be replicated to other areas.

h. Capacity Building for PEPI

The main responsibility of PEPI is to coordinate the formulation of investment and trade policies. The team consists of 17 ministers headed by the President and chaired by the Coordinating Minister for the Economy for day to day work. This team is responsible for preparing background materials for ministerial meetings, undertaking policy research and analysis, and monitoring the implementation of investment profiles. The working team of PEPI will consist of professionals. USAID can support PEPI by providing capacity building for the technical staff and provide consultants and senior advisers to develop strategies for improving the analytical and reporting capacities of PEPI.

VII. Business Development

A. Background/Key Constraints

The 2008 Doing Business Report ranks Indonesia 135 out of 174 on the ease of doing business. Comparatively, Indonesia ranks markedly behind its Southeast Asian neighbors with the primary constraints being macroeconomic instability and policy and regulatory uncertainty. The macroeconomic environment, poor infrastructure, unfavorable business climate, and corruption have compounded effects on entrepreneurship and small and medium sized enterprise (SME) development. These external constraints of business development result in SMEs working outside the formal sector further limiting access to finances, markets and participating in value chains. As a result the SME sector in Indonesia lacks the human capacity, technology inputs, and advanced and efficient production strategies. SMEs are also increasingly unable to compete with larger firms and SMEs in more advanced economies in Southeast Asia.

The government of Indonesia recognizes the import role the SMEs play in economic growth. micro, small and medium enterprises account for 99% of all enterprises and employ approximately 79% of the workforce, however small enterprises account for only 41% of GDP and medium enterprises16%. The Ministry of Industry’s strategy for National Industrial Development 2004-2009 includes targets for increasing the size of non-oil and gas manufacturing by an average of 8.56% per year and to contribute 26% of the GDP. Priority industry sectors have a high representation of small and medium enterprises and reinforce the need for increased productivity and efficiencies, development of downstream industries and SMEs. However, MOI and other government led programs and activities have historically failed to improve the productive capacity, competitiveness and integration of SMEs into larger value chains.

With over 240 estimated programs for micro, small and medium enterprises including business training, subsidies, business consulting, training and production facilities and access to finance, the GOI programs lack input from the private sector, market driven approach and focus (Tambunan, 2007). While Indonesia has a long history of microenterprise support, there has been little success in translating microenterprise development models to SMEs and limited acknowledgement of the different approaches required to support microenterprise development and SME development.

The newly adopted *One Village, One Product* approach, adopted by the MOI, is based on a Japanese Model, and will identify unique products and community assets using a cluster approach. Based on GOI past program experience, little evidence exists that this approach matches the current business realities, and domestic and international market demands and will improve the business environment and support for SME development. However, the GOI remains committed to supporting the SME sector.

This section briefly summarizes the key constraints to business development in Indonesia, specifically SME development and takes into account priorities identified in the Final Workshop

Report of the USAID/Indonesia Economic Growth Stakeholders Workshop (July 2008) and new issues identified during the process of this assessment. [17]

1. Business Development and SME Policy Constraints

The Ministry of Industry (MOI) is responsible for the design and implementation of policies that support industrial sectors. With SMEs employing approximately 73 million people, the role of the MOI Director-General of Small Scale Industry and the Minister of Cooperatives and SMEs are key to policies and programs that support SME development. The MOI is the lead government body responsible for activities related to business development. It is engaged with a wide range of programs to encourage growth in priority sectors, but only has a limited engagement with the private sector outside of traditional trade associations. Services are typically provided through local budget funds (APBD) and are provided free of charge through sanctioned business service providers.[18] GOI's approach to SME development is closely tied with microenterprise development and poverty alleviation and therefore lacks a larger view of the role that SMEs play in domestic value chains and inputs to larger productive industries. It is widely accepted that these efforts are considered philanthropic rather that building a vital part of the economy. For example, a recent MOI initiative to assist SMEs includes a diagnostic analysis reviewing financial management and production systems that are 100% subsidized. Government employees will act as specialized consultants under this program. Policy tools and programs meant to support SMEs and provide protection -- such as subsidies and fiscal incentives -- distort private sector development and are the products of the demand by SMEs for associations, chambers of commerce, or legacy programs from prior industrial strategies.

2. Local and Regional Business Environment

Decentralization efforts were initiated in 2001 and have resulted in an unprecedented devolution of local government *(kota/kapubatan)* authority. In this process local governments have received limited authority for business regulations, licensing requirements and other revenue raising functions. Despite efforts to review and limit the proliferation of new local regulations and prohibit local government regulations that conflict with central government, (Law No. 34 2000 and No. 32 2004) an estimated 6,000 new tax related regulations appeared between 2000 and mid-2005 (OECD, 2008).

The recent Local Economic Governance in Indonesia survey conduct by the KKPOD supported by the PROMIS project confirms in their 2007-08 results that approximately 80% of the sampled local regulations have errors related to legal references, omissions of required points of substance or violations on points of principles (Asia Foundation, 2007). Overall local government capacity for planning, budgeting and business promotion, and development remains weak.

3. Access to Finance

[17] Issues addressed in part and in whole in other sections: Transportation and Infrastructure. Not addressed in this report: Energy and the Environment.

[18] According to Government Regulation No. 02/2008 on Empowerment of Business Development Service Providers and may be funded by central government, local government, limited liability companies and the private sector. Government Regulation (PP) No. 3 2007 require local government s to empower SME through various support programs.

Participants in the business development working group at the USAID/Indonesia Economic Growth Stakeholders Workshop in July 2008 identified access to credit and finance as one of five key constraints. It is interesting to note that this conflicts with interviews conducted during this assessment where only one party listed access to finance among the top three constraints in business development. Access to finance was however cited among the top 5 constraints. Section V on Finance addresses SME finance specifically. As noted earlier, Indonesia has a well developed microfinance sector with over 50,000 Microfinance Institutions (MFIs) in Indonesia, including state run banks such as BRI. [19] Issues specifically noted related to access to finance were:

- Support for and passage of the Microfinance Law (RUU LKM) which will allow MFIs to mobilize lower cost funds and provide lower cost loans.
- The development of long-term financing mechanisms for SMEs. None of the persons interviewed expressed a shortage of access to working capital loans (i.e., lines of credit). However literature reviewed and interviews confirmed limited product offerings for longer-term financing.
- The ICT sector, however, appears to have limited access to finance for small and medium size firms attempting to develop innovative products.

4. Human Resource and Workforce Development

Human resource development was identified as a key constraint by the business development working group at the USAID/Indonesia Economic Growth Stakeholders Workshop (July 2008) and was one of the top three constraints cited by all parties interviewed including the MOI Secretary General Agua Tjahajana Wirakusumah, private sector leaders, local government and trade associations.[20] Human resource skills and improved productive capacity in quality and quantity are critical. The application of new technology is key to this area.

Indonesia has a prominent, highly developed university system; however almost 40% of first year graduates are currently unemployed or underemployed. Workers lack leadership and management capabilities. Firms lack the resources and skills needed to identify and recruit appropriate personnel.[21] Interviewees stated that approaches to human resource development which improve product capacity should seek to take advantage of international investors and internal training programs, the transfer of knowledge and technology, public private partnerships, universities, and the development of local ICT.

a. SENADA Project's Analysis of Human Resource Management (HRM) Practices

Indonesia Labor Intensive Light Manufacturing Industries provides details regarding HR and productivity and makes recommendations in three key areas covering research, training and setting of standards. The first recommendation is to conduct an in-depth survey on the link between HRM and performance. The purpose of the survey would be to show the benefits of investing in HRM and to test the most effective HRM practices for the Indonesian context. The most practical and requested support for HRM is in the delivery of training, the development of materials and training of trainers. The SENADA project, working on the development of executive training for the Garment Partnership Indonesia (GPI), has provided a solid model and is a scalable activity. Developing training manuals which incorporate industry specific needs would broaden the application of skills in quality control and help SMEs meet international

[19] Microfinance Innovation Center for Resources and Alternatives, http://www.micra-indo.org/content/view/29/45/en/.
[20] Cited specifically owner of HR consulting firm PT Aneka Search Indonesia, Kevin Thompson.
[21] Comments provided by members of the American Chamber of Commerce, Freeport, meeting with Ciputra Foundation.

standards in health and safety. Setting appropriate standards is the third recommended component. Standards include appropriate pay scales, production incentives and performance-based compensation. Manufacturers should also seek to adhere to international standards appropriate to their industry, for example the SA 8000 for garment and textile industries. Developing and incorporating standards will help ensure the consistency of HRM as well as improve management systems that support enhanced productivity.

B. USAID Current EG Business Development Projects: SENADA, PROMIS, DCA

The EG business development project portfolio encompasses three projects that have worked largely independently of each other. The SENADA program is working in three main areas to support selected industrial value chains (IVCs) including: garments, home accessories, footwear, furniture, automotive parts, and ICT; the business enabling environment at the national level; and knowledge development. The PROMIS activity worked primarily with local governments to improve local and regional business environments. The EG office manages the DCA with Bank Danamon, the second largest private bank in Indonesia. The one-time revolving loan portfolio guarantee for USD 8.2 million was signed in September 2005 and is not directly linked with other USAID EG activities. In addition, the EG office has developed several strategic public/private sector partnerships that leverage current project resources or work directly with project activities.

This section will provide a short assessment of the USAID/Indonesia's current business development activities, review accomplishments and challenges and comment on the status of the projects.

1. SENADA

The SENADA project, implemented by DAI, works with the private sector to improve the competitiveness of Indonesia's non-farm sector. The objective of the project is for Indonesia to generate growth, jobs, and prosperity by improving the business climate and the competitiveness of a select number of labor intensive light-manufacturing value chains/clusters in global markets. Activities focus on five value chains working on three crossing cutting issues and includes the provision of small grants for innovate activities and products. SENADA has engaged a large number of private sector firms into their value chain work, notably the Gap and Jones New York in garments, and Cisco and Microsoft in ICT.

a. SENADA's work with Industrial Value Chains (IVCs) has focused on five sectors, of which four are included in the MOI's National Industrial Development Policy (2005), and the fifth, home accessories, is under the Ministry of Cooperatives and SMEs. In all five sectors SENADA has used a targeted value chain methodology and approach; mapping the respective value chains and identifying appropriate areas and levels of intervention. SENADA works closely with industries through formal associations or groups of self identified firms. Success in the individual value chains has varied, in large part due to stakeholder buy-in and ownership of the specific IVCs. Below is a brief summary of the IVC activities.

    i. In auto parts SENADA has been providing technical and financial support for several key activities. SENADA has provided support to the Center of Automotive Indonesia (SOI), the Society of Automotive Engineers Indonesia (IATO) and the Indonesia Service Station Association

(ASBEKINDO) to develop and implement an “Indonesia First” product seal of quality for automotive components - QSEAL. SENADA has supported the development and distribution by Wahana Pengembange Usaha (WPU) of the Business Technical Services Provider Directory – Metal Stamping Pilot Edition and has secured distribution channels. SENADA is also working with two key investors on the development of the *Indonesian Global Sourcing Center (IGSC)*.

Work with the auto parts value chain has been challenging due to the structure of the trade associations. While SENADA has moved forward, stakeholder buy-in has been difficult to obtain. QSEAL is designed as a scalable activity, but will require support from sector leadership to ensure success. Ending support for this activity will likely result in a return to the status quo and have minimal impact. It is recommended that USAID consider extending support for this value chain for 6-9 months to ensure the adoption and sustainability of interventions and investments.

ii. The furniture value chain has been one of the strongest in terms of stakeholder engagement and ownership. By identifying market demand for sustainable wood products and demonstrating the link between international standards and market access, SENADA has made strong in-roads in supporting the development of certified wood products. Working closely with the furniture and wood products association, ASMINDO and a small group of manufacturers identified as Eco-Exotic, SENADA has support the development of standards, the training for certification of business services providers and the development of joint marketing materials.

The Eco-Exotic team is developing an agenda for further cooperation in the formation of an association and also exploring the development of a trading company to meet logistical needs for exports to U.S. markets.

iii. The garments sector was identified as a target sector for support and growth by the MOI. SENADA activities have focused on increasing the competitiveness of the Indonesian value chain through improved production and management systems in the form of an Executive Development Program (EDP) for the Garment Partnership Indonesia (GPI) alliance. Working with international brands and retailers, both formally and informally, the GPI has stimulated interest among key industry brands in the GPI partnership concept. Informal participation by the Gap, Jones Apparel, Adidas and Nike has helped in the development of GPI.

The garment manufacturers have become increasing interested in upgrading production standards to more effectively compete and meet market requirements. There is considerable local stakeholder buy-in and empowerment for the GPI and the EDP; however the program is still in the initial stages of development. USAID should consider extending support to the activities undertaken by SENADA in this value chain to ensure long term sustainability.

iv. The footwear sector is considered a sunset industry. Declining sales reflect weak product demand, high costs of inputs, and inefficient production. The MOI supported Indonesia Footwear Service Center (IFSC), located in Surabaya, is available to provide support to SME footwear manufacturers. However the IFSC suffers the constraints similar to other MOI supported SME development programs: not focusing on meeting market demand and out of date equipment.

    The availability of locally produced inputs, specifically leather, is also a constraint. Most locally produced leather is exported, while the leather used in the manufacturing of footwear is imported. Competing interests among the footwear association (APRISINDO) and the leather association (APKI) have been difficult to resolve. As a result, SENADA has limited their activities in this area. It is not recommended that USAID continue to work in this value chain.

v. The home accessories value chain has been growing in strength, following the examples and success of Eco-Exotic. Lead firms are committed to implementing changes that will improve market access and strengthen firms downstream. SENADA has also provided design competitions and has supported the development of market materials and Sustainable Home Furniture interactive educational modules.

    The recent cohesion of the stakeholders indicates stakeholder buy-in and ownership. USAID should consider extending support for activities in this value chain for 6-9 months to ensure sustainability.

b. Business Enabling Environment (BEE) regulatory reform and advocacy activities have also benefited from the value chain approach and from working closely with the IVCs business associations and lead firms to identify major regulatory constraints. SENADA has also worked with the MOI to develop a regulatory mapping tool (RegMap).

c. SENADA's Knowledge Development is specifically designed to strengthen lead firms with the capacity to support the transfer of skills and knowledge through the development of improved subcontractor performance management. Local software developer, InforSys, developed a subcontractor performance management software program and eight other ICT solutions are currently in development. Lead firms have demonstrated continued interest in supporting improved production and management of downstream suppliers.

d. ICT has been a crosscutting activity for the SENADA project as both a catalyst for value-chain interventions as well as for programs reducing barriers to and expanding service for ICT products and solutions. SENADA has developed key partnerships with local ICT service providers, universities, and the Cisco Corporation.

e. SENADA is providing institutional strengthening support for private sector business services development through embedded services delivery. SENADA's approach includes the wide dissemination of information and learning modules accompanied by training for associations and business service providers. Working with targeted institutions and lead firms, SENADA has given training to private sector certification providers and the ASMINDO on Verification of Legal Origin (VLO) and the Forest Stewardship Council (FSC).

f. The execution of the SENADA program has suffered from time lost in re-directing projects toward the objectives in the original statement of work. This was costly in terms of time and resources. SENADA's greatest challenge entering its 4th and final year is its limited timeframe, with the project scheduled to end in September 2009. With 10 months of the active project time remaining, the SENADA team and partners are looking to ensure the continuity and sustainability of key programs. In addition, SENADA's approach did not include strong linkages with GOI counterparts at the national or local level. As a result, SENADA's long-term impact will rely heavily on the ability, will and resources of private sector partners and stakeholders to continue efforts after the project has been completed.

g. The SENADA program was designed as a traditional competitiveness and business environment activity and matched objectives of the USAID Strategic Plan for Indonesia 2004-2008.. The ambitious original project design sought to address key constraints to competitiveness. The SENADA program would have benefited from a narrower focus, dedicating resources to only 2-3 value chains.

2. PROMIS

As noted above, one of the major constraints to private sector development in Indonesia is an unfavorable business-enabling environment. Indonesia ranks low on the World Bank's Doing Business Indicators, Ease of Doing Business, ranking 135 out of 174. PROMIS, implemented by the Asia Foundation, has worked closely with interested local governments to 1) streamline business licensing; 2) improve the formulation of SME regulations; and 3) rank local governments according to their business investment climate.

a. Project Objective/Activities
Streamline business licensing. The PROMIS project worked with 55 local governments to create One Stop Shop (OSS) licensing centers. Through technical assistance provided by the PROMIS project, local governments are reducing the cost and complexity of business licensing and permitting, resulting in higher numbers of businesses entering the formal sector and faster licensing for investors. By focusing on general licensee requirements for all businesses and incorporating information technology systems for better management and performance, PROMIS estimates that processing for basic licenses is 60% faster and the average cost has been reduced up to 30%. While mandated to all 467 districts by the GOI and Ministry of Home Affairs in 2006, only an estimated 30% of the districts have opened OSS and effectiveness varies greatly. Asia Foundation has also developed an OSS Performance Index to support monitoring and evaluation of OSS implementation.

