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A NOTE ON EXTERNAL ECONOMIC RELATIONS AND INEQUALITY IN INDONESIA

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The recent decline in oil prices has again made dramatically clear how vulnerable Indonesia's economy is to the conditions on the world market regarding this particular product. When measured by the share of Gross Domestic Product which is exported, about a quarter in 1985, Indonesia can be considered to have a moderately open economy. However, it is well-known that some institutions, most notably the Government, depend quite heavily on external resources. Speaking about the sources of income of the exchequer means that one already touches upon a potentially important determinant of the distribution of disposable household incomes. Moreover, the incidence of public expenditures naturally affects personal welfare. Since oil receipts account for the lion's share of both export earnings and government income, the most sizeable link between external economic relations and Indonesian inequality is still an indirect one, namely through the public purse.

In general, those advocating less inequality in Indonesia are faced with a serious problem. Obviously, the most important determinants of the household income distribution are the possession, the use and the valuation of factors of production. Indonesia is renowned for its riches in terms of resources, both human (a large population) and physical (e.g. the treasures of the soil). Unfortunately, the labour force is unskilled and therefore much less scarce in the world market than the mineral wealth. In addition, it requires some capital but hardly any labour to supply these minerals to the outside world. In the absence of a smoothly functioning domestic capital market, a somewhat equitable distribution of the benefits of this national property can thus only be ensured by intervention of the state. Simultaneously, it is also clear that the distributional consequences of external relations are less problematic, if the bulk of the population is involved in the supply of production factors (e.g. labour) which are highly

valued abroad (cf. Japan and Singapore). In case that the Government appropriates a large share of the foreign exchange receipts, it is not unreasonable to assume that the allocation of these resources is influenced by the power basis of the Government.

The rest of this paper is divided into three parts. First, we will make a few general remarks concerning the links between external relations and internal inequality. Second, the more concrete case of the bilateral ties between Indonesia and her major trading partner, Japan, will be reviewed. In the last section, possible areas for further research in this direction are explored.

EXTERNAL RELATIONS AND INTERNAL INEQUALITY

As already indicated above, external relations probably worsen the domestic income distribution unless the majority of the population participates, either directly (through the supply of production factors) or indirectly (through the supply of political power). The argument that an international orientation of economic policy (e.g. through 'export-led industrialisation') benefits the poor is therefore usually an indirect one. It runs through the accomplishment of higher growth rates, which would then be spread to the other (non-tradable) sectors of the economy and eventually "trickle down" to the masses. At present, the institutions which explicitly or implicitly support an economic open-door policy for Indonesia, commonly point to the employment opportunities which would be generated as a consequence. Although positive effects of breaking down trade barriers, and other "impediments" to an increasing foreign participation in Indonesia, on the effectiveness and output of local industries cannot be dismissed a priori, it is doubtful whether such a policy would create, on balance, sufficient jobs to remedy the massive lack of productive employment opportunities in the foreseeable future.[1)] It seems not too speculative to argue that the hey-days of standardised products of labour-intensive assembly industries

flooding the world market are over. Not only is the present world overrun with trade restrictions which are generally not in favour of a late-comer like Indonesia, but also there exists an increasing tendency to concentrate production processes in a few (developed or semi-developed) countries which are close to the markets, possess an abundant supply of high-skilled (but relatively cheap!) labour, offer a favourable regulatory environment and have a highly developed physical infrastructure.[2] Many industrialists believe that the possibilities of automation and of manufacture in small series, tailored to the needs of consumers with sufficient purchasing power, more than compensate for somewhat higher labour costs. More concretely this means that for instance Singapore has better prospects for continuing export-led industrial growth than Indonesia.

A resource-based industrialisation strategy (plywood, energy intensive products) with due attention to appropriate input prices, efficiency and possibilities for exportation, would thus make Indonesia probably less dependent on the vagaries of the world market than the exclusive concentration on assembly-type industries (for instance in so-called export processing zones). Being just a link in an international processing chain means that location decisions may be reversed with changing comparative advantage (cf. the recent closure of the semi-conductor factories in Indonesia).

Naturally, external economic relations encompass more than just international trade. Particularly in the case of Indonesia, foreign direct investment accounts for a sizeable share of company profits (in 1975 approximately 20% of total operating surplus in Indonesia accrued to foreign owners [Keuning, 1985] and this share may not have decreased since). This raises the question as to the choice of technology, employment generation and distributional consequences of these subsidiary companies. The available evidence indicates that, in general, foreign-owned industries use more capital intensive techniques than national firms, and in fact may employ

even less labour than could be argued on grounds of short-term profit maximation [Stobaugh and Wells, 1984].[3] Another well-documented effect is the segmentation of labour (see e.g. Nissen [1984]). This internal brain-drain probably occurs in Indonesia as well [Manning, 1980]. Besides, domestic income redistribution policies are often not in the interest of local branches of multinational enterprises, which typically sell luxury goods at a price which is far beyond the purchasing power of the bulk of the population. These issues have already been investigated in the Indonesian context for some time (see e.g. Short [1979], Pattiasina [1982], Kirchbach [1982], Chen [1983], Okada [1983] and Kian Wie [1984]).

