Agricultural trade reform and industry adjustment in Indonesia

by

David Harris

Rural Industries Research and Development Corporation

and the

Australian Centre for International Agricultural Research

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Introduction

This paper presents a component of a project on industry adjustment to agricultural trade reform in selected developing countries. The aim of the project is to examine the issues affecting the development of industry adjustment policies to manage the impact of trade reform. It will evaluate specific developing country examples of industries that are likely to face significant adjustment pressures from trade policy reform.

The study is focused on industry specific policy responses for two reasons. First, many LDC's are concerned about the consequences of future WTO reforms for adjustment in 'sensitive' industries. Governments in developing countries have received advice and assistance on how to comply with the requirements of their WTO commitments from the Uruguay Round of trade negotiations. However, very little attention has been devoted to the domestic effects of trade reform.

Second, the implementation of international trade commitments is likely to lead to industry requests for assistance. Adjustment policies used by developed countries may not be directly applicable to LDC situations. Differences in structural characteristics, institutional arrangements and the level of industry development require an investigation of the issues affecting adjustment in developing countries.

Project objective

The objective of the project is to identify the key principles in developing industry adjustment policies to manage the impact of trade reforms in developing countries. The project has three components:

1. Review selected industries in some developing countries that are likely to face adjustment pressures caused by reductions in border protection and domestic policy reform.

2. Analyse the nature of the adjustment issues and consider the policy response options for managing the impact of trade reform for the specific circumstances in each industry.

3. Describe the principles for designing transitional industry adjustment measures that will facilitate structural change and promote industry competitiveness in developing countries.

Background and project content

The WTO trade negotiations will require LDC governments to implement policy reforms that lead to adjustment pressures for some 'sensitive' industries. Regional and bi-lateral trade agreements will also require policy reform in many countries. Trade reforms are usually phased-in but in some cases the impact can lead to requests for other forms of industry assistance. LDC Governments may want to consider the option of transitional assistance measures that manage the effects of reform but also encourage adjustment to improve industry competitiveness.

Policy responses that provide on-going support could encourage a protectionist attitude by producers. Over time a dependency on assistance from trade barriers and/or domestic support measures could affect the relative competitiveness of these industries. Providing assistance without the incentive for change may impede the adjustment process, distort resource movement and affect industry development.

The project has only recently commenced. Stage one involves a general review of the major agricultural industries in selected developing countries that are subject to significant policy interventions. The review will focus on industries that gain assistance from border protection measures and domestic support arrangements. Indonesia, Viet Nam, China and India were the countries nominated for the initial review.

The aim of the review is to identify industries that have been adjusting to recent policy changes and those that could be ‘sensitive’ to future trade reforms. The review will consider country commitments to international trade agreements which are often the catalyst for industry policy reforms. This may involve the WTO Uruguay Round agreement, regional trade arrangements and bilateral FTA’s.

The first stage of the project is only partially completed. This paper covers an examination of the agricultural sector in Indonesia. It demonstrates the approach used to identify industries facing adjustment to trade policy reform in the other countries covered by the project.

Trade policy reform in Indonesian agriculture

The agricultural sector plays an important role in the Indonesian economy. In 2000 agriculture accounted for around 17% of GDP. Most agricultural industries are labor intensive and the sector accounts for about 40% of total employment. Indonesian agriculture is primarily composed of small scale subsistence farms which account for around 87% of cultivated land (WTO, 2003).

Food security is a sensitive issue. The government puts a high priority on ensuring there are sufficient supplies of rice and other basic commodities available at affordable prices. A primary policy objective is to encourage growth in food production and achieve self-sufficiency in rice and other staple food products.

The Government has introduced various policy initiatives to promote growth in food production. The initiatives include policies that relate to structural adjustment issues such as improving productivity and developing farm management skills. In recent years the government has also created specific programs that aim to increase the output of industry sectors such as:

- cereals – rice, soybeans and corn;
- animal protein – meat, dairy products; and
- tropical horticulture.

Indonesia applies a range of trade policy measures that affect exports and imports of a number of agricultural products. Export taxes are levied on crude palm oil and related palm oil products although the tax rate on palm nuts has been progressively reduced to negligible levels. Voluntary export restraints apply to rubber exports under the provisions of the international trade agreement for rubber. The government also controls exports of coffee, manioc and vegetables through discretionary export licensing arrangements.