Improve the formulation of Small and Medium Enterprise (SME) regulations. PROMIS worked with 28 local governments implementing Regulatory Impact Assessments (RIA).

This effort is being supported by USAID with additional training in fall 2008 to be provided in the US.

Strong incentives need to be created for local governments to implement business-friendly policies, resulting in higher numbers of local governments implementing market reforms and adopting best practices. The Asia Foundation worked with Regional Autonomy Watch (KPPOD) and AC Nielsen to develop a comprehensive new Indonesian economic governance survey covering all 243 cities and regencies within 15 provinces. This activity demonstrates the Asia Foundation approach to working with and through local partners. PROMIS provided technical and administrative support to KPPOD, supporting local buy-in and capacity building.

b. Improved community business environments
PROMIS was able to improve the community business environments by working with local governments and local stakeholders. While the will of local government officials had a direct impact on the effectiveness of interventions, several local governments emerged as leaders and examples. By further extension of this methodology, PROMIS also identified and worked closely with local partner organizations. By "putting Indonesia institutions in front" the program gains credibility while building on existing local talent and institutions. It is recommended that USAID use this approach as a model in future program design and implementation.

   i. Public and private sector dialogue in cities and districts that have engaged with the PROMIS activity validate a local community-based approach similar to the USAID LGSP activity. Capacity building and training with local governments is still needed as well as increased dialogue with the private sector. The "One Village One Product" approach, while potentially short-sighted in developing a diverse economic base, provides local government with a point of direction. Specific obstacles remain regarding the transparency of local procurement systems and budget management.

   ii. Challenges faced by the PROMIS project reflect the larger political dynamics of decentralization, weak provisional government structures, entrenched rent-seeking behavior, and a lack of workforce skill and capacity. The PROMIS activity was able to identify and streamline license registration, but had limited capacity to impact actual regulations. The RIA model has been an effective way to urge local government to review and analyze regulations; however, local governments are still limited in their ability to revise and govern regulations. In addition, since decentralization, it is unclear how change can be aggregated from local governments to the provincial and national levels.

3. DCA Alliances

In 2005, USAID/Indonesia signed a one-time revolving loan portfolio guarantee of USD $8.2 million (a 50% guarantee on a total portfolio of $16.4 million) with Bank Danamon to mobilize financial services to micro and small enterprises nationwide and in the communities affected by the tsunami of December 2004 and earthquakes of March 2005. Bank Danamon is the fifth largest bank overall and the second largest private bank in Indonesia. The guarantee enables the Danamon Simpan Pinjam (DSP) to enter new market sectors and expand the types of clients served. Danamon used the guarantee to facilitate the expansion of DSP and resume microfinance lending to tsunami affected communities. Although the DCA program was not designed to link into other EG activities, both the AMARTA and SENADA programs could have made potential linkages to the program, broadening the scope and benefits. Loans under this guarantee have been fully disbursed. To date, approximately 8,000 loans have been disbursed with an average loan size of $200 (18 million RPH).

Meetings with Bank Danamon in Yogyakarta indicated few differences in the offering of loans that were provided by the Bank Danamon private SME lending program and the DCA guarantee fund. No specific groups or industries were target recipients and loan offerings were comparable with other bank products. Sigit Setiawan, Unit Manager with Bank Danamon in Jogjakarta, specifically requested additional information on the overall program objectives and the inclusion of a group lending mechanism.

Based on the well developed market and with meetings with Bank Danamon in both Jakarta and Yogyakarta, this program should be further reviewed to ensure that resources are targeted to critical gaps and not duplicative of services available in the private sector. Demand does exist for SME financing tools, however SME financing needs to be de-linked with microfinance programs in order to ensure a market driven approach. USAID may consider a DCA guarantee designed to support the development of knew SME financial product. Any Future DCA guarantee program should be linked with other USAID activities to help ensure the delivery of appropriate technical assistance to banks and lenders as well as promote sustainability.

4. Public-Private Sector Partnership

The SENADA project has helped to pioneer innovative partnerships related to ICT and business development. Using an approach that builds partnerships around private sector partner needs; SENADA has ensured buy-in and longer-term support.

SENADA and Microsoft Corporation teamed up for a successful innovation competition called *iMULAi.* Using the SENADA project Business Innovation Fund grant mechanism, Microsoft contributed up to $75,000 in financing to support the award winning innovations launch. This partnership helped support Microsoft’s interests in Indonesia while increasing public awareness of SENADA’s Business Innovation Fund. The BIF continues to receive, review and award grants for innovative products and ideas and to date has awarded 20 grants totaling $429,288.

Partnering with Cisco Corporation, SENADA has launched a new public private partnership entitled the Industry Attachment program to place qualified Cisco graduates in 100 firms to increase industry competitiveness through ICT. Cisco International will provide training to dedicated Indonesia universities on Cisco systems and support student internships at local businesses. Embedding training programs in Indonesian universities will enable training to be extended to SMEs directly to identify and apply ICT solutions to their business needs.

Freeport Mining is working with the AMARTA activity in Papua. The activity, the Papua Agribusiness Development Alliance (PADA), is funded in part by Freeport and is providing technical assistance for fishing activities (including the development of ice factories for storage), coffee development and pig farming. The Freeport executive interviewed expressed an interest in working more closely with USAID and requested guidance on how the Freeport Foundation may engage in further alliances with USAID.

5. Portfolio Summary

- Limited contact and engagement with Central Government: The current activities in the business development portfolio have little contact with GOI central government agencies and institutions such as the Ministry of Industry and BAPPENAS. The MOI and BAPPENAS perceive that they have not been actively sought as stakeholders and partners in USAID's EG program. (See Gustav F. Papanek *The Indonesian Economy and USAID's Comparative Advantage.)*

- Projects such as SENADA and AMARTA have developed strong linkages with private sector partners, including Freeport Mining, Microsoft and Cisco, among others. This demonstrates USAID's interest and ability to leverage private sector resources to support its development objectives. USAID's EG activities, however, only have limited integration with the ten other donor assistance agencies and the myriad donor and private sector support programs. While this is not necessarily unique, given the size of the Indonesian economy and limited USAID EG resources, better coordination of resources and programs would likely result in wider and more lasting impacts.

- Several key themes and areas of success have emerged from SENADA's IVC and crosscutting activities: 1) capacity development for business development services; 2) the use of public private sector partnerships in the role of business solutions; and 3) accessibility of ICT partners for private sector solutions.

- The breadth of coverage in the design of EG business development activities (and AMARTA) has limited the program's effectiveness. Providing assistance to groups within value chains has not had large systemic impact and given the size of value chains and the Indonesian economy, has not provided a strong catalyst effect.

- Working with local governments and the private sector can support the democratization process by improving economic governance. Examples provided by both the PROMIS activity and LGSP demonstrate the effectiveness of building local capacity for business development and economic growth.

C. Work of other Donors

1. IFC/World Bank

The IFC-PENSA (World Bank Group) program supporting SME development in Eastern Indonesia began in 2003 and has recently been extended to 2013. Partners in this activity are local government, business associations and private sector stakeholders. The program is similar in design to USAID SENADA and PROMIS activities; developing sustainable supply chain linkages in eco-tourism, fisheries and forest/wood products, supporting legal and regulatory reviews through RIA, One-Stop-Shops and supporting SME business association and business development service providers.

The Microfinance Research Center for Resources and Alternative (MICRA) is implemented by Mercy Corp and supported by IFC-PENSA, GTZ, and others doing research and innovation and supports microfinance institutional development. Indonesia has a strong history of microfinance and microenterprise support. MICRA seeks to further develop Indonesia's capacity by identifying constraints and applying innovative solutions.

2. German Technical Cooperation - GTZ

The GTZ economic assistance program in Indonesia is focused on local and regional economic development, and applies a variety of methodologies and tools including participatory appraisals and competitive advantage (PACA), RIA, One-Stop-Shops, regional marketing, value chain and cluster development , business services development (BSD) or small-medium enterprises support. The current program works closely with BAPPENAS, in Central Java (Regional Economic Development - RED), directly supporting individual enterprises, improving regulatory framework conditions for SMEs, promoting inter-district cooperation, and developing a regional marketing strategy. GTZ regularly interacts with related donor programs, specifically the PROMIS project.

3. AusAID

The Australian bilateral assistance program, AusAID, is the dominant bilateral assistance program in Indonesia. Five year programs related to business development provide support to improve economic policy and private sector development. The Technical Assistance Management Facility (III) (funded at A$26 million), provides specialist technical experts to assist with policy development and implementation in key central economic agencies of the Indonesian government

Nusa Tenggara Assistance for Regional Autonomy (ANTARA) Program (A$30 million) is working to improve local government capacity, raise incomes and improve service delivery in two of Eastern Indonesia’s poorest provinces through an integrated area-based approach. A specific example of this program is the WiSATA - West Manggarai Swisscontact-AusAID Tourism Assistance. Located in Labuan Bajo, Flores, this program aims to achieve sustainable levels of local employment and skill formation opportunities by facilitating more effective eco-tourism promotion.

4. SwissContact

A private sector development agency, SwissContact has several small programs in Indonesia working in collaboration with other donors and/or projects.

1. The Local Economic Development project in Nusa Tenggara Timur Province (LED-NTT) in a collaboration with Cordaid from the Netherlands and is working on the Flores and Alor Islands. The project is working with local and provincial governments, loan cooperatives, the media, NGOs and other stakeholders to improve the enabling business environment, sector development, access to finance and access to information.

2. The Access project works in Jakarta and Jogjakarta as a collaborative effort with UK Department for International Development (DFID), Mercy Corps, the Centre for the Promotion of Imports from developing countries (CBI), HIVOS and the United States Agency for International Development (USAID). Activities cover improving SME access to markets, RIA process in Jogjakarta and value chain work in coffee, cocoa, fruit and honey.

3. The Small and Medium Enterprise Promotion (SMEP) is an extension of the STEP Project and is working with the garment cluster in Pesanggrahan and Kebayoran

Lama Areas of South Jakarta. The project is working with 300 micro and small entrepreneurs and firms focusing on increasing the competitiveness of the garment cluster by improving product and management capacity of SMEs increasing access to finance and market as well as the application of ICT for improved design and production. Partners on this activity are Bank Rakyat Indonesia (BRI), Allianz Insurance, Microsoft Indonesia, Hewlet Packard (HP), Jamsostek (Social Insurance for Workers), International Garment Training Center (IGTC), Bina Nusantara University and Triasa Foundation.

4. The Promoting Enterprise Access to Credit project (PEAC), scheduled to end this year, operates in Java and South Sulawesi and works with Bank Indonesia and the International Finance Corporation-Program for Eastern Indonesia Small and Medium Enterprise Assistance (IFC-PENSA) to improve the access of small businesses to bank credit.

D. Recommendations

US foreign policy objectives related to economic growth seek to develop well functioning markets, enhanced access to productive opportunities and strengthened international framework policies, institutions, and public goods. As noted in the *Economic Growth Strategy: Securing the Future,* "the ultimate value of growth lies in expanding freedom: giving people greater choice over what they can do with their lives." Indonesia's effort toward democratization through decentralization presents an opportunity to support both economic growth and democracy at both the national and local levels.

USAID Indonesia's economic growth resources are limited in comparison to other donors and relative to the size of the Indonesian economy. The 2008 USAID/Washington Economic Growth Strategy states that activities seek first to support large systemic impact and where systemic reform cannot be achieved, catalytic impact. This section provides recommendations for strategic areas for program design, program approach and crosscutting areas for future USAID economic growth, in particular on business development, with a view toward a long-term systemic impact supported by catalytic activities. Recommendations are presented in order of priority consideration. Priorities were determined using the USAID Economic Growth Strategy, GOI objectivities, current USAID activities and momentum, and complementing other donors and private sector actors.

1. Recommendations Related To Program Design

- Resources dedicated to business development in Indonesia are best integrated into programs and activities that reach a wide group of stakeholders. They should support sustained changes in the business environment and capacity building with the public and private sectors at the national, provincial, and local levels.
- Project design should be focused and driven by key USAID mission objectives.
- Program designs should be flexible to enable USAID to follow the leadership of champions both in the private and public sector with an aggressive focus on capacity

building and training. With the large number of donor assistance activities, USAID should focus on clear areas of opportunity and advantage.

- Stakeholders should be included in the project design process and in the development of objectives, activities, milestones and results.
- Monitoring and evaluation systems should be developed with stakeholder input with easy to measure targets reflective of short, mid and long term project objectives.

2. Recommendations for Specific Program Approaches

a. Local Economic Development

Decentralization has provided local governments with new authority in the business licensing regulations, planning and budgeting process. *The Local Economic Governance in Indonesia Report* cites a weak capacity for basic government functions in planning, budgeting, business promotion and business regulation.[22] Current USAID activities such as PROMIS and LGSP provide a basis for a local economic development approach. Projects should work with local governments to build dialogue between private sector leaders, associations, community leaders, and learning institutions/universities. This dialogue will help local governments to identify and alleviate constraints to economic growth and business development in their regions by ensuring that public officials are aware of the on-the-ground everyday constraints faced by firms. Specific constraints that can be addressed:

- Regulatory Impact – Expanding the RIA program and the ability for local governments to review the effectiveness of regulations and their impact on the business environment;
- Promotion of e-government – transparency in business licensee regulations, local procurement;
- Development of effective public-private sector dialogue – Ombudsman, *Forum Komunikasi;* and
- Re-design of business development programs to be demand driven with business services delivered through private sector agents.

With over 467 cities and districts, USAID should select local governments that have demonstrated an interest in economic development and capacity building through a rapid assessment of regional constraints and stakeholder interest. This approach can be accompanied by a provincial or national media campaign that promotes the *Local Economic Governance in Indonesia Report* and related studies. ITB's regional application and analysis of the Global Competitiveness Index to help stimulate interest and demand for improved local government economic planning and business promotion. Successful models of this approach include the USAID Vietnam Competitiveness Initiative, implemented by DAI and the Asia Foundation.

b. Leveraging Resources through Public Private Sector Partnerships

Partnerships with domestic and international private sector firms have been successful in supporting USAID economic growth and business development. Specific examples of this include the SENADA project's partnerships with Cisco and Microsoft. In addition, Indonesia's commitment to corporate social responsibility provides unique opportunities as firms are required to commit resources. Private sector firms and foundations that have programs aligned with USAID economic growth programs can provide USAID not only access to additional

[22] The report is a comprehensive review of attitudes toward local government.

resources, but also support capacity building and the sustainability of initiatives. USAID should build partnerships around the needs of private sector counterparts. Following the long-term business view of the private sector and market incentives for success will help ensure long-term impact and sustainability of activities. Corporate Social Responsibility initiatives through sector actors such as Freeport Mining and the Ciputra Foundation have expressed interest in working with USAID; both have programs that are compatible with findings in this assessment.

c. Support Business Services Development (BSD) in the Private Sector

Indonesia has a small but growing business services sector, indicating a willingness and ability to pay for services, particularly by medium and large firms. The SENADA project has been actively working with several Business Service Providers (BSPs) and trade associations to build service awareness and capacity.

The US Small Business Administration approach has been cited by BAPPENAS and local government officials as a possible example to provide SME business services. However, a change in mind-set is needed by both the GOI and SMEs from the current system of highly subsidized and government-provided services to the development of sustainable business services provided by the private sector.

USAID can support SME business services development by leveraging existing resources in an approach that works with local governments to competitively contract out services to multiple providers.[23] This would in effect replace current public services and leverage market knowledge of private firms. Continued local government APBD support through discounted programs, such as vouchers and public education and media campaigns can support a transition to a fee for services business model while also supporting small business development. Using local firms to deliver services increases the capacity of local service providers, and lends credibility and sustainability to programs. The competitive process and multiple awards of contracts to private BSPs reinforce market incentives. In this approach, programs can seek to establish ties to local universities and training institutions for research and academic support.

A new program sited by the Bali International Consulting Group, a BSP company with projects in Bali, Aceh, Nias and Eastern Indonesia, states that the GOI is considering forming new contractual relationships with BSPs based on the One Village, One Product cluster development model.[24] Partnerships would last 3 years and in exchange, government will provide start-up capital to the BSPs. Currently details on this program are limited, initiatives that seek to link the private sector to GOI efforts through competitive process such as this should be encouraged through USG assistance.

When asked what support USAID might provide to support microenterprises, a senior director of BRI stated that sufficient local funds and expertise exist in the microfinance area, but that assistance is needed in increasing access to markets for SMEs. This ties in with the development of local, private BSPs to provide sustainable services over the longer term.