On the contrary, much less is known who benefits from foreign aid. In view of the increasing importance of foreign concessionary funds in Indonesia, this may become an interesting subject for further analysis.

As a modest first step and example, we will try to sketch below the economic relations between Indonesia and Japan. Probably this relationship is unique, not only on account of the enormous interests involved, but also because of the integrated way in which the Japanese Government treats the three major aspects involved: trade, investments and aid.

JAPAN AND INDONESIA[4]

Recently, the Japanese Government has announced a new programme for development cooperation with the ASEAN-countries.[5] This so-called new Asian Industries Development (AID) Plan is predominantly aimed at supporting private investments in the manufacturing sector. The emphasis shifts away from the financing of (public) investments in infrastructure, with the exception of the construction of export processing zones. Subsequently, private enterprise interested in erecting a plant in such a zone would then be subsidised by means of cheap credits, the costs being borne by the

Japanese budget for development cooperation. This programme is meant to promote non-oil exports from the ASEAN-countries.

In spite of these noble objectives, the impression cannot be avoided that Japanese industry will reap the largest benefits of these plans. As a consequence of the higher value of the yen, the capital surplus in Japan and the selective protectionist measures of other industrialised countries, Japanese entrepreneurs are looking for an outlet, so that they can continue their profitable business. Since the availability of a cheap and docile labour force is still an important determinant of company profits in many production activities, nearby developing countries are eligible for part of the capital export. However, potential Japanese investors in ASEAN-countries, including Indonesia, are not fond of regulations limiting their degree of freedom, to the benefit of the (future resilience of the) host country. Some months ago a Japanese businessman listed again "...five suggestions which may help to encourage the flow of foreign investment into Indonesia in the medium term" [Kinoshita, 1986: p.55]. Besides tax incentives and streamlining of administrative procedures, these related to the postponement of localisation schemes and a "prudent" policy on technology transfer.

A notable difference between export-processing zones and ordinary industrial sites tends to be the lack of regulations governing foreign investments in the former areas. In view of the above statements, the preference of the Japanese Government for subsidised foreign (read: Japanese) investment in these zones does not surprise anymore. However, it is open to some doubt whether the host countries will receive substantial long-term benefits from assembly-type industries which obtain all their inputs from Japan and add little value locally before the products are shipped abroad.[6)] It seems questionable whether these companies which use hardly more local resources than cheap unskilled labour will become firmly rooted in Indonesian society. Yet, without such linkages, it is quite easy to stop operations again, as soon as shifting comparative advantage (automation!) dictates

another location of the production process. Although these investments should not be rigidly kept out during the intermediate stage of building a firm industrial base, it seems that in the medium term a more viable route leads through the gradual addition of more value locally to the abundant reservoir of natural resources, before exporting them. Plywood represents a rather successful case here. It stands to reason that foreign capital may help in developing this capacity. In this way, Japanese development aid would however be less tailored to the needs of their own business.

The case of plywood also sheds more light on Japanese trade policy with respect to Indonesia. Although the tariff rate has been lowered to some extent recently,[7)] it is still significantly higher than the rate on logs, the raw material. This is illustrative for the Japanese tariff structure, where the tax rate increases with the value added incorporated in the imported product. Another major problem of the developing countries with the Japanese trade barriers are the manifold non-tariff restrictions (quota, unnecessarily harsh quality inspections and quarantaine procedures) and the preferential treatment given to more powerful countries, such as the United States.

Even in the case of raw materials, Japanese trade policy is not determined exclusively by "free market" considerations. Indonesia is able to supply relatively cheap oil with a low sulphur content, which is quite suitable to this pollution-ridden nation. Nevertheless, Japan buys as well a considerable share of this strategic fuel in the Middle East, in order not to become too dependent on one supplier, namely Indonesia. In practice, the reverse is more the case: about half of Indonesia's exports and a quarter of its imports are traded with Japan.

Indonesia also presents a typical example of Japanese foreign investment policy which passed through a number of stages.[8)] At first, securing a steady flow of raw materials to Japan was the dominant motive. In order to be able to control this stream, direct investments in the supplier countries

were needed. This argument was reinforced by the price rise. The Japanese involvement in the extraction of minerals ensured that part of the benefits of higher prices accrued to these foreign companies.

