Indonesia in Post COVID-19 Global Value Chain Restructuring

ASIA’S PATH FORWARD

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INTRODUCTION

Amidst the unfolding pandemic, governments across the world are struggling to find ways to keep their economies afloat. As corporations switch to survival mode, market liquidity is draining rapidly and this is expected to drag international trade and investment down by over 30% (WTO 2020; UNCTAD 2020; OECD 2020). Global Value Chains (GVCs), which hinge on open borders and lean production methods, are beginning to rethink their dependence on China. Calls for reshoring or nearshoring are taking an increasingly urgent tone as governments encourage corporations to shorten their supply chains to improve resilience.

It is worthwhile to note that COVID-19 is simply accelerating an existing GVC restructuring trend, which began with the U.S.-China trade war. Escalating tariffs have caused technology giants to begin mulling Southeast Asia as an alternative supply base (Chatterjee 2019; Cheng and Li 2020b; 2020a). Reports cited over 1,000 Japanese manufacturers looking to diversify their supply chain beyond China, backed by the USD $200 million provided by their government for nearshoring. Again, Southeast Asia will be the main beneficiary of such nearshoring (Reynolds and Urabe 2020).

STAGNATING WHEN THE TIDE TURNS

For many developing countries, participation in GVCs has boosted their economic growth and, like a rising tide, has lifted many out of poverty (World Bank 2020). However, this rising tide often has the side effect of submerging and obscuring structural weaknesses. In Indonesia’s case, this weakness stems from a highly complex regulatory framework that has made the country sluggish in responding to global economic challenges, such as the commodity downcycle of 2011-2015 and the U.S.-China trade dispute. As the tide began to go out, this new crisis has suddenly drained the sea and laid bare jagged reefs of regulatory overload that threaten to ground the ship.
Commodities are Indonesia’s biggest export. As such, Indonesia was negatively affected by the commodities downcycle. GDP growth declined from a high of over 6% in 2010 to a more modest 5% when President Joko “Jokowi” Widodo was elected for his first term in 2014. This lower growth rate meant that jobs were not being created fast enough to match the growth of the working-age population, creating an unemployment spike in 2015 which steadied around 7 million from 2016 onwards (Figure 1). This figure is likely to double in the near future, with the pandemic expected to cost 5.5 – 6.4 million jobs this year (Suroyo, Diela, and Jefriando 2020).

To increase labor absorption, President Jokowi promised 7% growth for his first term. His key strategy to achieve this was a major infrastructure drive and sixteen Economic Policy Packages (Hill 2020; Cheston n.d.). These brought significant improvements to both Indonesia’s Logistics Performance Index (LPI) and Ease of Doing Business (EODB) ranking. However, the regulatory improvement – represented by the EODB – has stalled since 2017 even as neighboring countries continue to improve (Figure 2).

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Looking deeper into each indicator in the EODB index reveals that Indonesia is a difficult and risky place for business. Ease of Starting a Business is Indonesia’s worst-performing indicator and the lengthy and unpredictable court system also makes Enforcing Contracts difficult. Foreign investors have it even harder, as Indonesia is notorious for being the second most restrictive country for foreign Equity Restrictions and Foreign Key Personnel Restrictions (Figure 3).

The weak judicial system is compounded by pervasive corruption. The Global Corruption Barometer reports that nearly a quarter of public service users pay bribes and 65% of respondents believe that corruption is on the rise in the last year (Transparency International n.d.). The recent changes to the Corruption Eradication Commission Law do not help either, as they undermine the Commission’s independence (Cook 2019). With so many restrictions and risks to grapple with, it is no surprise that Foreign Direct Investment (FDI) continues to play a marginal role in Indonesia’s economy.
AN INWARD-LOOKING SHIP IS HEAVY AND RIGID

Economic Gravity Theory suggests that in the absence of barriers, larger economies should attract more trade and investment flows compared to smaller ones. As such, larger economies should be better placed to participate in the GVCs as they have more to offer. However, Indonesia’s GVC participation is lower than most of its ASEAN counterparts, behind that of Singapore, Malaysia, the Philippines, Vietnam, and Thailand (ASEAN-Japan Centre 2017). Furthermore, it is on a retreat. The OECD (2018) calculates that the proportion of Indonesian domestic value-add driven by foreign consumption dropped from 26.7% in 2005 to 18.3% in 2015. Indeed, Indonesia seems to be turning ever more inward as the EODB index shows relatively poor performance in Trading Across Borders criteria (Figure 3).
Things are not much better on the investment front. As the largest economy in ASEAN, Indonesia is behind most of its neighbors in terms of FDI contribution to its economy. In fact, its average net FDI inflows as a proportion of GDP is the second lowest in ASEAN (Figure 4). The World Bank (2019) highlights how waves of relocations in 2017 and 2019 largely bypassed Indonesia, with 150 corporations choosing Vietnam, Thailand, and the Philippines as their new hosts and only 10 coming to Indonesia. The pandemic has proven to be an even greater challenge for FDI attraction. The Indonesia Investment Coordination Board recorded a 7% quarter-over-quarter drop in FDI during the first quarter of 2020 (BKPM 2020). Because FDI is an important source of productive long-term capital which also supports broader GVC integration, serious efforts to improve the Indonesian investment regime will be necessary for economic recovery when COVID-19 subsides.