The Indonesian Chamber of Commerce and Industry (KADIN) has established a company named PT Usaha Kita Makmur (UKM) Indonesia that serves as a trading house to help SMEs market their products. The privately held company is under the management and direction of KADIN and provides research, training, business incubator services and advocacy. The initial intent of UKM was to spin it off via an IPO after the first 3 years; however changes in leadership

[23] BSD is described the services needed for businesses to develop. Business services can be both supportive of business development and profitable for the Business Service Providers if they are designed properly.
[24] Bali International Consulting Group, http://www.bicg.org/bicg.php?sectionID=16

and other challenges have resulted in a re-evaluation of this target. Partners include the United Nations Development Program (UNDP), United National CPF, Persatuan Bank Perkreditan Rakyat Indonesia, Gema PKM Indonesia, Citibank, Citigroup Foundation, MOT Center of Small and Micro Trade, and other GOI actors. KADIN's current role and the natural link between SMEs and business services make them a strong partner and stakeholder in the design and implementation of efforts to improve BSD. USAID should consider exploring partnerships with KADIN in this area.

d. Linkages with Key University Business Education Programs

Capacity building, human resource management and workforce development were consistently mentioned among the top three as key areas for assistance. An estimated 740,000 university graduates are currently unemployed or underemployed with 300,000 new students graduating each year. Indonesia has a highly developed system of universities with strong research and business development programs, notably ITB, University of Gajah Mada and the new University Ciputra. Foundations and universities are dedicating resources toward entrepreneurship education and experiential learning with business education programs. There is an opportunity for US assistance in business education and supporting the development of a network of entrepreneurship education institutions. By targeting the unemployed educated population, US assistance can help existing programs reach a greater target audience, and draw linkages back to BSD support programs for innovative business start-ups and new business models that support the development of venture capital funds. Possible activities include the Pierce-Babson Symposium of Entrepreneurship Education and support to the Ministry of Research and Technology. Activities in this area should link to efforts to promote venture capitalism, and support for innovation.

In addition, the Ministry of Research and Technology has initiated the Business Innovation Center as public lead initiative to improve linkages between research centers and universities and the private sector. The mandate of the Business Innovation Center is to promote private sector linkages and investment in research and innovations support in government research centers. USAID should consider the Business Innovation Center when making linkages to Universities and research centers to support innovation, entrepreneurship and local technology solutions.

Specific interest has been expressed for support of creative industries. ITB is helping to support the development of a Creative Industries center that will provide training for creative design and market research. A targeted approach for creative industries that ties into export strategies for furniture, home décor and handicrafts as well as support for tourism should include strong linkages with the ITB program and local BSPs.

e. Central Government Capacity Building and Training

USAID's perceived disengagement with central government actors is in need of renewed efforts. Activities with the Ministry of Indonesia have been limited.[25] While it is has been noted that working with champions within government agencies lends to greater support, champions can exist at multiple levels. Key to supporting champions is the capacity building of institutions and teams. One of the specific recommendations made by Gustav F. Papanek in the recent paper *The Indonesian Economy and USAID's Comparative Advantage,* was to increase training and capacity building within the central government. Internal capacity building for both the MOI and BAPPENAS will promote institutional change in better understanding of the role of government and the private sector in business development.

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[25] See *A Review of Select Policies of the Indonesian Ministry of Industry,* SENADA Project. March 2008.

E. Cross-cutting Themes

1. Catalytic Role of ICT

The information communication technology sector (ICT) is one of the fastest growing sectors in Indonesia. Contributing an estimated 16% to the GDP growth rate, ICT is rapidly changing how Indonesia does business, governs and socializes.

> *A recent survey shows that mobile users in Indonesia were recorded at 68 million by the end of 2006 and grew to 94.7 million in 2007. It is predicted to reach 133 million in 2010. Meanwhile, Indonesian PC market growth reported in early 2007 was exceeding expectations, at around 20%. Hence, the Indonesian IT market should grow at a compound annual growth rate (CAGR) of at least 14% between 2006 and 2010. http://www.ictindonesia.com/industry.htm*

Projects such as SENADA, PROMIS and IN-ACCE support the expansion of ICT into improved government and business. Given the local capacity and the availability of international partnerships, USAID should consider a strategic approach linking ICT providers with SMEs to provide business solutions. SENADA has worked with local ICT software developers and service providers in the development of tools for SMEs. Specific areas of concern are the development of business models that can meet the needs of SMEs, education of SMEs on the importance and application of ICT and access to finance for ICT innovations.

2. Tourism Sector Support

International tourist arrivals to the Asia Pacific region increased by more than 10% in 2007 after a record 8% increase in 2006. Despite a respectable increase of almost 12% in the first half of the year to 2.9 million, Indonesia still lags behind other Asian destinations, with the exception of Vietnam, a relatively new player in the international travel and tourism industry.

Table 3: Tourist Arrivals for South-east Asia

Country	Tourist arrivals/million
Singapore	103
Thailand	14.5
Malaysia	21
Indonesia	5.5
Vietnam	4

Tourism has a multiplier effect which supports the development of service industries and particularly lends itself to SME development. USAID's experience in sustainable tourism in supporting business development and economic growth has contributed to expansion of service sectors in Eastern Europe, South America, and the Caribbean.[26] In addition, the growing middle class in Indonesia presents opportunities to promote domestic tourism. Given Indonesian cultural and natural endowments, USAID may seek to support the development of national and or local tourism development strategies. The model of Yogyakarta Tourism Agency Association (ASITA) can be considered at the local level. The Ministry of Culture and Tourism's Visit Indonesia 2008 program allocated US$108 million for tourism promotion indicating a commitment by the GOI to attracting tourists. While current institutional and regulatory constraints limit tourism development, Indonesia's unique attributes will continue to draw in tourists.

[26] For examples see Croatia, Montenegro, Bulgaria, Ecuador, the Dominican Republic, and Jordan.

USAID/Indonesia should consider allocating specific STTA for further analysis of the tourism sector and consider strong collaboration with the natural resource management/environment office to help promote sustainable and eco-focused tourism.

3. USAID Indonesia Environment and Natural Resource Management Program

The USAID/Jakarta Office of Basic Human Services expressed interest in working with the Economic Growth Office on several strategic activities. With 55% of non extractive industries relying on Indonesia natural resources for production and contributing 20% to the total GDP, effective and sustainable management of resources for economic growth is essential.

Community Forest Certification. ASMINDO expressed specific interest in USAID support for a community forest certification program. Manufacturers and producers of wood products, specifically furniture and home accessories, rely on community forests for resources. With the average size of community forested areas estimated at 300-400 hectares, certification may be cost prohibitive in some communities. An education and awareness program on the economic benefits of sustainable forest management in collaboration with ASMINDO would benefit both community economic development, and the sustainable management of resources.

AMARTA Seaweed and Alga Cultivation. While currently a small activity under the AMARTA program, this activity has scalable potential and has the potential to replace economic activities that are damaging to the coral reefs.

VIII. Agriculture and Agribusiness Sector

A. Background

Employment growth and its twin, poverty reduction, is a central concern of all observers of the Indonesian economy. That is the focus of this section on agriculture and agribusiness. Along the way several other policy objectives of Indonesia and the US are addressed. Judging from experience in other countries, the employment/poverty issue will morph into concern for rural urban income disparities. That is signaled by the current distress push of rural people into cities. Agricultural growth also addresses that issue.

With the labor force growing at 1.9% per year and only about one-fourth of the labor force in the formal sector (OECD, 2008), agriculture and its powerful multipliers to the labor intensive, non-tradable, rural non-farm sector will dominate the solution to the employment/poverty problem over the next decade or two. In examining the various commodity and functional sectors of Indonesian agriculture from the point of view of US comparative advantage and the aggregate impact on employment, the focus settled on the horticulture, coffee and cocoa sub-sectors. Optimal assistance to those sectors focuses on an integrated set of technology, local government, policy, and targeted direct support to the private sector. Throughout, the emphasis is on building Indonesian institutions that can have an aggregate impact and will continue the efforts into the indefinite future. The priority needs draw from USAID’s current ARMATA project and two recent past projects, one on agricultural policy and the other on bio-technology, as well as on early project training staff for the Indonesian policy and agricultural research systems.

1. Agriculture and Employment Growth

Over the long run the economy will be transformed and manufacturing and the formal services sector will come to dominant employment growth. However, two factors inhibit the formal sector’s role in the short run. First is its current modest base of employment with less than half as much employment as the non-formal sector. Second, in a globally competitive market, formal, tradable sectors must continually reduce costs, and in labor intensive industries that means increasing labor productivity. Thus, at the very best, for every ten percent increase in output there will be only a 2-3% increase in employment (Mellor 1996, 1976). The recent Indonesian experience has shown no increase in employment as these formal sectors grew (OECD 2008). Papanek states that in the past ten years 20 million people have been added to the Indonesian labor force and only 15% of those absorbed in the formal sector (Papanek 2008).

In the 1980’s Indonesia experienced rapid agricultural growth (averaging an extraordinary 6.8%) and the percent of the population in poverty declined by three-quarters – an equally extraordinary decline (Asra 2000, Ravallion and Huppi 1989). Even more startling, the standard measure of income inequality showed a 30% **increase** in equality (Asra 2000). Concurrently the real wage rate rose (Asra 2000). With the severe dislocations of the mid 1990’s, slower agricultural growth and high rice prices saw the poverty percentage increase by a third and then as the dislocations passed drop back to its previous level. The current pace and composition of growth are bringing only marginal declines in poverty.

Why is there such a powerful relation between agricultural growth, employment growth and poverty decline (Ravallion and Datt 1996)? There are two parts to the answer. Without open trade, rapid growth in cereal production brings down food prices. Poor people spend at least two-thirds of their income on food. Thus there can be a large income effect on poverty operating through food prices (Mellor 1972).

Much more important, and operating with open markets, farmers spend at least half of increments to income on the local, rural non-farm sector (Mellor and Ranade 2007). That sector depends on rising farm incomes if it is to expand since the goods and services are non-tradables. Examples are housing improvement, local furniture and garment purchases and of course a wide range of retail and other services. These rural non-tradable sectors tend not to increase labor productivity nearly as much as the globally competitive sectors, thus the elasticity of employment with respect to output growth is close to one – i.e., employment expands almost proportionately with output. Labor productivity is low in this sector, but that is because of so little capital use and hence low payments to capital as compared to industry. A further characteristic, the demand for educated people in the rural non-farm sector, is elastic with respect to the agricultural growth rate. That is demand for educated labor, particularly primary and secondary school expands more than proportionately to the total employment – examples are retail clerks, bus conductors, and private providers of health and education services, all in prospering market towns.

Rapid growth in agriculture is based on yield increasing due to technological change that also raises labor productivity, so employment in agriculture does not expand nearly as rapidly as output (Rao 1976). However, that is far more than made up for by the multipliers to the rural non-farm sector (Daryanto 1999, Haggblade et al. 1989). To summarize, in Indonesia, if all sectors in the economy grow rapidly, agriculture through its multipliers will account for an astounding 80% of incremental employment.[27]

A major acceleration in the formal sector would make a significant contribution to employment, but not enough to absorb all the growth in the labor force. In recent years, the roughly 3% growth rate in agriculture has given enough increase in farm incomes to provide a very small reduction in poverty. To expand jobs as rapidly as required, absorb all the annual additions to the labor force and raise real wages and reduce poverty requires both a major acceleration in growth of the formal sector, driven substantially by labor intensive exports, and a near doubling of the agricultural growth rate and its large employment multipliers to the labor intensive rural non-farm sector.

It is of course raising per capita incomes of farmers and hence the **per capita** rate of growth of agriculture that drives employment. In the past few years, agriculture has grown only two percentage points faster than population. Hence farm incomes have grown little and the stimulus to the rural non-farm sector has been small. Thus, a project

[27] This calculation is based as follows. Initial share of labor force 30% agriculture, 32% rural non-farm, includes those with too little land to provide half of employment, 38 percent urban tradable and non-tradable; GDP growth rate respectively 5%, 7%, derived from agriculture increments to income with an elasticity of 1.5, and 8%; elasticity of employment respectively 0.5, 1, and 0.3; resulting in respectively an overall growth rate of employment of 3.9 percent, 2.6 times the labor force growth rate. All data extrapolated from BSD statistics, various years and Mellor 1992 and 1976.

is proposed that focuses on a major contribution to increasing agricultural production much more rapidly than population growth. Prior to that analysis the current food price situation will be reviewed as well as recent USAID financed projects in agriculture.

2. The Indonesian Response to the Current World Food Situation

Food prices have recently shot up to unprecedented levels throughout the world creating great privation for the poor who spent up to 80 percent of their income on food. Wages tend to adjust to food prices, but with a few years lag. Rice prices joined this parade in early 2008, and along with many other primary commodity prices have lost a significant portion of that increase in recent months. Adjustments to food scarcity are always made by the poor who despite the privation it creates have elastic demand for food because of the real income depressing effect of higher prices (Mellor 1976).

In addition to the urban poor, large numbers of rice farmers with insufficient land to rise above the poverty line are net buyers of rice and therefore also lose from high rice prices. However, rice prices are an important determinant of the incomes of the politically influential farmers who produce the bulk of the rice and who are not poor by the standards of their communities. That is the complex environment of conflicting interests within which Indonesian rice policy is determined. The issues are complex and have received a great deal of attention from economists, most recently in a special edition of the Bulletin of Indonesian Economic Studies (2008) containing eight major papers on the subject. All these issues are well researched in Indonesia. USAID's past programs have played a distinguished role in those debates.

Indonesia has a long history of attempting self sufficiency in rice production. Subsidies have been an integral part of that process. In the 1980's period of rapid increase in rice production, fertilizer and credit subsidies increased the profitability of the new high yielding rice varieties with consequent accelerated adoption and growth. Restrictions on rice imports have been frequently used to push up domestic rice prices.

Rice farmers are the most numerous of farmers; higher prices particularly benefit the politically influential middle farmer. The politically less influential rural poor have an unfavorable price effect on their income muted, although with some lag, by the increased employment from local expenditure of higher farm incomes. The politically more vocal urban poor benefit from food subsidies. This is a politically winning combination.

The Government has emphasized rice production over the rest of agriculture in its agricultural growth programs. Statistics for the two most recent years show rice production growing at about 4% per year. Whatever the cause, and weather was important in one of the two years, that seems unsustainable. First, it would move Indonesia in a few years to being a rice exporter, with a huge increase in cost to the government as the country moved from import parity to export parity in the market. Second, the comparative advantage in Indonesia does not call for increase in area planted to rice. Yield increases derived from an effective research program, are unlikely to average more than 2% per year. That would about match demand growth.

Thus, just as in the case of economically unjustifiable farm subsidies in the US, the efforts to raise rice prices in Indonesia are not likely to be stopped by economic arguments. Control of imports can be used to stabilize rice prices and thereby reduce the risk of innovation. That is a small potential side benefit. A potential cost of

Indonesian rice policy is slowing the shift to high value crops (horticulture) which can increase farm incomes by far more than technological change within the rice sector. However, that shift is far more influenced by increasing market opportunities by better roads and improved technology in the production, cost reducing side. A more substantial negative aspect of the political focus on the rice sector is the understating of potentials in the high potential growth sub-sectors and inadequate support for those sub-sectors.

The lesson for foreign assistance strategy is to skip the politically potent rice sector in favor of relatively neglected high potential growth sectors such as horticulture. A modest help to rice technology from the assistance to bio-tech recommended below and a small presence in rice policy in the context of horticultural policy would be low cost.

B. Brief Review of USAID Projects in Agriculture

USAID currently has one substantial agriculture project, AMARTA, and two projects from the recent past that have been highly influential. The latter two were in agricultural policy and bio-technology and are distinguished by their focus on strengthening Indonesian capacity. In the distant past the US provided the bulk of the highly trained economists and scientists who dominated economic policy and agricultural research for several decades.

1. AMARTA

AMARTA is a wide ranging three-year $15 million project with one year remaining (AMARTA, 2008 and other AMARTA publications listed in the references). It covers all aspects of the value chain for 13 commodity groups and covers innumerable functions from boat building to seaweed seed. The project has been reviewed for this effort through extensive interviews with staff, reading the extraordinarily voluminous written output and an intensive visit to the Bandung field site. The AMARTA staff without exception went to great lengths to be helpful. The purpose of this effort was not to make an assessment of the project – that would have related the project entirely to the objectives and terms of reference for the project. Rather it was analyzed from the point of view of developing a future long term strategy for USAID – the quite different terms of reference of our effort.