The average rate of applied tariffs on imports of agricultural products is relatively low. According to the WTO applied tariff protection currently averages around 4% (WTO, 2003). There has been a range of trade related reforms implemented in the period since the financial crisis of 1997. However, some industries continue to retain relatively high levels of protection from imports.

Before the financial crisis occurred imports of several agricultural products were subject to restrictive licensing arrangements that limited access for imports. Rice, corn, soybeans and sugar imports were affected by these restrictions. A government agency held the monopoly rights on imports of these products. Imports of some meat and dairy products were also subject to non-tariff barriers.

In 1998 the IMF required the implementation of a structural adjustment package which imposed several policy reforms on the agricultural sector. Many applied tariff rates were adjusted to negligible levels to off-set the impact of the substantial currency depreciation on food prices. Import licensing requirements were removed and the private sector was allowed to import products that were previously controlled by the Government.

Indonesian commitments to trade reform

Since the Asian financial crisis in 1997 the Indonesian government has been committed to trade liberalisation as a means of promoting economic development. Trade policy reform has been a key component of the IMF-supported stabilization program. The Government has also implemented a range of agricultural policy reforms based on their commitments to international trade agreements.

Agriculture trade reforms have involved tariff reductions and the removal of non-tariff barriers in various industries. Indonesia is not currently involved in any bilateral trade agreements. The trade liberalisation measures relate to three major commitments:

- trade liberalisation commitments for the ASEAN Free-Trade Area (AFTA);
- WTO commitments from the Uruguay Round; and
- APEC voluntary unilateral trade liberalisation based on Individual Action Plans (IAPs).

Indonesia's AFTA reform commitments primarily involve the adoption of a Common Effective Preferential Tariff (CEPT). For most products the CEPT requires ASEAN members to reduce tariffs on intra-ASEAN trade to a maximum of 5% by the end of 2002. There is also a requirement to eliminate quantitative restrictions and other non-tariff barriers.

Some products can be temporarily excluded from the CEPT tariff reduction scheme. These products may be classed as sensitive products or as temporary exclusions from the scheme. Temporary exclusions were to be progressively included in the CEPT scheme over a five year period beginning in 1995. Sensitive products have until 2010 before they must be included in the CEPT scheme.

Indonesia has progressively transferred all temporary exclusions and sensitive products into the CEPT scheme. There has been no indication that the AFTA tariff reductions have created adjustment issues for specific agricultural products. If adjustment issues were to emerge the most likely candidates are sugar and poultry because Thailand is a competitive supplier of these products on the world market.

In the longer term agricultural industry adjustment pressures may emerge from the adoption of trade liberalization agreements between the ASEAN group and non-member States. A proposal to examine the creation of an East Asian FTA involving ASEAN + 3 members (China, Japan and Korea) was announced in late 2002. Indonesia has also expressed support for the establishment of an ASEAN-China FTA within 10 years.

Indonesia is a member of the Cairns Group although Government officials have indicated they do not necessarily agree with all Cairns Group proposals for trade reform (WTO, 2003). At the launch of the Doha Round Indonesia supported the proposition of 'special and differential' treatment for agricultural products. This was to accommodate non-trade concerns such as food security, reductions in poverty and rural development issues.

Uruguay Round commitments by Indonesia required tariffication of import restrictions and the imposition of tariff bindings on all agricultural products. At the start of the implementation period the average bound rate for agricultural tariffs was more than 70%. This requirement has been implemented. By 2005 the average bound rate will be reduced by 24% with a minimum reduction of 10% on each tariff line.

Indonesia's APEC reform commitments involve the adoption of voluntary targets for trade liberalisation based on an Individual Action Plan (IAP). The goal of the APEC initiative on trade reform is free trade in the Asia-Pacific community. Developing country members have until 2020 to achieve this goal. The IAP's contain voluntary reform intentions in 15 policy areas. Three of the key policy areas cover tariffs, non-tariff measures and WTO obligations. They include commitments to:

- progressively cut tariffs until the goal of free trade is achieved;
- eliminate non-tariff measures that are inconsistent with WTO agreements (eg trade bans, levies, licensing arrangements, etc); and
- accelerate and deepen the implementation of Uruguay Round WTO commitments.