Figure 4. Average FDI net inflows 2009 - 2018 (% of GDP)

Source: World Development Indicators

In its coverage of the relocation cases, the World Bank (2019) asserts that the complicated Indonesian regulatory regime turns away investors. Ministries are making too many rules that often overlap and many regional regulations contradict national regulations. Such overlaps and contradictions create an opening for discretionary enforcement which, in turn, increases the probability of graft. All these create uncertainty that increases business costs.

Indeed, the regulatory database maintained by the Ministry of Justice and Human Rights (Figure 5) records that there are over 40,000 regulations, over 75% of which are Ministerial and Regional Regulations (Ministry of Justice and Human Rights n.d.). Around 95% of Ministerial Regulations were issued in the past decade. On top of that, following the decentralization process at the turn of the century, over 500 sub-national governments can issue their own regulations. In the President’s own
words, such “hyper-regulation” or “regulatory obesity” traps the country and slows its response to global changes (Rohmah 2020).

To illustrate how complex the regulatory overlap can be, as many as 13 agencies control non-tariff measures (NTMs) in trade (Gupta 2020). Firms looking to set up factories with linkages to GVCs must ensure that they do not breach any of the 1600+ rules set out by the Ministries of Manpower, Industry, and Trade. There are also sectoral ministries to heed. Pharmaceutical manufacturers, for example, would have to keep an eye on the Ministry of Health’s regulations; currently tallied at 709. Furthermore, even after ensuring that all central-level regulation is fulfilled, investors will likely find more terms and conditions set out in hundreds of Regional Regulations.

**Figure 5. Number of regulations issued in Indonesia annually since 1997**
(as of 19th July 2020)

Source: Ministry of Justice and Human Rights
LIGHTENING THE LOAD TO STAY AFLOAT

Regulatory simplification efforts have, in fact, been underway since President Jokowi’s first term. The Ministry of National Development Planning (BAPPENAS) published a report in 2015 that points out the declining quality and uncontrolled quantity of regulations. The President then instructed BAPPENAS to lead the work on reducing the number of regulations by half. However, progress has been slow and, by 2017, just 164 national regulations were revoked, replaced, revised, or merged (“Joko Widodo - Jusuf Kalla 3rd Year Report (Laporan 3 Tahun Pemerintahan Joko Widodo - Jusuf Kalla)” 2017). Indonesia’s stagnant EODB rank and repeatedly missing out on GVC relocation seem to have convinced the President that a much bigger reform is needed, hence the Omnibus Bill on Job Creation.

Introduced for the first time during the President’s inauguration speech for his second term, the Omnibus Bill was drafted in a little over two months and submitted to the People’s Representative Council (the Legislative Body or DPR) in February 2020. It makes changes to over 1,200 articles in 79 laws grouped into 11 clusters (Coordinating Ministry of Economic Affairs 2020). These articles are identified based on inputs from the local business associations and the Omnibus Bill is well received among foreign investors, despite having no direct involvement in its creation. The American Chamber of Commerce in Indonesia believes the Omnibus Bill can be the most important economic reform in the past two decades (AmCham Indonesia 2020). However, most labor unions and numerous civil society organizations oppose it on grounds of rushed process and lack of public consultation. Discussions have since been delayed and there were even talks of rebranding the Omnibus Bill itself (Akhlas, Ghaliya, and Aritonang 2020; Katadata 2020).

However, the Omnibus Bill does not seem to address the root cause of hyper-regulation. It revises the laws at the top of regulatory hierarchy, but the problem is at the bottom, i.e. the Ministerial Regulations. Based on Law No. 12/2011 article 8, ministries and equivalent agencies can issue regulations when: (1) instructed by higher regulations, or (2) based on their own discretion. This discretionary power has contributed to the explosion of ministerial regulations in the past decade. The Omnibus Bill, unfortunately, does not make any revisions to this article. In fact, the Omnibus Bill itself instructs the Executive to draft more than 400 new implementing regulations. Without tight discipline, these hundreds could easily become thousands, negating any simplifying effect.