The project has consistently exceeded the nine USAID approved targets. It has also had direct contact with a very large number of government agents and agencies as well as with many private sector agencies. The many specific successes potentially serve as pilots that could be emulated on a large scale. In that context the project has done a thorough job of publicizing its efforts and accomplishments. It is likely that the rate of return on the specific investments has been high. Thus, by USAID standards, AMARTA has been a major success. However, the very measures of success set by USAID lead to limitations of the project from the point of view of larger US government objectives. Most important, the impact on the agricultural growth rate is negligible. There has been at best spotty impact on national institutions. The impression given to Indonesians is mixed. The reasons for the deficiencies are three

First, the very modest resources are spread thinly over a large set of only loosely related value chains. These value chains in turn were not selected for the aggregate impact that interventions could have. For that, it would be necessary to measure the base weight of each intervention and multiply that times the likely growth rate.

Second, working with national institutions was driven by the implications to meeting the USAID targets rather than as a means of developing those institutions. Development of institutions was at best a subsidiary target in the terms of reference.

Third, the attention to meeting USAID targets with attendant heavy publicity for the AMARTA project and USAID resulted in considerable criticism of the project by influential Indonesians. That in turn makes it difficult for the project to serve as a pilot for widespread Indonesian emulation. Having said that, the Coffee and Cocoa Research Station and the Vegetable Research Station did benefit from the project.

The strengths of the project are hard driven management focus on the USAID M & E targets with a high level of efficiency in meeting those targets and ready response to USAID suggestions for program adjustment. The project also showed strength in recognizing that although its focus was on the total value chain that the good private sector marketing systems were hindered by inadequacies with respect to cost of production, quantity produced and quality on farms and so AMARTA focused considerable effort in solving the many problems at the farm level. The additional strength is the large amount of knowledge generated within the program as to how production and productivity in the various value chains might most efficiently be pursued.

The weakness is the diffusion of effort, and the lack of focus on building the Indonesian institutions as an objective itself. Of course, as will be developed in this project's recommendation, the development of Indonesian institutions itself must be with a clear purpose – most simply achieving an aggregate increase in national output and along the way broad participation in that process, including by the poor. A final weakness is that despite the large amount of publication, the institutional memory for the project will prove very short because of the tenuous connection with Indonesian institutions.

The lessons for the future are three: first, projects which have direct impact at the farm and business level bring knowledge that can be useful to achieving rapid growth; second, national impact and building lasting Indonesian institutions focused on national objectives are integral to US objectives; and third, attention to US comparative advantage in development and application of production technology is critical to agricultural growth.

2. Bio-technology

USAID financed, ending in 2002, a modest project supporting bio-technology development in Indonesia. The effort had three major thrusts: 1) building Indonesian capacity in bio-tech through TA and training; 2) assisting in practical applications of bio-tech; and 3) helping Indonesia develop Genetically Modified friendly legislation. The effort brought the highest quality technical assistance from two leading bio-tech institutions in the US: Cornell University and the University of Wisconsin. Input of the best from the United States is still favorably noted by the Indonesians involved.

The applied work, derived from out front bio-technology work was successful in developing disease resistant tomatoes and potatoes, both important crops in Indonesia and forwarding applied work in rice. As part of that work, Indonesia progressed from tissue culture to more advanced bio-technology and potential to generate genetically modified (GM) varieties. In addition a close working relationship was built between the

Indonesian bio-tech personnel and institution and the work at Cornell and Wisconsin. Finally, desirable legislation was adopted in Indonesia. This was seen by Indonesians as a very successful project. The primary implication for the future is that Indonesia now has an excellent bio-technology resource ready for further advances and interactions with US institutions.

3. Policy

USAID, in the late 1990's and ending in 2004, provided substantial technical assistance to individual Indonesians in policy research. The project worked with a Chief of Party bringing the very best from the US in agricultural policy analysis and understanding of Indonesia (built on long term contacts growing from the Berkeley "mafia" of Indonesians who essentially ran Indonesian economic policy for more than two decades). Working in close collaboration with Indonesian top policy researchers, spread across many Indonesian institutions, analytic topics were defined, US top-level researchers contracted and the work performed. Much of the work was on rice policy. It was all of first level quality. Although Indonesia did not fully reform rice price and trade policy, for reasons explained above, the work contributed to a generally open trade policy and in general kept trade restrictions on rice to levels that largely stabilized rice prices. That served the useful purpose of reducing risk and contributed to more rapid growth in rice production. Substantial institutional capacity was built in a large number of institutions. Some of these institutions have reached critical mass. The implication for the future is that it is now appropriate to choose two of these institutions for major policy impact. The very success in building Indonesian capacity provides scope for a more specialized approach to policy, as delineated below.

C. Brief Review of Other Donor Projects

There is very little donor activity in agriculture. The World Bank is largely out of agriculture because the Minister of Agriculture has said that he does not to take loans for agriculture – partly because of Shariah law, but also partly that loans should be used for investments with quick returns. Nevertheless, the World Bank is planning a substantial project to assist in broad development of the Agricultural Research and Extension system. The Bank would greatly welcome USAID input into the horticultural research system. AusAID is planning to co-sponsor the work in agricultural research and has a modest project developing agricultural research and extension at the provincial level in eastern Indonesia with a concentration on horticulture. The ADB has not worked in agriculture in Indonesia, as part of a policy of only doing infrastructure in rural areas. Other donors have very small projects. In discussion with Bayu Krishnamurti, Deputy for Agriculture and Marine, Coordinating Ministry of Economic Affairs, the Government would welcome support to agriculture and is puzzled that given the importance of poverty in rural areas, that there is so little donor activity in agriculture.

D. A Center Piece Project for the USAID Long Term Strategy

The agricultural sector through its employment multipliers to the rural non-farm sector, can dominate employment growth and poverty reduction. A five percent agricultural growth rate would ensure employment growth sufficient to push up real wages and rapidly reduce poverty. Achieving that growth rate requires participation of each of the major sectors of Indonesian agriculture. However, the horticulture sector, in a fast growth strategy will be the largest contributor to rapid growth because of its initial large size and the potential for exports and elastic domestic demand to facilitate the highest growth rate of all commodity groups.

1. Choice of Commodity

Farmer's decisions are heavily commodity specific. Applied technology development and much micro policy is also commodity specific. Thus, it is recommended that US foreign assistance strategy focus on a large commodity sub-sector and set in motion processes that will have major and lasting aggregate impacts. Horticulture, coffee and cocoa are proposed for the commodity focus on the basis of their current importance, potential for rapid growth, and past history of US effort. Horticulture is the most important of this set. While the GOI has a Director General for horticulture, it is a sector somewhat neglected by the government. Coffee and cocoa are estate crops to which the Indonesian government attaches importance, which have strong export demand, and in which AMARTA has built competence including working with government institutions.

Table 4: The Relative Importance of Commodity Sub Sectors in Base Production and Growth 2008 shows an estimated base weight for eight commodity sets; estimated current growth rates that add up to the current 3.2 percent agricultural growth rate; and an estimated high growth rate of each sector, that adds up to an overall five percent growth rate. That is in the range of high growth rate middle income countries (Mellor 1992), nearly twice the current per capita growth rate, and makes a major contribution to employment growing more than 2.5 times faster than labor force growth.

The growth rate shown for rice is achieved entirely through yield increase. That would increase supply slightly faster than domestic demand. The estate crops are set at a rapid 6% growth rate consistent with rapid growth in export demand but requiring substantial research support to defeat disease and raise yields.

Horticultural growth is set at the highest rate of eight percent reflecting rapid growth in domestic demand, potential to export a quarter of incremental output and a research system that increases profitability and consequent expansion of the area planted. Working to meet the needs of the domestic supermarkets will prepare Indonesian farmers and traders to meet requirements of export markets. The 8% growth rate would meet domestic growth requirements and allow one-fourth of incremental output for import displacement and eventually for export growth. The 8% growth rate puts horticulture in the same league on growth as the industrial sector. Note that while rice is one-third more important than horticulture in the base, horticulture in a fast growth strategy is 50% larger in increments to output.

Table 4: The Relative Importance of Commodity Sub Sectors in Base Production and Growth 2008
(All figures are in percent)

Commodity	Base 2007	Growth rate 2007	Share of growth	High Growth rate	Share of growth
Rice	24	3.0	24	3.0	14
Estate crops	18	4.0	21	6.0	22
Horticulture	17	4.0	19	8.0	27
Livestock	11	3.5	12	6.0	6
Fisheries	11	3.5	14	6.0	6
Other food crops	9	2.0	8	2.5	4
Maize	2	3.0	2	5.0	2
Forestry	8	0	0	2.5	4
TOTAL/AVERAGE	100	3.2	100	5.0	100

Notes on Table 4: The Relative Importance of Commodity Sub Sectors in Base Production and Growth 2008 *Indonesian official statistics do not report share of agricultural GDP by commodity sub-group. Thus the base figures were calculated from data for rice and livestock and for crop area adjusted for estimated value per unit area. Interviews found the data generally sensible. The growth rates for 2007 are rough estimates based on plausible relative growth rates providing a weighted average equal to the official statistics for the period. The growth rates for fast growth are based on achievements for other countries and adjustments for Indonesia. Rice assumes no change in area and very rapid yield increase based on rice research and extension; estate crops assumes rapid growth in production and favorable external markets; horticulture assumes rapid growth in domestic market and ¼ of incremental production exported; livestock assumes rapid growth in demand, the high growth rate for corn is based on growth on demand for livestock feed.*

2. Technology

The most striking finding from the field was that although farmers placed great emphasis, as expected, on improved roads, they placed even more emphasis on improved production technology. They had seen specific vegetables lose competitiveness because other countries had improved technology and they had not. Thus, major weight on the project should be on working with the national vegetable, fruit, and cocoa/coffee research stations. These are all well operating stations. They are short of Ph.D. staff, they do not link well with extension, and they are short of operating funds. A key element is to develop workable relationships between research and extension (World Bank 2008, Asian Development Bank 2006). That is taken up in the next section.

The first need is to strengthen the research staff with Ph.D. training in the US to push in the direction of applied research that diagnoses and treats the real problems of farmers. Ph.D. candidates should do two years of intensive course work and return to Indonesia for thesis research on a project that fits the priorities for their research station. Funds should also support the US thesis Director to spend time in Indonesia at each stage of the research. Top level research and its application to real problems would be demonstrated.

The second need is to expand the bio-technology research through renewed contacts with Cornell and Wisconsin. The emphasis should be on applied horticultural research. It would be useful to depart marginally from the horticulture specialization in order to do work on rice, thereby assisting Indonesia with its top agricultural priority. This would of course also forward the important policy objective of the US with respect to GM crops.

The third need is to bring top level US researchers to Indonesia on short-term assignments specific to special problems delineated to help develop the applied research program.

3. Link with Local Government

Rapid growth of agricultural sectors involves three important links with local government: extension, farmer's organizations, and roads. Each is of special importance for the horticulture sector and would show striking results in production and farmer income.

As in the United States, agricultural research is a central concern while extension is at the local level. In these early years of decentralization, Indonesia is having coordination problems. The US has been successful in bringing the two together. The research stations in Indonesia need to do on farm demonstrations and field days and use the occasions to train extension people. Technical assistance in extension to the local governments and to the research stations would help build the institutional structures for such links. Although the link is important to all parts of agriculture, horticultures (as well as coffee and cocoa) have the potential for high profits to farmers from technological improvement. That provides an added incentive to make the linkages work.

Local governments have the primary responsibility for organizing farmers. Such organizations are critical to the success of horticulture because of the difficulty of farmers individually meeting the quantity and quality requirements of supermarkets that are rapidly taking over retail distribution (World Bank 2007) and of the export markets. A link between research, extension, and development of farmers organizing provides a valuable synergy.

Rural roads are in deplorable condition and are the responsibility of local governments. If USAID does something in the infrastructure area, giving attention to local governments, increasing their capacity for rural roads construction and maintenance would fit well with the horticulture emphasis. Because of the problems of perishable goods, horticulture gains much more from improved roads than any other sub-sector of agriculture, and thus increases the incentives for improving the institutional structures for roads.

4. Policy

USAID has a distinguished record, remembered by many influential Indonesians, in agricultural policy research in Indonesia. Horticulture has several major large policy issues, such as the place of horticulture in the agricultural strategy, the need for a priority to rural road policy that serves these key commodities; opening of trade; reform of agricultural credit systems; GM policy, and even rice price policy as it relates to competitiveness of alternatives to rice. There are also a host of micro issues from the constraints to the seed industry, to taxation and regulation of transport, to choice of commodity emphases within horticulture.

It is recommended that the policy work, unlike the earlier effort, have a core emphasis on horticulture policy but also branch out to the larger issues and that it be concentrated in two institutions: The Indonesian Center for Agriculture Socio Economic and Policy Studies (a Center in the Ministry of Agriculture, located in Bogor) and the Center for Agricultural and Rural Development Studies (located in Bogor Agricultural University). These are both strong centers at present, but have good work in horticulture, especially Bogor University, and both would welcome strengthening. The strengthening would occur though Ph.D. training in the US and TA from major US universities and research centers. Including IFPRI in this effort would be a major plus, particularly given the cadre of senior staff who have worked in Indonesia. The policy work would be data based and relevant through its integration with technology, local government, and private sector.

5. Private Sector

The program greatly strengthens competitiveness of farmers and meets the most important problem of private sector traders and processors – difficulty in obtaining adequate quantities and quality. The private sector marketing is generally strong, but strengthening trade associations would be very desirable. They are now rudimentary and narrow special interest oriented. They need strengthening on policy advocacy and could draw on the policy work. The seed sector was immediately noted by technical people as weak. Strengthening the private sector horticultural seed industry would be valuable. That will be most effective as part of an integrated effort linking research, extension, farmer's organizations and seed development.

E. Cross-Cutting Issues

1. Relation to Other Donors

AusAID has significant projects on agricultural research, working at the district level, in Eastern Indonesia, with emphasis on specific high value crops. The World Bank is developing a major project to assist the Indonesian agricultural research and extension systems (SMARTD, World Bank 2008). Both the World Bank and AusAID would enthusiastically welcome a technology effort by USAID as fully complementary to their efforts. The World Bank has very little in agriculture at the moment, substantially because the Minister of Agriculture has shown reluctance to take loans for the agricultural sector, and also because of his concerns about Shariah law. The ADB has no work directly in agriculture. Other donors have only minor projects in the sector.

2. Relation to Government of Indonesia Priorities

The Ministry of Agriculture has a Director General for Horticulture, significant capacity on horticultural research, recognizes the importance of the sub sector and would welcome US assistance in this area. Having said that, the first priority for the government and the Ministry of Agriculture is the rice sector and rice self sufficiency. The second priority is estate crops. There are domestic political reasons for each of these emphases.

3. Environmental issues

The most important environmental impact of the proposal comes from the large increase in value of output per hectare and farmer income from existing land and consequent lifting of the poverty pressures to clear marginal lands.

There are two environmental concerns related to horticulture that are met by improved extension systems. Returns to pest control and high fertility levels are greatly increased in horticulture. Integrated pest management is a well proven technique to radically reduce pesticide use. Similarly improved management greatly reduces the wastage of fertilizer which is a principle source of environmental damage. Both techniques are management intensive, requiring applied research and intensive extension.

4. Input from US Universities

US universities, particularly the land grant institutions, still have capacity to be of great help. There is a highly respected capacity to build applied research capacity. The US is a world leader in applying bio-technology to agriculture and the US universities demonstrate close cooperation with private sector research. There is great experience in integrating locally funded and private sector extension with a centrally run research system. The land grant colleges have capacity to assist in the organization of farmers and the development of local government. They are also experienced in providing technical and management assistance to private sector seed firms. Thus the role of the US universities could be substantial in this project.

5. Priorities within the Proposal

The strengths of the strategy presented is building on past USAID work and choosing a minimal set of activities that are closely interconnected. The first cut to make would be to eliminate the coffee and cocoa – the highest priority is horticulture because it is larger with greater potentials for growth. But eliminating coffee and cocoa eliminates the base of very useful work in AMARTA. The next cut would be the bio-technology, but that eliminates a major US policy objective as well as an area in which the US is highly respected. It also sacrifices the big long term impact in favor of the shorter term. Cuts after that should be in the intensity of the effort rather than eliminating critical complements. The smaller the effort, the lower the growth rate and employment creation.

F. Conclusion

While the urban formal economic sector is growing to dominant status in the economy, agriculture and its multipliers will have to carry the brunt of employment creation and poverty reduction. All commodity groups in agriculture will have to play a significant role if the desired 5% growth rate is to be achieved. However, the horticulture sector, with the capacity for the highest growth rate of the major sub-sectors of agriculture and already with a major weight in production, will play the single most important role. USAID is already providing support to horticulture and has a significant effort in two estate crops – coffee and cocoa. The returns to continuing to build on that success are high. Six major concerns of the US are forwarded by rapid growth of these sectors.