Under their APEC commitments Indonesia has progressively reduced tariffs based on a schedule of reductions adopted in 1996. Indonesia has also eliminated all import levies and most of the non-tariff barriers identified in their Uruguay Round commitments. These measures were implemented as an acceleration of the WTO schedule for reform.

Industries adjusting to trade reforms in Indonesia

In general Indonesia's commitments to agricultural trade reform have had a limited impact on most agricultural industries. For many products applied tariff rates were substantially below the bound rates that were subject to reduction commitments. However, for some products there have been significant changes to non-tariff barriers. The pressure for adjustment has increased in some industries and led to requests for assistance.

The review of Indonesia's agricultural sector has identified rice and sugar as the two key industries facing adjustment issues in relation to trade reform. These two industries will be included in the second stage of the project.

There are other industries facing increased competition from imports due to changes in trade policy. For example, in recent years the soybean industry has asked the Government for increased import protection. High costs of production have reduced the competitiveness of the domestic industry against imported product. In late 2002 the Ministry of Agriculture proposed increasing the tariff on soybean imports from 0% to 27%. The proposal is still under review.

The Indonesian rice industry

Rice is a sensitive industry for Indonesia and there have been significant policy changes in recent years. Indonesia is the third largest producer and consumer of rice on the world market. Food security is a sensitive issue for the Government and rice has a dominant role in the national diet.

Substantial imports are required to meet market requirements and Indonesia has become the world's largest importer of rice.

The rice industry is dominated by small scale subsistence farming. Industry development has been constrained by limited growth in production areas and slow rates of productivity improvement. A Government program is in place to encourage plantings with the aim of achieving self-sufficiency. High costs of production, limited access to credit and high interest rates have discouraged producers from expanding production (USDA, 2003b).

In recent years improvements in rice yields have been limited. Inefficient harvesting practices, poor farm management and difficulties in obtaining fertilizer supplies have been the major contributing factors. Rice yields are currently averaging around 4.5 t/ha. This compares with yields of 9 to 9.5 t/ha in Australia. The Government has introduced fertilizer subsidies to off-set the high cost of production and improve yields.

Government policy has been concerned with managing the impact of world market conditions on domestic prices and providing subsidised sales to support social programs for the poor. Domestic producers gain support through a floor price scheme which is currently set at 2,790 Rp/kg (US$315/t). In recent years market prices have been supported at levels 20-30% above world prices. This reflects a recent policy of linking the floor price to production costs (WTO, 2003).

The level of protection against imports has varied and the industry has been adjusting to several trade related reforms. Up until 1998 the National Logistics Agency (Bulgog) had monopoly rights on rice imports. Those rights were removed under the IMF Structural Adjustment package. Special licensing arrangements for private sector imports were introduced. Bulgog import activities are now limited to handling government contracts that relate to the provision of food aid.

Bulog is responsible for domestic rice procurement to support the floor price. It is also required to hold one month's supply of the total market requirements in order to guarantee adequate supplies. The Agency has a price stabilisation role and releases rice stocks onto the market if retail prices rise too high. Bulgog is also responsible for distributing subsidised rice to low income earners under Government poverty assistance measures such as the "food-for-poor" program.

Imports account for less than 10% of total domestic rice sales. The Government recently imposed a tariff of 430 Rp./kg (US$50/t) on rice imports by private traders. Previously the applied tariff rate was zero. The policy change was introduced to strengthen market prices and provide an incentive for increase plantings. Subsequently the industry has made requests for an increase in the tariff to 735 Rp./kg (US$85/t). Indonesia's WTO bound rate is 160%.

Indonesia's WTO commitments required the establishment of a tariff-quota (TQ) for 70 kt of rice imports with an in-quota tariff of 90%. The rice TQ has never been utilised as the applied tariff remains substantially below the in-quota tariff rate. Indonesia also has WTO commitments on subsidised rice exports. The maximum sales volume declines from 295 kt to 257 kt over the implementation period. Export subsidies for rice have never been utilised.

The Indonesian sugar industry

The Indonesian sugar industry revolves around a combination of private sector and government owned milling operations. Small scale family farmers account for around 50% of cane plantings. The State owned mills purchase cane from these farmers as well as processing cane from their own plantations. The privately owned sugar mills manage their own cane plantations.