In the second phase, more Japanese foreign investments were directed at producing manufactured products for the domestic (e.g. Indonesian) market, preferably behind high tariff walls. In some cases, these trade barriers were even erected on request of the Japanese partner. At the moment, the high value of the yen and selective protectionist measures taken by other industrialised countries against Japan, encourage a third type of investments abroad, namely in the assembly of imported (Japanese) components. The final products are then re-exported, mainly to Western markets. Moreover, Japanese (and other) multinationals increasingly work with more "flexible" arrangements, like license agreements and management contracts, instead of the establishment of their own subsidiaries abroad [Kirchbach, 1982].

In conclusion of this section, we review one particular Japanese aid project. This project aimed at the construction of a comprehensive overview of the economy in each of the ASEAN-countries by means of a so-called bilateral input-output table. This included a precise description of the use of all imports in these countries. Thereby the origin of these imports was shown as well, distinguishing Japan on the one hand and the rest-of-the-world on the other hand. In this way Japan was provided with detailed information about the markets in all ASEAN-countries: in which sectors Japanese imports already had a large market share, where possibilities for further sales could be traced and so on. Naturally, each of the ASEAN-countries also obtained more insight in their own economy, but only Japan got an overview of the region as a whole, under the cloak of Official Development Aid.

AREAS FOR FURTHER RESEARCH

The above glance at economic relations between Indonesia and Japan illustrates that actual policies of IGGI-countries may sometimes contradict official rhetoric about their role in "raising Indonesia's economy to a higher level" (cf. Abe [1986: p.4]). It may be worth-while to investigate further the combined effect of trade-, investment- and aid policies of individual donor countries on Indonesia's economy in general and on poverty and inequality in particular.[9)]

The implications of changes in world market prices, in trade patterns, in the terms-of-trade etc. on the income distribution and, reversely, consequences of shifts in inequality on the balance-of-payments situation should be studied within an integrated statistical framework. For this purpose, the Indonesian Central Bureau of Statistics (BPS), in cooperation with the Institute of Social Studies (ISS) in The Hague, has compiled a so-called Social Accounting Matrix (SAM).[10)] Such a SAM contains a detailed overview of the sources of income and the expenditures of several household groups (say, agricultural labourers, small, medium and large farmers, and rural and urban, formal and informal non-agricultural households). This information on household conditions is then linked, in a consistent way, to the production structure, company profits, the Government account, the balance of payments and so on. These integrated data sets can shed more light on, among other things: a) the household groups, which have benefitted most, directly of indirectly, from the oil boom, and b) the direct and indirect foreign exchange requirements of the consumption demand of various (rich and poor) population groups.[11)]

Furthermore, the implications of rapid technological changes on a world scale for Indonesia's most desirable industrialisation strategy should be studied more in depth. Thereby, the links to external relations (trade,

direct foreign investments) on the one hand and to internal distributional aspects on the other hand are obvious.

Finally, the exact motives of multinational corporations, for example in the agricultural sector, for producing either within or outside Indonesia are still not always clear. More insight into these considerations will be necessary in order to design policies vis-à-vis foreign investments which ensure that sufficient benefits accrue to the Indonesian population at large.

Notes

*) This paper has been presented at the third INGI-conference in Zeist, the Netherlands on April 28th, 1987.

1. This should not be read as a general plea for autarky, an overvalued exchange rate or import restrictions (tariffs, quotas, import monopolies and such). It is well-known that domestic assembling of imported inputs may cost more in terms of foreign exchange and employment foregone than importing the finished product, while the quasi-rent of quotas and import monopolies does certainly not accrue to the underprivileged part of the population. See also Glassburner [1978], Baldwin [1985] and Djojohadikusomo [1986] on these points.

2. Refer to Kaplinsky [1984], Pack and Westphal [1986] and Pfaller [1986] for an overview.

3. In this regard there seems to be a difference between investors from developed and from developing countries, the latter employing less capital intensive technologies (see e.g. Wells [1983]).

4. This section is partly based on Keuning [1987].

5. Refer also to the discussion in the Far Eastern Economic Review (5 November 1986, pp. 66-67, and 29 January 1987, pp. 43-45).

6. See also Warr [1987] on the Philippine experience with export processing zones.

7. See e.g. Far Eastern Economic Review, 8 January 1987, pp. 35-36.

8. The idea of a classification in stages is based on Sumarlin [1986]. Refer also to Ozawa [1979] and Sekiguchi and Krause [1980].

9. For instance, the Dutch plans for the maritime sector are criticised by Dick [1985].

10. At the moment, Indonesia is one of the few countries for which two full-fledged SAMs are available [BPS, 1982 and BPS/ISS, 1986].

11. The distributional impact of foreign direct investments and foreign aid can only be traced fully by means of a dynamic analysis, which calls for the use of a simulation model (cf. BPS/ISS/SOW [1986]).

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