First, major impact on employment growth and poverty reduction is a core contribution to political stability and self sustaining growth in Indonesia. The three commodity groups chosen account for nearly one-fourth of current agricultural production and in a fast growth strategy would account for about one-third of incremental growth. That provides nearly one-fifth of all employment growth – considerably more than the formal tradable.

Second, USAID has an objective of increasing the competitiveness of Indonesia in the global economy. This effort would bring down the cost of production in a major sub sector of agriculture in which productivity and efficiency are low even by Indonesian standards and with strong export potentials. It deals with the single most important problem of the large private sector with respect to horticulture – obtaining adequate quantity and quality of produce.

Third, the effort plays to the comparative advantage of the United States by emphasizing what the US is particularly noted for – at the frontiers on application of biological science to agricultural production and integrating central and local government functions.

Fourth, the objective of forwarding support for GM technologies plays to US comparative advantage not only directly in agriculture, but also in agribusiness, such as Monsanto, Pioneer and others. It does so by increasing the vested interest of Indonesia in bio-technology.

Fifth, the US also has a comparative advantage and particularly well developed expertise specific to Indonesia in agricultural policy and policy reform. The policy aspect of this project would provide to the Mission continuous insight and contacts with key Indonesians into the most important segment of the Indonesian economy from an employment, poverty reduction and political stability point of view.

Sixth, the US has an interest in the efficiency of its projects. Integrating the US assistance into Indonesian institutions would not only increase the impact on those institutions but greatly reduce the cost of the US effort. This project is intended to at once build Indonesian capacity and concurrently to utilize Indonesian staff and facilities to the maximum in achieving project objectives.

Finally, a constantly recurring theme in my discussions, more so than any other mission I have been on in the past 56 years, and emphasized in the Papanek paper, we must pay attention to what Indonesians are saying, show respect for their institutions, and in that context to show humility with respect to our understanding and ability to advise.

IX. Infrastructure Sector

A. Background

There is a consensus among experts that low infrastructure access and capacity is a key binding constraint to Indonesia's economic growth. For example, out of seven key issues/constraints identified in USAID's July 8-10, 2008 Economic Growth Stakeholder Workshop, three related directly to infrastructure.[28] Similarly, the conclusion of the Asia Foundation's Local Economic Governance Survey of 2007 was that *Government efforts to improve the investment climate should focus more on infrastructure and land issues.* From the Survey; "When asked to identify the most important constraint on their business activities, 35% picked infrastructure problems – only 9% picked licensing and 10% picked the transaction costs associated with taxes and user charges…." Improved infrastructure has also been identified as a key to alleviating poverty in Indonesia by providing the poor with greater access to markets. According to noted local expert Dr. M. Chatib Basri, "inequality in Indonesia is driven in large part by differences in access to infrastructure."

Despite this identified need, government investment levels in infrastructure have fallen from their pre-1997 highs. According to the World Bank, in the period prior to the 1997 financial crisis, Indonesia had maintained an infrastructure investment rate of 5-6% of GDP per year. Such healthy levels of infrastructure investment directly contributed to the significant growth and poverty reduction that took place during that period. However, in the last decade infrastructure spending as a share of GDP has declined to an average 2-3% of GDP per year, leading to significant deterioration and increasing bottlenecks effecting both individuals and businesses. According to the OECD (2008), while government spending has recovered somewhat recently, it is still not at a level sufficient to spur rapid growth and convergence with neighbors such as Singapore and Malaysia.

Private sector investment in Indonesia's infrastructure has also not recovered from the financial crisis[29] and the level of private sector participation in infrastructure in all sectors is far too low and needs to continue to increase significantly in order for Indonesia to have a realistic chance at improving its outcomes. The results of this government and private underinvestment are clear from the standard indicators for infrastructure in Indonesia (Table 5: Standard Infrastructure Indicators). Notice that Indonesia underperforms its regional peers and differences with the West are stark (Indonesia actually comes in dead last for infrastructure out of 55 countries ranked in the IMD's World Competiveness Yearbook (WCY)).

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[28] Specifically, these were "Poor state of transportation infrastructure (e.g., roads and ports)"; "Lack of sufficient access to electrification, especially in rural areas, and alternative sources of energy"; and "Insufficient levels of foreign investment flows into Indonesia due to poor transportation networks…."

[29] Over 1995-1997, 35 infrastructure projects with private participation reached financial closure for a total investment value of around US$17 billion. Over 2001-2005, just 14 total projects were concluded and average private investment per year was around US$1.5 billion, most of which was concentrated on mobile telecom. Investment picked up a bit in 2006-2007 with the financial closure of four energy projects and 12 transport projects (all toll roads) cumulatively worth over US$3.5 billion. Source: Private Participation in Infrastructure (PPI) database, World Bank.

Table 5: Standard Infrastructure Indicators

Indicator	Indonesia	SEA Regional Avg.	OECD Avg.
Electric Power Consumption (kwh per capita)*	509	3,642	10,807
Paved Highways (km per 1,000 people)$	0.65	1.13	11.9
Fixed and mobile Phone Subscribers (per 100 people)**	35	73	157
Internet subscribers (per 100 people)*	7.25	23.5	59
Time for Export (avg. number of days)#	21	22	9.5
Time for Import (avg. number of days)#	26	21.6	10.4
Aircraft departures (per 1,000 people)$	0.69	4.17	27.3
Railways, goods transported (million ton-km per capita)*	21.3	229	2,110
Logistics Performance Index (Out of 5)***	3	3	3.67
IMD WCY Infrastructure Rank^	55	31	16

*World Bank, WDI, 2005;**World Bank, WDI, 2006; ***World Bank, 2007; #World Bank, Doing Business, 2007; CIA World Factbook, 2005; 2006, ^Out of 55 countries.

Even though government support for infrastructure has been falling, private sector demand continues to climb.[30] Yet while the infrastructure sector is increasingly directly important for Indonesia's economy, it also could not be more vital for Indonesia's future growth path because of its indirect wider impacts on other sectors. For agribusiness, the lack of accessible and quality rural roads is a widely identified constraint because it "hinders production, marketing, and sales."[31] A World Bank study reveals that poor infrastructure creates high transaction costs. As a result, farmers only get 25-30% of the gross value of their high-value products.[32] The consequence is a disincentive to expand production and an increase in local food prices, issues that could not be a more pressing in Indonesia as the rural poor are becoming increasingly food insecure. For importers

[30] According to the Asia Foundation (2008, p.9), the infrastructure sector is growing in spite of these bottlenecks: Between 2004 and 2006, the transport and communications sector made up an average of 6% of Indonesia's Gross Domestic Product. The growth of the sector also exceeded the growth of all other sectors. The three-year average annual growth rate, between 2004 and 2006, of 13%, was more than double the non-oil and gas average annual growth rate of 6%. Road transport, as part of the transportation sector, is growing steadily, although it is surpassed by the growth in air and sea transport.

[31] USAID EG Stakeholder Workshop Final Report.

[32] World Bank, http://siteresources.worldbank.org/INTINDONESIA/Resources/Publication/280016-1106130305439/617331-1110769011447/810296-1110769073153/agriculture.pdf

and exporters, the time and cost to move goods at ports lowers trade volumes and limits badly needed foreign investment. According to Ray (2008, p.3), “Producer competitiveness in both national and international markets, internal distribution efficiency, and, more generally, national economic cohesiveness and integrity are to a significant extent influenced by port sector performance.” Private banks in Indonesia have little experience financing infrastructure and local governments have little experience issuing bonds to finance public goods production. Creating enhanced local capacity for infrastructure finance could have broader demonstration effects for the development of the financial sector in general.

According to USAID’s 2008 Economic Growth Strategy, programs should seek “improvements in policies affecting all businesses within a sector or across the entire economy.” The infrastructure sector in Indonesia is an area where USAID can have an indirect, catalytic, and systematic impact in economic development through a program of providing technical assistance through an Infrastructure Advisory Unit (IAU) to either national or local government units that are identified as having the political will to improve their policies, effectiveness, and outcomes related to providing essential public goods such as roads, sea, air, and dry ports, and energy services. Improving the capacity and effectiveness of the Indonesian government in managing infrastructure policy can have the result of improved and expanded infrastructure across the nation without having to fund construction directly.

B. Work of Other Donors

1. ADB

ADB’s Infrastructure Reform Sector Development Program (IRSDP), consists of a US$400 million loan in 2006 (Subprogram 1) and a follow-on $300 million loan in 2008 (Subprogram 2) for budget support. Each one of these loans includes an additional US$100 million contribution from JBIC. Disbursements of the IRSDP loans are conditional on policy reforms related to the procurement of PPPs. The IRSDP loans are supported by a US$26.5 million Project Development Facility (PDF) loan from the ADB and supported by a US$2 million grant from the ADB and a US$7.56 million grant from the Netherlands Fund and managed by BAPPENAS.

2. AusAID

In the third AIPRD Joint Ministerial Statement released on December 2005, Ministers agreed to support the Eastern Indonesia National Roads Improvement Project (EINRIP) through the allocation of up to $300 million in AIPRD loans. An additional $28 million in AusAID grants has been allocated to fund project preparation, design and project-related technical assistance and implementation support.

AusAID has also just begun its Indonesia Infrastructure Initiative, a A$65 million grant fund for infrastructure related TA, of which A$10 million is earmarked for a trust fund to be managed by the World Bank. This money will initially focus on the PDAMS – the local government water authorities -- as well as support for various activities at the central level that have yet to be defined.

3. World Bank

The World Bank is providing annual US$200 million IBRD infrastructure development policy loans (IDPL) for budget support which are channeled through the Ministry of Finance. Prior actions for the 2007 loan include: (i) increasing the central government budget allocation for infrastructure by 30% 2007-2008 (ii) publication of the PLN PSO compensation payment by region and customer category; (iii) ending government support for infrastructure projects that are Perpres 67 non-compliant and lack a project specific Perpres allowing for non-compliance; (iv) allocating Rp 3 trillion in the 2008 budget for the Indonesia Infrastructure Fund, the Guarantee Fund and land acquisition (v) issuing a decree to establish an inter-ministerial Land Working Group; and (vi) use of semi-e-procurement system for all national roads projects in Java and Sumatra above Rp. 10 billion.

4. JICA

JICA has embedded a consultant in the Ministry of Transportation, division of Ports and Dredging. They provide limited training in Japan for Port Masters and largely avoid regulatory policy issues.

C. Recommendations for Country Assistance

The following recommendations are based on literature reviews and interviews with local experts, private sector stake holders, donors, and central and local government officials in Indonesia over a three week period. They are the result of reoccurring themes and expressed needs. The four recommendations are in order of judged priority and potential effectiveness given USAID's limited resources, but they need not be exclusive, and could easily be bundled together or unbundled as needed.

1. Establish a Local Government Infrastructure Advisory Unit (IAU)

The recent process of decentralization in Indonesia has resulted in a large transfer of resources and responsibilities from the central to the local governments. Yet provincial and district level governments often lack the capacity and expertise to effectively carry out their new functions, and this is becoming more apparent as infrastructure bottlenecks accumulate at the local level.[33]

One of the largest responsibilities facing local governments will be fixing district level roads and building new ones. The results of the Asia Foundation (2008) survey suggested that district governments should pay greater attention to improving the maintenance of local level roads. According to a World Bank study, district level roads make up 72% of the classified road network in Indonesia, yet 50% of these roads are in

[33] USAID's Local Government Support Project (LGSP) is aimed at addressing some of the constraints identified by local governments, but have not worked directly on infrastructure issues.

"poor or bad" condition and only 19% are in "good" condition.[34] This is a serious problem since it is widely accepted that "Rural roads typically have significant effects on the reduction of poverty"[35]

Yet many local governments are finding themselves unable to adequately plan, produce best practice pre-feasibility studies and project documents, and coordinate with the central government as well as other local governments when roads cross districts. According to multiple sources, only a fraction of allocated resources for development and recurring budgets have actually been spent for the last two years, indicating the lack of capacity that exists at this level of government.[36]

While the provision of electricity is primarily a national responsibility due to the transmission and distribution monopoly held by PT Perusahaan Listrik Negara (PLN), local governments are empowered to promote off-grid independent power generation (especially by using renewable energy). With respect to seaports, local governments now have some regulatory authority over private (captive) ports which may soon be able to apply to become general cargo terminals and process third party cargo. Airports and even dry ports are other areas where local governments exercise considerable control and work in these sectors is sorely needed. Even in areas where local governments have no direct control, they can often initiate projects and coordinate with the central government for implementation support.

The IAU would identify provincial and district level governments that express a willingness to enhance their effectiveness at infrastructure planning and production.[37] Consultants would advise local institutions[38] on a full range of issues in the infrastructure sector related to improving local transportation and energy outcomes.[39] Areas where consultants could potentially provide TA to local governments on infrastructure include:

- Planning and logistics -- Local governments often do not have medium term development plans for infrastructure and are not able to produce best practice pre-feasibility studies for proposed projects. Training for planning and logistics is needed. Consultants could work with local government units to produce clear priorities, strategies and goals for various sectors utilizing best practice logistics. They could also provide training for the production of best practice project documents. Consultants should work with local governments to see selected projects through the entire process from planning to implementation in order to create learning and demonstration effects.

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[34] World Bank Indonesia Country Profile, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/INDONESIAINBAHASAEXTN/0,,contentMDK:20534330~isCURL:Y~pagePK:1497618~piPK:217854~theSitePK:447244,00.html

[35] World Bank, "Indonesia Infrastructure Development Policy Loan, Program Information Document," Report No. AB3407. 2007.

[36] Conversations with David Hawes and Ed Gustily. For example, a real problem has been that central government transfers for revenue sharing programs are being used by local governments to purchase treasury notes rather than invest in public goods such as infrastructure.

[37] USAID could work in coordination with AusAid's Indonesia Infrastructure Initiative, which will also be providing some TA to local governments on infrastructure. AusAID has expressed support for this idea.

[38] The authority with the most direct influence over planning and budget at the local level is BAPPENDA, the local equivalent of the central government's BAPPENDAS. Local Transportation departments as well as Public Works agencies also have significant influence.

[39] From meetings and conversations with experts and local officials, there would be no shortage of demand for such a project coming from local governments.

- Regulatory efficiency -- According to the Asia Foundation (2008, p.4) "The regulatory framework for road transportation still creates unnecessary costs and is far simpler in other countries … in particular, local governments often issue permits and licenses and impose user charges that act as barriers to the transportation of goods throughout the country." Indeed, across all infrastructure sectors, regulatory inefficiencies are a major complaint of stake-holders. While regulatory policy is normally a political problem, producing regulatory assessments/mapping can be an effective instrument to pressure political elites to adopt rational reforms.
- Attracting Public Private Partnerships (PPPs) in infrastructure construction and management -- While toll roads and private energy generation are largely under central government authority, it may be possible to assist local governments to coordinate better with the central government and BAPPENAS on related issues. Local governments have identified a significant number of potential PPPs, but are unable to produce commercially viable and bankable project documents that could jump start the process of procurement. Consultants could work directly with local government officials through the entire process, from pre-feasibility studies, to producing viable project documents and working as an advocate for the local government with the central government in order to move them forward.
- Transparent and efficient procurement and tendering -- This is always a problem at all levels of Indonesian government. Building the effectiveness of procurement regulations and procedures could improve construction efficiency and have larger impacts on reducing corruption.
- Coordination -- Local governments could use assistance in their efforts to coordinate with other local governments as well as the central government in infrastructure planning and production. Government coordination is necessary because authority and responsibilities are often overlapping or perhaps even unclear. Coordination with the private sector and other stakeholders is also necessary and could be facilitated. Consultants could promote dialogue between stakeholders and different levels of government.
- Work with the DCA to secure local government infrastructure bond guarantees in order to generate a demonstration effect -- Local governments have little experience with issuing bonds to finance infrastructure and private banks have little experience lending to local governments for this purpose. Consultants should inquire about the possibility of involving the Development Credit Authority (DCA) of USAID. The DCA can and has provided guarantees for local government bonds for infrastructure.

Deliverables could include: Quarterly reports detailing activities; a model framework for project vetting and implementation; Best practice pre-feasibility studies and project documents produced; Best practice regulations or procurement rules produced; Regulatory mapping; Number of officials trained in logistics, planning, procurement, or project document production.

Potential Pitfalls: Initially, such a program could be risky because it may take significant time and resources upfront to identify local partners and the best margins on which to work to produce wider benefits. Many local governments still do not feel that the provision of these services should be their responsibility and simply prefer to wait for the central government to act; an attitude that could create a political constraint to TA effectiveness. Ideally, such a program should start small with pilot projects, perhaps in more low capacity local governments. It is not clear how effective such a program would be given existing political incentives, but outcomes from the LGSP project suggest that significant political will exists in many local governments to improve outcomes. If successes could be generated, it could have demonstration effects across a wider area.