Industry development has been constrained by low returns which have discouraged producers from expanding production. High input costs, limited access to credit and high interest rates are important contributing factors (USDA 2003a). Inefficient farming practices and disruptions to fertilizer supplies have limited the rate of productivity improvements. Cane yields are around 73 t/ha which compares with yields of around 95 t/ha in Australia in a normal season.

The Government has announced plans to stimulate productivity improvements in small scale farmer plantations. The objective is to achieve industry self sufficiency by 2007. The assistance package will include measures to improve irrigation infrastructure, introduce high quality seed and increase credit subsidies for farmers (USDA 2003a).

The industry gains support through import protection and domestic support arrangements. A floor price of 3,100 Rp/kg (US$350/t) is imposed to support producer returns. The policy arrangements are part of the Government's overall policy to encourage the development of the industry through increased cane plantings.

In recent years the impact of Government support policies has created a substantial gap between retail prices and the prevailing world price (USDA 2003a). For example, in early 2003 the retail price for domestically producer white sugar was around 4,300 Rp/kg (US$ 480/t) more than double the world market price for refined sugar (US$ 230/MT).

The National Logistics Agency (Bulgog) has responsibility for conducting market procurement activities in support of the floor price. The Agency lost the monopoly rights on sugar imports in 1988 as part of the IMF Structural Adjustment Package. Bulgog is still allowed to import raw sugar according to Government directives. In conjunction with the distribution of procurement stocks Bulgog sugar imports are used to stabilize market prices.

Imports account for a substantial share of domestic consumption of refined sugar with a market share of more than 40% in recent years. The large gap between the domestic price and the world price creates an incentive for smuggling. In response the Government uses special import licence to restrict private sector trade in raw sugar. Only nominated 'Importer-Producers' (IP) can import raw sugar which must be refined before being released for sale on the domestic market.

Domestic producers are unable to compete with imported sugar at current world prices. To improve producer returns the Indonesian Cane Farmers Association has made several requests for greater protection from imports in recent years. The specific import duty on raw sugar is 550 Rp/kg (US$62/t) and the duty on white sugar imports is 700 Rp/kg (US$79/t). The Government has so far rejected these requests but has indicated it may consider the introduction of a tariff-quota to improve their control over import levels.

In early 2003 the government announced a proposal to liberalise sugar imports from ASEAN countries as part of their AFTA commitments. The import duty on ASEAN members would be progressively reduced to zero. The Indonesian Cane Farmers Association is opposed to this proposal in view of the competitive threat from Thai sugar imports.

Government concern about the impact of trade reform on the domestic sugar industry is evident in the position adopted by Indonesia in the WTO modalities discussion for the Doha Round. Indonesia strongly supports the proposal for developing countries to gain special consideration for particular products. The Government has indicated that sugar along with other sensitive industries (rice, corn and soybeans) would be nominated for exclusion from WTO trade liberalisation if the negotiations lead to an agreement on this issue.

Further work on LDC adjustment to trade reform

Reviews of industry adjustment are in progress for Viet Nam, India and China. When stage one is completed the results will establish the dimensions of the later stages of the project. Budget limitations require the project to be limited to some selected examples of industries facing adjustment pressures caused by trade policy reform. The final selections will provide a cross-section of adjustment issues and industries that are relevant to developing country situations.

The nominated examples will be analysed as industry case studies. The analysis will examine the nature and the scale of the adjustment issue that has or is likely to emerge. This will include an assessment of the industry circumstances including structural characteristics, productivity growth and any regional differences in performance. The analysis will also examine the nature of the Government response if adjustment assistance has been provided.

The final stage of the project will consider policy options for responding to the adjustment pressures in each of the industry examples. It will draw upon work from a related study that is reviewing recent examples of Australian agricultural adjustment policies. In recent years several industries in Australia have faced adjustment issues created by policy reform. The study on Australian experiences will examine the industry circumstances and Government response for a variety of policy reforms including:

- reduced import protection;
- increased import competition from relaxing quarantine barriers;
- deregulation of domestic support arrangements; and
- producer competition for diminishing natural resources.

Australian experiences with adjustment policies are unlikely to be directly applicable to developing country situations. The structural characteristics of LDC agricultural industries are different. They often involve small scale farming units, limited use of capital, high labor inputs, low productivity and limited access to investment capital. However, the Australian study will provide a useful information base for considering LDC policy options for facilitating industry adjustment.

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