The Omnibus Bill may also inadvertently increase overlap and complexity. Article 173b of the Omnibus Bill maintains that revised laws are still valid, but their implementing regulations must be adjusted for consistency within one month. To illustrate how this may increase overlap, consider the following example: Investment Law No. 25/2007 has 40 articles, 5 of which are revised by the Omnibus Bill. It mandates a new Presidential Regulation for one of these and adjustment to the implementing
regulations of the other four articles will likely be needed. The other 35 articles in Law No. 25/2007 remain valid, including their implementing regulations. If the Omnibus Bill passes, future investors will have to refer to both laws, each with their own implementing regulations. Rather than simplifying matters, it may have the opposite effect.

Added to these problems is the extremely tight timeframe the Omnibus Bill sets for implementing regulations. Within the same one-month timeframe stipulated for revising implementing regulations, new regulations must also be concluded (Article 173a). History shows that the highest number of Government Regulations issued in a year was 243 back in 1961. For Presidential Regulations, the highest number was 196 in 2014 (Ministry of Justice and Human Rights n.d.). In fact, it is not unusual for implementing regulations to come out years after a law is passed (Pramusinto 2016). Drafting 400 new regulations and potentially revising 900 more in a single month is a gargantuan – if not impossible – task. Focusing on speed at the expense of quality will muddy the waters further and deter investors even more.

Interestingly, the aforementioned BAPPENAS report has provided some useful guiding principles for regulatory reform. It proposes that the main goal of regulatory reform should be to create a national regulatory system that is “of [high] quality, simple, and orderly” (“berkualitas, sederhana, dan tertib”) (Sadiawati 2015, 14). To attract more investment and integrate into GVCs, the Indonesian government should continue the regulatory simplification process beyond the Omnibus Bill. This will lighten the load and prepare the ship to respond quickly to the ever-shifting winds of the global economy.

NAVIGATING INTO THE FUTURE

The following recommendations seek to improve the chances of Indonesia's integration into GVCs post COVID-19:

1. **Allow enough time to craft high quality regulations**

   With the Bill’s drafting process criticized for being rushed and opaque, the DPR should extend the one-month deadline for drafting and adjusting affected implementing regulations. The legislators should also require that this extra time is to be used for extensive research (Academic Script / Naskah Akademik) and intensive public consultations. Allowing 3-6 months of preparation per regulatory cluster, depending on the size of each cluster, seems more realistic. A consultation process that includes as many stakeholders as possible will help to minimize overlap risks and maximize effectiveness of the new and adjusted regulations.
2. **Ensure regulatory reform momentum continues**

While the broad scope of the Omnibus Bill is an excellent starting point, more regulatory simplification is still needed. A review of the entire regulatory network should be conducted to identify which regulations are outdated (and thus should be revoked) or vague (and thus should be clarified). Furthermore, since foreign businesses experience more restrictions but had no direct channel to provide input for the Omnibus Bill, the Coordinating Ministry of Economic Affairs should engage them more directly for the next stage of reform. This will improve certainty by reducing the probability that businesses will be ensnared by old, irrelevant, or unclear rules.

3. **Review regulation-making authority and process stipulated in Law No. 12/2011**

The President and the DPR should consider revising Law No. 12/2011 to limit situations where ministers can make regulations without being instructed. The Law should also specify a mandatory review milestone for all regulations. Indonesian government can emulate similar practices already in place in other countries, such as the U.S. Regulatory Flexibility Act (National Oceanic and Atmospheric Administration 2019). Any regulations exceeding the review milestone (for example: 10 years) must be reviewed. This can serve as a legal basis to initiate the process of reviewing old regulations as proposed above and ensure a regular check-up is built into future regulation-making process.

4. **Build an awareness of the cost impact of regulations**

The principles of high quality, simple, and orderly regulations proposed by BAPPENAS are useful as a guide. High quality regulations are clear and leave little room for discretion. Simple rules reduce the cost of compliance. Orderly policies increase predictability, which facilitates business planning. The key here will be to build policy makers’ capacity to create regulations that leave no loose ends and critically assess compliance costs. As a matter of fact, a compliance cost analysis should be integrated into the research component of the regulation draft (*Naskah Akademik*). To assist with this analysis, a submission process should be established for associations or organisations to submit compliance cost estimates for any proposed regulation.
References


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