2. Establish an IAU for Sea Ports, Railroads and Logistics

According to Ray (2008, p.3), “Despite its obvious critical importance to the national economy, Indonesia does not have a port system that performs well from the perspective of its users. This is due to a number of factors including problems associated with lack of private sector participation (PSP) and, related, the overall lack of competition in the ports system.” These reported inefficiencies show up clearly in standard indicators of port performance.[40]

However, the newly passed 2008 Shipping Law is intended to reorganize the ports sector by unbundling the power of the Indonesian Port Corporations (IPC), the four state-owned monopolies that currently own, operate, and regulate most ports in Indonesia. It will shift regulatory authority away from the IPCs and (theoretically) open the sector to competition from the private sector. The 355 articles in this new law also cover maritime related issues such as navigation, security, environmental protection, labor issues, maritime accidents, and the creation of a coast guard among many others. While passed, the new law will not come into effect until 2010-2011.

Introducing competition into Indonesia’s port system is critical for port performance, but since the country has never had a competitive port system, *the implementation of this change is a huge question mark.* The Port Authority, the arm of the MOT now empowered with regulatory authority, has little to no experience with managing ports, planning for investment and basic maintenance, and orienting themselves towards effective customer service.

The other issue involving ports is the lack of an integrated system of transportation logistics in the hinterland. Improvements in port efficiency will achieve little if containers cannot then be moved efficiently once they are off loaded.[41] To this end, another recent measure, the 2007 Railways law, has been passed that aims to open up this sector to competition as well by allowing private sector firms to own and operate railroads independent of PERUMKA, the incumbent SOE. As with the new law on seaports, implementation, not intentions, is the key.

With respect to logistics, there is a “logistics team” housed in the Coordinating Ministry of Economic Affairs with little capacity. This unit needs to be strengthened and made into a National Logistics Council in order to improve the linkages between seaports, airports, rail, and roads. A master plan would seek new efficiencies and reduce bottlenecks to transporting goods through better sector integration.

[40] For example, a major indicator of port productivity is moves per hour (mph). In early-mid 2008, Jakarta port was achieving only 40-45 mph whereas Singapore and the major Malaysian transshipment ports were working at 100 – 110 mph.

[41] Out of 150 countries ranked in the World Bank’s Logistics Performance Index 2008, Indonesia ranks 43rd, not bad overall, but behind neighbors Singapore (1st); Malaysia (27th); China (30th); and Thailand (31st). Particular identified problems include port congestion; hinterland connections; and the efficiency of trucking and freight forwarding services.

Seaports and hinterland logistics are of vital importance to Indonesia's economy since 90% of Indonesia's external trade is transported by sea, almost all of which is transshipped though Singapore and, increasingly, Malaysia. If Indonesia could build its seaport capacity and efficiency as well as improve its transportation logistics and efficiency, it could compete with these neighboring seaports and accommodate direct calls from large vessels, thus reducing the costs of imports and making Indonesian exports more competitive worldwide. Other donors have paid considerable attention to customs, but are noticeably absent on issues related to port operations and logistics.[42]

Possible areas for USAID sponsored TA could include:

- Provide port management and regulatory training to the Port Authorities, the new regulatory port body;
- Monitor implementation of the 2008 law on ports and 2007 law on railways and provide implementation oversight;
- Follow up on the Asia Foundation's (2008) study on "The Cost of Moving Goods" in Indonesia and work toward creating a functioning National Logistics Council;
- Provide logistics training to relevant planning officials and work to better integrate the rail and road system with the ports;
- Coordinate with JICA to provide TA to the MOT;
- Production of best practice project documents (e.g., pre-feasibility studies and commercially viable and bankable procurements) for PPPs and other projects.

Deliverable could include: Quarterly reports detailing activities; Regulatory reports and assessments/mapping of the port and rail sectors; Port management assessments; Monitoring reports on the progress of the implementation of the 2008 and 2007 laws; Number of officials trained in port/rail operations/management and logistics; Pre-feasibility studies carried out for new ports and railroad lines.

Potential Pitfalls: According to sources, the real problem isn't attracting investment to Indonesia's sea ports, but rather the regulatory risk and uncertainty that are faced by private sector firms. While the new central government laws appear to genuinely want to attract increasing private investment in ports and rail, when it comes down to it, some ministries have not been willing to expose either the IPCs, PERUMKA, or other small and medium Indonesian owned firms to the increased international competition that would result. One concern is that many of the provisions in the new law are either unclear or even conflicting, leading many to wonder how serious the government is about effective implementation. For example, the 2008 Seaport law is not clear on who, exactly, can compete with the IPCs, leaving the government with significant discretion. To be effective, TA to the ports and rail sectors will need to have a strong GOI champion. As mentioned, the needs are clearly visible but the demand for donor assistance is less visible. The World Bank pulled out of the seaports sector in the early 1990s and while ADB stayed engaged, it has been largely unable to achieve much traction.

3. Establish an IAU for Public-Private Partnerships (PPPs)

[42] JICA largely provides engineering type training to the MoT, but nothing specifically related to policy.

According to the World Bank, "an Infrastructure Summit was held in January 2005, offering 91 public-private partnerships (PPP) transactions to the private sector. The reaction to these offerings was disappointing; many existing policy blockages remained to the preparation of bankable projects, and in practice many projects were not well prepared."[43] Since that time, the central government has issued new regulations aimed at securing well designed and transparently and competitively bid PPP projects (Perpres 67), yet as of August 2007 had only secured one additional Perpres 67 compliant PPP project, which was in the energy sector. The World Bank and ADB have both expressed an urgent need for USAID support for their respective policy loan programs aimed at securing sorely needed private investment in infrastructure.[44]

The government has committed to an ambitious goal of increasing private investment in infrastructure to US$10 billion per year by 2010.[45] Yet one of the major identified constraints affecting national and local governments in securing private investment in infrastructure across all sectors has been a lack of well executed pre-feasibility studies and commercially viable and procurable project documents. BAPPENAS, the Coordinating Ministry of Economic Affairs, the Ministries of Transport and Public Works, as well as the new inter-governmental KKPPI unit are the agencies that have the most influence over major PPPs. These agencies appear to have some political will to attract and execute PPPs (at least on an initially limited basis) but lack the expertise to carry out a proposed project from beginning to end and ensure its compliance with Perpres 67, which some argue was hastily crafted and is too strict to be realistic for Indonesia at this time.

Other than the lack of technical knowledge to produce project documents, the inability of the government to provide financial, operational, and political risk guarantees to interested private sector firms on a rational, consistent and predictable basis is also a major constraint to attracting PPPs. To address this issue, the MOF has recently established a Risk Management Unit (RMU) within itself. Within the RMU, there are currently plans to create a revolving fund to guarantee PPP projects. However, this initiative is in its early stages and TA is needed to ensure proper design and implementation.

Given these identified constraints, an IAU could provide TA to BAPPENAS, the Coordinating Ministry of Economic Affairs, the Ministries of Transport and Public Works, KKPPI, and even local government units. Potential activities could include:

- Work directly with these agencies to produce pre-feasibility studies and procurable, commercially viable, and bankable project documents. Consultants should see select projects through from beginning to implementation and work

[43] World Bank. "Indonesia Infrastructure Development Policy Loan, Program Information Document," Report No. AB3407.

[44] Both the World Bank and the ADB are providing both BAPPENAS and the MoF with Project Development Facility (PDF) loans for TA, but both complain that these resources have been poorly spent. These donors are unable to provide grants to hire their own consultants directly, but rather must channel the money for this purpose through the central government which creates inefficiencies as the resources have reportedly not been well spent. USAID does not face this constraint and is thus well positioned to complement the work of other donors by providing them with *on the ground* consultants.

[45] Neighboring Malaysia is an example where the PPP model was successfully employed and resulted in widespread gains and improved outcomes across all sectors. India is another model where private investment in infrastructure is propelling that nation's superior growth rates.

- directly in coordination with the World Bank, ADB, and the IFC to build political and financial support.
- Work with the Risk Management Unit of the MOF to build their capacity and to establish an implement the guarantee fund for private investment.
- Train government employees in the production of best practice project documents and in regulatory effectiveness, particularly with Perpres 67 compliance and setting tariff structures.
- If existing regulations are not found to be rational, produce regulatory assessments/mapping and model regulations in order to produce pressure for reform.

Deliverables could include: Pre-feasibility studies produced; a model framework for project vetting and implementation; Number of officials trained in designing best practice project documents and/or regulatory compliance; Regulatory assessments produced; Quarterly reports on overall progress and activities designed to attract and implement PPPs.

Potential Pitfalls: As always, a potential pitfall in undertaking such activities is lack of political will/incentives to move projects forward to begin with, resulting in wasted efforts. Many times, a new private infrastructure project stands to compete with some existing private interest or state-own enterprise and these entrenched interests are able to block the PPP. For example, in sea ports and electricity, securing PPPs may be politically difficult due to the IPC port monopoly and the PLN transmission and distribution monopoly. The World Bank and the ADB are getting frustrated in their efforts and warn of the many difficulties involved in securing PPPs in infrastructure. While significant potential exists to work with BAPPENAS and (especially) the Coordinating Ministry, the Ministry of Transport has been accused of lacking leadership and political will, so it would need to be determined if this ministry would be a barrier to USAID efforts.

4. Build the Capacity of the National Land Agency (BPN)

One of the biggest and most often identified constraints to road construction in Indonesia is the inability of the government to acquire land for public purpose.[46] This stems largely from policy and implementation failures at the central government level and has resulted in significant political unrest.[47] The major identified problems are the lack of a well-established and rational policy for public land appraisal, acquisition, compensation, and resettlement.

The National Land Agency (BPN), an independent agency under the President, is the central government unit empowered to acquire land for public purpose.[48] It has relatively low capacity for the key role that it plays. The policies and laws it is guided by are also weak and often ineffective. For example, one of the critical aspects involved in government land acquisition for public purpose is accurately appraising land values to,

[46] The state rarely exercises the power of eminent domain in Indonesia, mainly because it is considered too politically risky, so the BPN normally has to reach agreement with all landowners involved.
[47] According to the BPN"s own figures, there were 7,491 land disputes and conflicts covering 607,886 ha in 2007.
[48] The Ministry of Forestry also has the power to acquire land for public purpose, but only "forestry area", a not so well-defined term that often causes disputes with BPN. Local governments are only allowed to acquire up to 2 hectares of land for public purpose.

among other things, ensure that those selling their property are adequately compensated and to ensure that the government does not pay significantly above market price. However, up until the recent passage of a reform, all appraisal responsibilities fell within the BPN's Land Appraisal Committee, which had no private sector representatives. This clearly produced a conflict of interest as evictees often protested that they were not adequately compensated for the value of their property by the state or that members of the Committee were involved in corrupt practices. The BPN has also not been expedient in its compensation, forcing some evictees to wait years before they received their check.

Under a new regulation, however, an independent authority for land appraisal is to be set up, but it is not clear how effectively this new policy will be implemented. There are still no clear rules, for example, on the process for licensing appraisers or on the relocation of evictees. Another major issue is lack of spatial data. The existing Base Map only covers approximately 5% of the total area of Indonesia.[49]

In order to significantly expand public and private investment in roads (and to a lesser extent in other sectors) the critical issue of land policy needs to be addressed. There appears to be political will at the BPN to improve their performance and capacity. Therefore, USAID could embed consultants in the BPN (and possibly BPGT, the toll road regulator, as well the Ministry of Public Works) to provide TA across all issues related to land acquisition for public purpose. Possible tasks include:

- Commission policy/regulatory assessments and conduct regulatory mapping and analysis, possibly in coordination with the ADB.
- Specific work/capacity building on issues related to:
    - Public land appraisal and acquisition; fair and expedient compensation to evictees; resettlement programs for evictees; licensing of land appraisers; conflict and dispute resolution.
- TA for Spatial Data and Information enhancement.
- Trainings for staff on implementation of new laws, appraisal, and effective land acquisition regulatory policy.

Deliverables could include: Quarterly reports that outline the activities and the accomplishments achieved by this program; Number of model regulations/regulatory mappings produced; Number of assessments produced; Number of BPN employees trained.

Potential Pitfalls: The political sensitivity of this issue may make it unattractive for sponsorship by the USG. The theory of eminent domain is not well understood in Indonesia and land acquisitions for public purpose have caused considerable political unrest, especially when they are not done transparently. USAID should tread carefully on this issue lest it become identified with unpopular and even corrupt practices.

The other concern is the profitability of the "land mafia" in Indonesia. It is suspected that government employees may benefit from the insider speculation that inevitably occurs prior to public announcements of projects. Moving to a more transparent land acquisition

[49] BPN, Power Point Presentation, 2008.

process may not be in the immediate interest of BPN employees and therefore TA efforts could be wasted.

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Annex II: Trade and Investment - Tables and Figures

Table 1: Indonesia's export growth and price effect

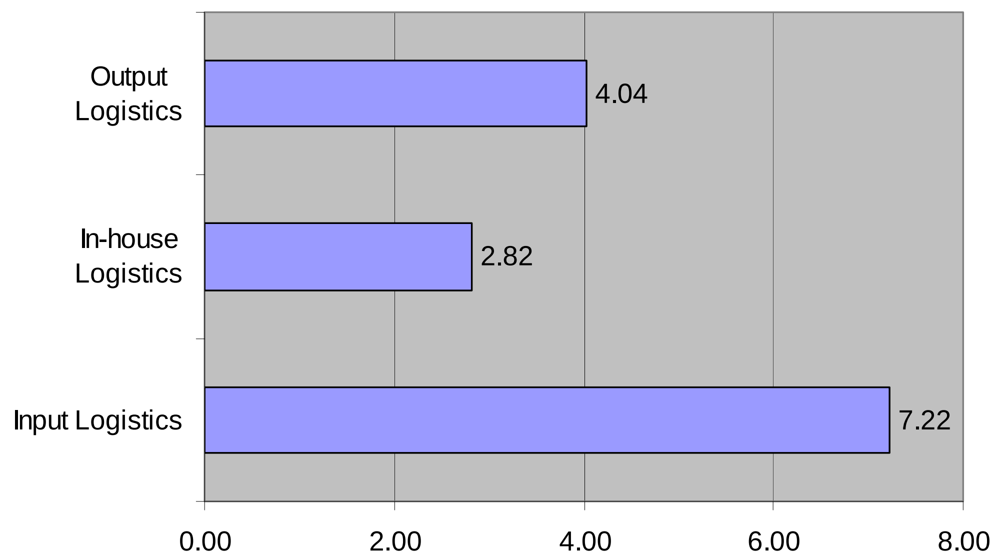
				Constant Prices		Current Prices		Price Effect	
Categories	1990	1996	2006*	90-96	96-06	90-96	96-06	90-96	96-06
Oil/Gas	13.1	15.1	9.3	2.4	-4.7	8.4	6.2	6.0	10.9
Agriculture Commodities	3.7	5.4	13.0	6.5	9.1	15.3	8.4	8.8	-0.8
Fish and Shrimp	1.0	1.3	2.1	5.5	4.8	9.7	0.6	4.2	-4.3
Rubber	0.9	1.4	2.3	8.4	5.1	18.7	9.2	10.3	4.0
Palm & Palm Kernel Oil	0.4	0.8	5.1	12.9	20.4	27.4	17.3	14.5	-3.0
Coffe & Cocoa	0.7	0.9	1.3	4.6	4.1	12.9	4.2	8.4	0.1
Minerals	2.1	4.3	10.1	13.0	8.8	19.4	14.0	6.4	5.2
Copper	0.4	1.9	2.5	28.7	3.0	27.8	12.0	-1.0	9.0
Coal	0.1	1.0	5.4	39.0	18.8	37.3	17.2	-1.7	-1.6
Nickel & Tin	0.4	0.5	1.3	6.2	9.1	4.9	14.3	-1.3	5.1
Forestry Products	1.0	5.7	6.6	33.6	1.4	46.2	0.1	12.6	-1.3
Plywood	0.2	3.0	1.4	63.1	-7.4	80.5	-7.9	17.4	-0.5
Paper & Paper Products	0.1	1.4	2.5	48.3	6.2	35.6	10.5	-12.7	4.3
Pulp & Waste Paper	0.1	0.5	1.3	42.1	10.4	33.8	9.1	-8.3	-1.3
Manufactured Products	4.3	17.7	38.4	26.5	8.0	29.5	5.9	3.0	-2.1
Textiles & Footwear	2.2	8.0	12.1	23.6	4.2	23.3	1.6	-0.3	-2.6
Textile Fabric	0.5	1.8	2.5	22.1	3.2	16.2	-1.4	-5.9	-4.7
Textile Fiber & Thread	0.1	0.9	2.3	53.9	9.6	50.4	6.0	-3.5	-3.5
Garments	1.0	3.3	6.0	20.9	6.3	20.5	3.9	-0.4	-2.4
Footwear	0.6	2.0	1.3	23.0	-4.1	30.2	-4.0	7.2	0.0
Electronics & Computers Parts	0.2	3.4	8.6	61.6	9.7	90.2	8.1	28.6	-1.6
Other Manufactured Products	1.9	6.3	17.7	22.2	10.8	27.9	8.6	5.7	-2.3
Chemicals	0.2	1.5	5.4	34.9	13.8	34.8	11.1	-0.1	-2.7
Furniture	0.2	0.8	1.8	22.4	8.5	24.5	5.6	1.0	-2.9
Machinery	0.1	0.4	2.4	41.0	18.3	53.3	15.8	12.3	-2.5
Tires & Rubber Products	0.1	0.2	0.7	26.4	11.6	28.9	11.3	2.5	-0.3
Total Exports	24.2	48.3	77.3	12.2	4.8	16.3	6.7	4.1	1.9
Total Non Oil/Gas	11.1	33.2	68.0	20.0	7.4	26.3	6.8	6.4	-0.6
Labor Intensive Manufactured Exports									
Textiles & Footwear	2.2	8.0	12.1	23.6	4.2	23.3	1.6	-0.3	-2.6
Furniture	0.2	0.8	1.8	22.4	8.5	23.5	5.6	1.0	-2.9
Total Labor Intensive Manufacture	2.5	8.8	13.9	23.5	4.7	23.3	2.1	-0.2	-2.6

Source: Papanek and Basri (forthcoming), using BPS data from Tim Buehrer and the World Bank. *) 2006 estimates

Table 2. Top Five Sources of Inefficiency Costs of Logistics Export Industry

No	Sources	Category of Logistics Cost
1	**Infrastructure (Road)**	*Logistics cost from vendors to manufacturers (input logistics)*
2	**Informal Collections**	*Logistics cost from vendors to manufacturers (input logistics)*
3	**Infrastructure (Road & Port)**	*Logistics cost from manufacturer to port (output logistics)*
4	**Government Policies (e.g., Export Procedure)**	*Logistics cost from manufacturer to port (output logistics)*
5	**Government Policies (e.g., Minimum Wage)**	*In house logistic in manufacturers (in-house logistics)*

Figure 1 Comparison among Input. In-house and Output Logistics Costs



	Input Logistics	In-house Logistics	Output Logistics
Actual Logistics Cost	7.22	2.82	4.04

Source: LPEM-FEUI (2005b)

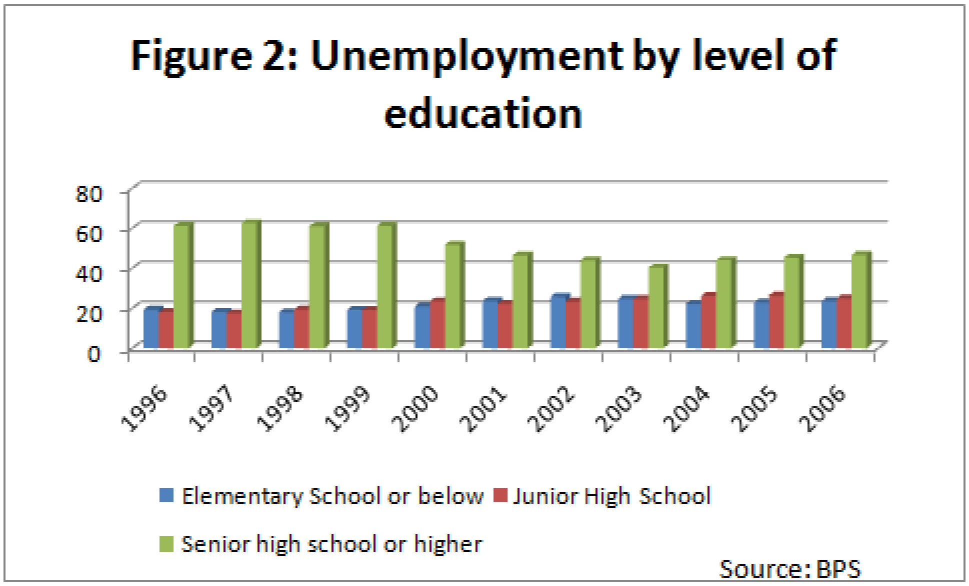


Figure 2: Unemployment by level of education
80
60
40
20
0
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
Elementary School or below
Junior High School
Senior high school or higher
Source: BPS

Annex III: Trade and Investment - Investment Package Summary

Below is the summary of the 2006 and 2007 Investment Package (Presidential Instruction 3/2006 and Presidential Instruction 6/2007)

Summary Presidential Instruction 3/2006
Customs and Excise
▪ Acceleration of export- and import clearances.
▪ Development of bonded zones.
▪ Eradication of smuggling.
▪ De-bureaucratization of Customs offices.
Taxation
▪ Provision of tax incentives for investment.
▪ Application of consistent self-assessment system.
▪ Revision of value added tax to promote exports.
▪ Protection of taxpayers" rights.
▪ Promotion of transparency and disclosure.
Labor
▪ Development of good industrial relationships that promote employment.
▪ Protection of Indonesian migrant workers abroad.
▪ Promotion of a conflict resolution system that is fast. inexpensive. and fair.
▪ Creation of a more productive and flexible labor market.
▪ Promotion of "new transmigration" as a means to employment creation.
Summary of the Presidential Instruction 6/2007
Improvement of the Investment Climate
▪ Institutions
▪ Empowerment of investment services institutions
▪ Synchronization of central and local regulations
▪ Trade flows
▪ Improvement of cargo services in Tanjung Priok port. Jakarta
▪ Improvement of customs service
▪ Improvement of customs facilities
▪ Improvement of customs control
▪ Taxation

▪	Improvement of cargo tax payment services.
▪	Promotion of good governance.
▪	Protection of taxpayers” rights

ANNEX IV: Alternative Business Enabling Environment Rankings

See attached.

ALTERNATIVE BUSINESS ENABLING ENVIRONMENT RANKINGS

A REVIEW

This publication was authored by Dr. Donald Snodgrass of Weidemann Associates Inc. for the Business Growth Initiative Project and financed by the Office of Economic Growth of EGAT/USAID. This report is also available on the Business Growth Initiative project website at www.BusinessGrowthInitiative.org.

ALTERNATIVE BUSINESS ENABLING ENVIRONMENT RANKINGS

A REVIEW

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ALTERNATIVE BUSINESS ENABLING ENVIRONMENT RANKINGS: A REVIEW

Introduction

Business Enabling Environment Ranking Systems have become an important tool in promoting reforms in countries to improve the prospects for economic growth. A number of these systems have developed over the past decade or so and some have achieved prominence in discussions about how countries are progressing toward free market economies. The Business Growth Initiative (BGI) project of the U. S. Agency for International Development (USAID) commissioned this report by Don Snodgrass to review a number of key ranking systems and analyze the strengths and weaknesses of each. This was done in order to provide some guidance to USAID Economic Growth Officers and private sector development practitioners on how to use these different ranking systems in determining if progress is being made on improving the business environment in particular countries.

USAID Bureaus in Washington and some USAID missions have been using ranking systems to pull together indices for internal use that help to determine the effectiveness of reforms supported by USAID and other donor assistance programs. The Millennium Challenge Commission (MCC) has made improvement in some of the Doing Business Indicators of the World Bank as part of the criteria for qualifying for MCC assistance. These indices have been helpful in encouraging dialogue among development practitioners, private sector players and government officials in how to promote enterprise development and, thereby, economic growth within countries. One lesson learned on this topic is how important it is to establish on-going public-private dialogue mechanisms in countries, both at the national and local levels. These permit the private sector to provide input and impact on macroeconomic policy and microeconomic regulatory decisions by government on the business environment. There is no single ranking system or index that necessarily provides a complete picture of the business climate within a country. There are differences both in the definition of the components of the business environment and in methodologies used to collect and analyze data for each ranking system. This paper is meant to help guide the reader to a better understanding of these differences and how, taken together, these different ranking systems and indices can be used effectively to gauge progress in the reform of the business environment.

Stephen C. Silcox,
Business Growth Initiative/ USAID

Overview

The purposes of this note are:

- To summarize the best known and most widely used indexes of the business enabling environment (BEE)
- To see how they have been applied to the countries in which USAID works
- To speculate about which indexes best reflect the quality of the BEE in which the clients of USAID private sector development (PSD) programs actually work.

The note analyzes the two best known and most commonly cited rankings, namely:

- The *Global Competitiveness Index* of the World Economic Forum (GCI); and
- The *Doing Business* indicators of the World Bank (DB).

It also reviews:

- The *Index of Economic Freedom* of the Heritage Foundation (IEF);
- The *Business Environment Rankings* of the Economist Intelligence Unit (BER);
- The *Global Entrepreneurship Monitor* produced jointly by Babson College and the London Business School.[1]

The summary description of each index reviewed provides the following information:

- How long it has been in existence
- How it is compiled; what the components of the index are
- How many countries it covers in its latest edition
- How many of the countries in which USAID works are covered
- How relevant it seems to USAID PSD programs and clients

The five systems reviewed in this note are only a few of the many attempts that have been made to create country ranking systems based on criteria related to the business environment. Other more or less prominent examples are listed and briefly described in the Annex.

Global Competitiveness Index

The Global Competitiveness Report has been published by the World Economic Forum, based in Geneva, Switzerland, since 1979. The latest edition, dated 2007-2008, was edited by Michael Porter of the Harvard Business School, Xavier Sala-i-Martin of Columbia University, and Klaus Schwab, Executive Chairman of the WEF. Its GCI covers 131 countries, including 66 of the 89 countries in which USAID currently works.[2]

Each edition of the Global Competitiveness Report contains a genuine wealth of information on the countries covered. The report's cornerstone is the GCI, which was

[1] Thanks to Elaine Allen, Svetlana Bagaudinova, Margareta Drzeniek Hanouz, Anthony Kim, and Cory O'Hara for comments, corrections, and constructive suggestions on earlier drafts.

[2] A few countries with projects but no mission may be excluded from this list of countries in which USAID currently works.

developed by Xavier Sala-i-Martin in cooperation with the Forum and initially inspired by Michael Porter's analysis of national competitiveness. The index scores countries on a total of 131 variables grouped under twelve "pillars." The pillars are:

1. Institutions (public and private)
2. Infrastructure
3. Macroeconomic stability
4. Health and primary education
5. Higher education and training
6. Goods market efficiency
7. Labor market efficiency
8. Financial market sophistication
9. Technological readiness
10. Market size
11. Business sophistication
12. Innovation

Seventy-nine of the 131 variables included in the index are measured according to data gathered in the Executive Opinion Survey conducted annually by the WEF among more than 11,000 respondents (an average sample of about 90 firms per country). The remaining variables are taken from published sources. Countries are scored and ranked according to each variable and pillar as well as in terms of their overall competitiveness. The scores and rankings of individual variables allow competitive strengths and weaknesses to be identified for each country.

The Global Competitiveness Report also classifies economies into five groups based on Porter's schema of what drives economic growth at different levels of development:[3]

1. Stage 1: Factor-driven (GDP per capita less than $2,000); includes 44 countries, of which 36 are countries in which USAID works
2. Transitional from Stage 1 to Stage 2 ($2,000-3,000; includes 18 countries, of which ten are countries in which USAID works
3. Stage 2: Efficiency-driven ($3,000-9,000); includes 27 countries, of which 16 are countries in which USAID works
4. Transitional from Stage 2 to Stage 3 ($9,000-17,000); includes 11 countries, of which four are countries in which USAID works
5. Stage 3: Innovation-driven (over $17,000); includes 31 countries, none of which is a USAID country

Doing Business

Doing Business made a big splash when it first appeared in 2004. While most previous efforts had relied on a combination of macroeconomic data and subjective judgments by business people or experts, this series broke new ground by providing more objective micro-level measures: the documented costs (in time and money) of a number of common business operations. Its cost estimates are based on consultations with knowledgeable local authorities, usually lawyers and accountants, in each country

[3] In addition to the GDP criterion, the GCI also uses the factor intensity of the economy as a second criterion for classifying countries into stages of development.

covered. Details for all costs and the steps involved in each process, as well as the specific laws on which they are based, are all available on-line at www.doingbusiness.org. The fifth and latest edition, *Doing Business in 2008*, came out in 2007.

This approach to rating a country's BEE is based on the hypothesis that simplifying the way regulations are implemented will improve the BEE and thus promote PSD. The data generated by the *Doing Business* series clearly indicate that the cost, time, and complexity of complying with business regulations varies substantially among countries and tends strongly to be higher in poorer countries than in richer ones, especially when measured as a percentage of GDP per capita. Data displayed in the *Doing Business* reports suggest that higher regulatory costs are associated with lower labor productivity, greater informality and corruption, delays, and higher female unemployment.

The business transactions covered in *Doing Business in 2004* were starting a business, hiring and firing workers, enforcing contracts, getting credit, and closing a business. By the latest version (*Doing Business in 2008*), other topics had been added: dealing with licenses, registering property, protecting investors, paying taxes, and trading across borders. Topics that might be added in future editions include not paying bribes, opportunities for women, and infrastructure.

Doing Business in 2004 covered 135 countries. Coverage has expanded over the years, in part with support from USAID, and *Doing Business in 2008* was able to cover 178 countries, including 84 of the countries in which USAID currently works.[4]

Index of Economic Freedom

The Heritage Foundation has compiled an Index of Economic Freedom since 1995. The 2008 edition is the 14th issued. This index now covers 162 countries, including 78 of the countries in which USAID currently works. It gives countries ratings of 0-100 on ten broad areas of economic freedom:

1. Business freedom
2. Trade freedom
3. Fiscal freedom
4. Government size
5. Monetary freedom
6. Investment freedom
7. Financial freedom
8. Property rights
9. Freedom from corruption
10. Labor freedom

Aggregating across these ten measures, the Heritage Foundation assigns countries to five broad categories:

1. "Free" (seven countries in the latest edition)
2. "Mostly free" (23 countries, including 3 USAID countries)

[4] The only USAID countries not covered were Burma, Cuba, Cyprus, Kosovo, and Turkmenistan.

3. "Moderately free" (51 countries, including 27 USAID countries)
4. "Mostly unfree" (52 countries, including 33 USAID countries)
5. "Repressed" (24 countries, including 15 USAID countries)[5]

In addition to the 78 USAID countries that are ranked in the current IEF and four countries that were analyzed but not ranked, five USAID countries/regions were left uncovered: Afghanistan, Kosovo, Liberia, Timor Leste, and West Bank/Gaza.

These rankings are highly correlated with per capita income. The Heritage Foundation argues that the relationship is causal – in other words, that greater economic freedom leads to greater prosperity.

The IEF draws on a wide range of published data sources, which are listed in the report on the latest edition of the index. The report also provides a detailed explanation of the methodology used to compile the various components of the index.[6]

Business Environment Rankings

The Economist Intelligence Unit (EIU) was founded in 1946. Its *Business Environment Rankings* examines ten separate criteria or categories:

1. The political environment
2. The macroeconomic environment
3. Market opportunities
4. Policy towards free enterprise and competition
5. Policy towards foreign investment
6. Foreign trade and exchange controls
7. Taxes
8. Financing
9. The labor market
10. Infrastructure.

Each of these categories includes a number of indicators. Approximately 250 indicators are included in the rankings. About half of these indicators are drawn from national and international statistical sources. The rest are qualitative in nature and are taken from a range of data sources and business surveys, frequently adjusted by the EIU.

These rankings draw on the in-depth country knowledge that the EIU gains from the compilation of frequently revised reports to its subscribers on economic and political conditions in all the countries concerned. This index differs from the two described above in that it reflects both historical information (covering the past five years) and forecasts for the medium-term future (next five years) made by the EIU itself. This permits trends in the quality of the BEE, as gauged by the EIU, to be measured.

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[5] Five additional countries were analyzed but not ranked: Montenegro, Serbia, Sudan, Iraq, and the Democratic Republic of Congo. All but Montenegro are USAID countries.

[6] See http://www.heritage.org/index.

The latest EIU ratings, published in October 2007, covered 82 countries. A complete set of country rankings is not provided on the website, but extensive information on the BEE in various world regions has been published. Also available is a list of the 15 lowest ranked countries. In ascending order, these are Angola, Venezuela, Iran, Libya, Cuba, Ecuador, Kenya, Nigeria, Bangladesh, Azerbaijan, Algeria, Pakistan, Ukraine, Morocco, and Kazakhstan. Eleven of these 15 lowest-ranked countries are areas of USAID activity.

Unlike the World Bank, WEF, or Heritage Foundation, the EIU is a commercial organization that sells its services to those willing to pay for them. For this reason, it emphasizes the larger world economies, especially those likely to be of interest to foreign investors. This no doubt explains the much narrower coverage of the EIU's rankings compared to those of the previous two organizations. It may also be the case that its rankings more accurately measure the quality of the BEE for foreign direct investors than for business more generally.

Global Entrepreneurship Monitor

The *Global Entrepreneurship Monitor,* produced annually since 1999 as a joint effort of Babson College and the London Business School, has three main objectives:

- To measure differences in the level of entrepreneurial activity between countries;
- To uncover factors determining national levels of entrepreneurial activity; and
- To identify policies that might enhance national levels of entrepreneurial activity.

The latest GEM report (Niels Bosma, Kent Jones, Erkko Autio, and Jonathan Levie, *Global Entrepreneurship Monitor: 2007 Executive Report)* draws on data gathered by a consortium of national teams that participate in the Global Entrepreneurship Research Association (GERA; see www.gemconsortium.org). Information on entrepreneurial activity (entrepreneurs and business owner-managers as a percentage of the adult population) is collected through a survey of individuals called the GEM Adult Population Survey. GEM also collects information on ten "Entrepreneurial Framework Conditions"[7] and compiles a "red tape index" that rates national expert perceptions of regulation affecting new and growing businesses and can be compared to the World Bank's Doing Business indicators.

The 2007 edition of GEM measures the prevalence of entrepreneurship in 42 countries, of which 23 are high-income countries and the remainder middle- and low-income countries in Europe, Asia, and Latin America. Important developing countries such as China, India, and Brazil are included, but most of the smaller countries are not and Africa is excluded altogether. Only 13 countries where USAID is active were included in the latest edition of GEM.[8] Coverage for the red tape index is slightly broader, with 58

[7] Financial support; government policies; government programs; education and training; research and development transfer; commercial and professional infrastructure; internal market openness; access to physical infrastructure; cultural and social norms; and intellectual property rights protection.

[8] Brazil, China, Colombia, Croatia, Dominican Republic, Hungary, India, Kazakhstan, Peru, Romania, Russia, Serbia, and Thailand.

countries included using data for one or more years in the 2003-2007 range. This includes 21 USAID countries (see Table 2, below).

Comparison of Ranking Systems for USAID Countries

This section compares the DB, GCI, IEF, BER, and GEM indexes in terms of coverage of countries in which USAID works and considers how consistent their rankings of these countries are.

Table 1 summarizes characteristics of the four ranking systems noted earlier.

Table 2 shows how each of the 89 USAID countries ranks in the four of these systems. The rankings are broadly similar and generally confirm that poorer countries have worse business environments than richer countries, but some interesting differences do emerge.

Some countries are judged by the WEF to be relatively competitive despite low DB and IEF rankings. An objective measure of this phenomenon would be that a country ranks at least 25 places better on the GCI than in the DB rankings. Countries that meet this criterion are Albania, Benin, Bolivia, Brazil, Cambodia, China, Croatia, Ecuador, Egypt, Guatemala, Honduras, India, Indonesia, Jordan, Madagascar, Mali, Morocco, Philippines, Russia, Senegal, Sri Lanka, Tajikistan, Tanzania, Ukraine, and Uzbekistan. Some of the countries listed (e.g., Brazil, China, India, Russia) appear to be nations – often large ones – that are experiencing strong economic growth despite relatively illiberal regulatory environments. It has also been suggested that some of the countries that rank higher on the DB scale have reformed rapidly in a short period of time, while the responses given by business people in the WEF survey may reflect their cumulative experience rather than what happened in the past year.[9]

There are also a few discrepancies in the opposite direction. The following countries ranked 25 or more places *worse* on the GCI than in the DB rankings: Armenia, Georgia, Kenya, Kyrgyzstan, Mongolia, Namibia, Peru, and Romania. At least some of these countries have simplified their business regulations but may not yet have improved other aspects of competitiveness. Georgia was given an award by the World Bank for achieving the greatest number of regulatory reforms. Interestingly, *Doing Business 2008* reports (p. 1) that the Eastern Europe and Central Asia region now rates as more business-friendly according to their measure than East Asia and the Pacific. This probably reflects efforts by several Eastern European countries (e.g., Estonia and Slovenia) to qualify for membership in the European Union.

[9] Thanks to Amy Cogan Wares of USAID for this insight.

Table 1. Characteristics of Indexes Reviewed

CHARACTERISTIC	DOING BUSINESS	GLOBAL COMPETITIVENESS	ECONOMIC FREEDOM	EIU BUSINESS ENVIRON-MENT	GLOBAL ENTREPRENEURSHIP MONITOR
When started	2004	1979	1995	???	1999
Definition of business enabling environment	Private cost of government regulations	12 "pillars" of competitiveness	10 measures of economic freedom	10 criteria	Regulations affecting new or growing businesses
Source of information	Local lawyers & accountants	Published statistics + executive opinions	Published statistics	Published statistics, analysis, forecasts	Survey of at least 2,000 individuals per country
Type of measure	Cost in money and time	Scalar ranking	Scalar ranking	Scalar ranking	Scalar ranking
Total number of countries covered in latest edition	178	131	162	82	58
Number of USAID countries covered in latest edition	84	66	78	??	21

Table 2. Ranking of USAID Countries by Three Indexes

COUNTRY	DOING BUSINESS	GLOBAL COMPETITIVENESS	ECONOMIC FREEDOM	GEM Red Tape Index
Afghanistan	159	---	---	
Albania	136	109	102	
Angola	167	---	143	
Armenia	39	93	28	
Azerbaijan	96	66	107	
Bangladesh	107	107	148	
Belarus	110	---	150	
Benin	151	108	110	
Bolivia	140	105	123	
Brazil	122	72	101	56
Burma	---	---	153	
Cambodia	145	110	100	
China	83	34	126	8
Colombia	66	69	67	
Congo, DR	178	---	---	
Croatia	97	57	113	45
Cuba	---	---	---	
Cyprus	---	---	22	
Czech Rep.	56	33	37	
Dominican Rep.	99	96	87	39
Ecuador	128	103	108	42
Egypt	126	77	85	
El Salvador	69	67	33	
Ethiopia	102	123	124	
Georgia	18	90	32	
Ghana	87	---	94	
Guatemala	114	87	78	
Guyana	104	126	136	
Guinea	166	---	127	
Haiti	148	---	138	
Honduras	121	83	79	
Hungary	45	47	43	52
India	120	48	115	27
Indonesia	123	54	119	
Iraq	141	---	---	
Ireland/N. Ireland	8	22	3	10
Jamaica	63	78	45	41
Jordan	80	49	58	14
Kazakhstan	71	61	78	43

Kenya	72	99	82	
Kosovo	---	---	---	
Kyrgyzstan	94	119	78	
Laos	164	---	137	
Lebanon	85	---	73	
Liberia	170	---	---	
Lithuania	26	38	26	
Macedonia	75	94	71	
Madagascar	149	118	65	
Malawi	127	---	120	
Mali	158	115	104	
Mexico	44	52	44	29
Moldova	92	97	89	
Mongolia	52	101	62	
Morocco	129	64	98	
Mozambique	134	128	96	
Namibia	43	89	72	
Nepal	111	114	112	
Nicaragua	93	111	81	
Nigeria	108	95	105	
Pakistan	76	92	93	
Panama	65	59	50	
Paraguay	103	121	77	
Peru	58	86	55	50
Philippines	133	71	91	31
Poland	74	51	83	54
Romania	48	74	68	25
Russia	106	58	134	37
Rwanda	150	---	116	
Senegal	162	100	91	
Serbia & Montenegro	86	91	---	18
Sierra Leone	160	---	138	
Slovak Rep.	32	41	35	
South Africa	35	44	57	33
Sri Lanka	101	70	90	
Sudan	143	---	---	
Tajikistan	153	117	114	
Tanzania	130	104	97	
Thailand	15	28	54	20
Turkmenistan	---	---	152	
Uganda	118	120	52	26
Ukraine	139	73	133	
Uzbekistan	138	62	130	
Vietnam	91	68	135	
West	117	---	---	

Bank/Gaza			
Yemen	113	---	125
Zambia	116	122	99
Zimbabwe	152	129	155

Note: Color codes in table show which quartile of the distribution of all countries covered by the indicator a particular USAID country's ranking falls into. The top (highest ranking) quartile is highlighted in green, the second-ranking quartile in blue, the third-ranking quartile in yellow, and the lowest quartile in red.

Analysis and Conclusions

Each of the ranking systems reviewed in this note measures something a bit different from what the others measure. Doing Business measures the quality of the regulatory environment and employs relatively objective measures, as opposed to the more subjective opinions used in other rankings. With financial support from USAID, Doing Business has achieved nearly complete coverage of the countries in which USAID works. Besides being limited to the quality of the regulatory environment – just one element of the BEE broadly defined, although an important one – the DB indicators have five limitations that have been noted by the World Bank itself.[10]

1. The measures refer to the cost of doing business in the country's "largest business city"; conditions elsewhere may differ -- most likely the costs are higher elsewhere. To deal with this shortcoming, sub-national surveys have been carried out for some countries. The World Bank recently released such reports on Colombia (13 cities and provinces; five topics), Egypt (three cities; three topics); and Morocco (eight cities; four topics).
2. To achieve cross-country standardization, respondents are asked to give estimates for a limited liability company of a specific size. Costs for other forms and scales of businesses may differ.
3. For the same reason, the transactions to be costed out are very specifically defined. The costs of other types of transaction may differ.
4. The cost estimates come from individuals identified as expert respondents. Sometimes the estimates given by such individuals differ. If so, the responses are averaged.
5. The estimates assume that a business knows what is required and does not waste time. Satisfying regulatory requirements will obviously take longer if the business lacks information or is unable to follow up promptly. A related point is that Doing Business may not understand "work-arounds" that speed approvals and reduce costs but may involve paying bribes or "facilitation fees."

While Doing Business covers more countries, including more USAID countries, than the Global Competitiveness Report, its definition of the BEE is much narrower than that of the Global Competitiveness Report. Doing Business limits itself to measuring regulatory costs and ignores other major issues considered in the Global Competitiveness Report,

[10] *Doing Business 2007,* p. 61. The Independent Evaluation Group of the World Bank just published a report title *Doing Business: An Independent Evaluation* (2008). The analysis in this report was not incorporated into this note.

such as infrastructure provision, macroeconomic stability, and the quality of the labor force.

The GCI employs a much broader concept of the BEE. It uses a combination of quantitative and qualitative information, interpreted through a well-known and popular although not universally accepted analytical framework. One limitation is that it covers a smaller number of countries, especially countries in which USAID works. USAID has partnered with the WEF to expand coverage to a number of USAID countries.

A significant limitation of the GCI is that the sample sizes for WEF's Executive Opinion Survey are often quite small. This is especially true for the least developed countries of particular interest to USAID, where typical sample sizes range from 50 to 80 firms. Firms that participate in the survey also tend to be leading firms with international presence (they are best positioned to offer legitimate cross-country comparisons) and are significantly larger than the average firm in the country. For example, in Peru more than 80 percent of the firms surveyed had more than 100 employees. The quality of the survey data also depends on the capacity of the local partner that WEF uses to implement the survey.

The IEF seems to measure an even broader concept of economic freedom. A number of specific questions have been raised about its use of data. More broadly, Jeffrey Sachs and a number of critics have asked why, if economic freedom as measured by this index is what brings prosperity, countries like China, Russia, and Vietnam that have undemocratic systems of government and thus get low ratings in the IEF have managed to grow so rapidly.[11] Philip Bowring pointed out that the high ratings accorded to Hong Kong and Singapore reflect high levels of freedom for foreigners to trade and invest enjoy low taxes, rather than the lower levels of freedom accorded local inhabitants.[12]

The GEM red tape index measures something similar to the DB indicators, but uses the opinions of national experts instead of objective measures of time and money spent. Its rankings for the 58 countries that it covers differ substantially from the World Bank's ranking of countries on the ease of starting a business indicator.[13]

So which system best reflects the true BEE for USAID private sector development clients? Obviously no one index merits exclusive reliance. DB and the GCI both have their strong points and indeed complement each other. The growing acceptance and prominence of Doing Business has made it a powerful tool for motivating reform in several countries. Reportedly, more than 90 countries have reformed the Starting a Business indicator since Doing Business began publishing data in 2004. However,

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[11] Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (2006).

[12] Philip Bowring, "Economic Freedom? It Depends on Where You Stand." *International Herald Tribune,* January 8, 2006.

[13] GEM officials stress that their Total Entrepreneurial Activity (TEA) rate is the primary index used by GEM. They regard the Red Tape Index as a minor feature of the 2007 report. As noted in Table 1, the TEA's coverage of USAID countries is still quite limited.

since Doing Business measures only a part of the BEE (and does so imperfectly), improvement in a country's DB indicators does not guarantee successful private sector development. It does provide a starting point, but for any specific private sector development project, it would not be sufficient to rely on any single global ranking system, or perhaps even two or three of them.

A USAID official or contractor working on the BEE in a specific country might be well advised to consult all the indexes discussed here, consider possible reasons for ranking discrepancies and their implications, and then reach his or her own conclusions. A new web-based tool from the World Bank called Business Environment Snapshots (http://rru.worldbank.org/besnapshots) could aid this process. It pulls together material from several sources. For each of 160 countries, this feature gives highlights, rankings according to several different ranking systems, quantitative data (Doing Business indicators), legislation, analytical work done by the World Bank Group, and the Bank's project portfolio.

Low scores on Doing Business, or any other set of indicators, can be seen as analogous to a high temperature registered by a thermometer. They indicate the presence of a fever but do not diagnose the nature of the disease. Further analysis of the business environment is required.[14]

[14] For this analogy and extensive discussion of how to use (and how not to use) the Doing Business indicators, see Wade Channell, "Uses and Abuses of *Doing Business* Indicators" (USAID/EGAT/EG)

ANNEX: SOME OTHER RANKING SYSTEMS

Besides the systems analyzed in this paper, there are many others that might be consulted in particular circumstances. Some of the most important are briefly described below.

- The *Human Development Index,* was introduced in 1990 by the United Nations Development Program as an alternative to GNP per capita rankings and has been updated annually ever since. The HDI tries to measure countries' levels of human development, based on data on life expectancy, literacy, education, and per capita income. The HDI is viewed primarily as a welfare measure but it can also be used to measure the quality of a country's human resources.
- Transparency International's *Corruption Perception Index,* begun in 1995 and revised annually, reports business people's and country analysts' perceptions of the prevalence of public sector corruption (in 110 countries in the latest version). The CPI incorporates findings by several other agencies (e.g., the World Bank, regional development banks, EIU, Freedom House, the WEF) to produce a consensus evaluation of this particular dimension of the business environment.
- The World Bank has an annual rating system called the *Country Policy and Institutional Assessment* that it applies to IDA-eligible countries and uses to influence the allocation of IDA resources. The CPIA uses 16 criteria grouped in four clusters: economic management; structural policies; policies for social inclusion and equity; and public sector management and institutions. The ratings, which are based on judgments made by Bank staff members, theoretically range from 1 to 6 but typically run from a low of 2 to a high of 3.5. Seventy-six countries were included in the 2005 exercise.
- Since 1998 the World Bank Institute has published a set of *World Governance Indicators* that can be used to rank countries by each of six aggregate indicators that relate to the quality of their governance. These indicators (voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption) "are based on 33 individual data sources and hundreds of variables, capturing the views on governance of tens of thousands household and firm respondents, as well as hundreds of nongovernment organizations and public sector experts, and commercial business information providers worldwide." (from WBI website). The latest version of this survey, with data for 2006, has been issued as *A Decade of Measuring the Quality of Governance: Governance Matters 2007.*
- The tireless World Bank also does *Enterprise Surveys* that capture business perceptions on the biggest obstacles to increasing employment and productivity and measures productivity levels in the firms surveyed. This source covers more than 70,000 firms worldwide in 104 countries. National surveys are carried out by private contractors working for the World Bank. Large and small firms are covered, but large firms are over-sampled. The World Bank regards these surveys as complements to Doing Business as a tool for assessing a country's business environment.
- The United Nations Conference on Trade and Development is developing a *Trade and Development Index*, which ranks 110 countries and is described by UNCTAD as a work in progress. The TDI tries to measure a country's trade and development performance, based on data relating to structural and institutional factors (human capital, physical

infrastructure, institutional quality, economic structure, and environmental sustainability), trade policies and processes (openness to trade and effective access to foreign markets), and level of development (economic, social, and gender).

- The PRS Group publishes an International Country Risk Guide that covers 161 countries. This service began in 1980 and has been refined over the years. Its ratings comprise 22 variables in three categories of risk: political, financial, and economic. Users (banks, multinational corporations, traders, etc.) can change the weightings to reflect their particular concerns. Ratings for particular countries must be purchased.
- Several other companies compile country risk assessments and sell them to clients.

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