The Impact of the AFTA Tariff Reduction on Districts Economic Growth in Indonesia[1]

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Abstrak*.Saat ini telah banyak upaya pertumbuhan ekonomi melalui liberalisasi perdagangan dan integrasi ekonomi. Melalui kedua upaya ini diharapkan dapat mendorong pembangunan daerah melalui peningkatan keterkaitan ekonomi lokal dengan perdagangan global. Dalam dua dekade terakhir, Indonesia telah terlibat aktif dalam perdagangan bebas ASEAN (ASEAN Free Trade Area/AFTA) sebagai perjanjian perdagangan multilateral antar negara-negara Asia Tenggara. Artikel ini mengkaji dampak liberalisasi perdagangan AFTA terhadap inklusifitas pembangunan ekonomi kabupaten/kota pada era otonomi daerah. Artikel ini menganalisis dampak AFTA terhadap pembangunan kabupaten/kota di Indonesia. Artikel ini menunjukkan bahwa dampak AFTA masih pada pusat kegiatan industri manufaktur dan daerah maju. Selanjutnya, artikel ini berpendapat bahwa peran dominan pemerintah pusat tetap diperlukan untuk menjamin manfaat AFTA bagi pembangunan daerah.*

Kata kunci. ASEAN FTA, konvergensi wilayah, Tarif CEPT

Abstract. *Trade liberalization and economic integration have been globally adopted to accelerate the collective economic growth. Specifically trade liberalization is viewed as a crucial economic factor that promotes local economic development through promoting local economy into the global trade. This phenomenon is also found in Indonesia with its involvement in the ASEAN Free Trade Area (AFTA) as a multilateral agreement that selected specific industry sectors for trade inclusion. This article reviews the impact of AFTA trade liberalization on districts economic growth in the context of Indonesia's decentralised domestic political system. The article argues that the persistent dominant role of central government is still needed to ensure the AFTA's benefits for the district development.*

Keywords. ASEAN FTA, regional convergence, tariff CEPT

Introduction

As the decentralisation transfers industry and infrastructure development policies to the districts, this paper aims to examine the impact of AFTA at this level. This paper examines the inclusion of stakeholders in the AFTA tariff reduction and elimination and how this may influence the regional economic growth. As globalisation and trade liberalisation are defined by trade modalities, it is crucial to understand the policy making and inclusion of actors that involved in the decision. The first method used the econometrics analysis to examine the districts economic structure and types of the districs (eg. Economic structure, socio-economy type, and local

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endowments). Whilst the second part examines larger scoop by analysing supranational and national governance, such as ASEAN Way and the utilization of AFTA CEPT tariff, that influence trade modalities and its impact on district economic growth.

Following previous research on Indonesia, this paper improves Aritenang (2011) in two ways; first this paper expands the analysis in the post-authoritarian period which is between 2001 and 2010. Second, the paper also adds spatial and time variables to the econometrics model to examine the effects on districts economic growth.

The paper is organised as follows; section II elaborates Indonesian economy related with political shift in decentralisation and in ASEAN. Section III provides explanation on data and methodology and section IV displays the impact of inclusivity in AFTA on Indonesia regional development. Section V provides the research conclusion.

Indonesia Economy in AFTA

The ASEAN Free Trade Area (AFTA) is a trade liberalisation framework to accelerate economic integration among the ASEAN country members. The ASEAN summit 1992 establish the ASEAN Free Trade Area (AFTA) along with the council to supervise, coordinate, and review the implementation of Common Effective Preferential Tariff (CEPT) scheme for ASEAN FTA.

The ASEAN free trade area tariff elimination is the common effective preferential tariff (CEPT), which is a unilateral tariff reduction scheduled and set individually by the countries. CEPT took place in 1993 and expected to be zero tariff zone at 2010 for all member countries. The CEPT approach on sectors rather than product-by-product has been indicate to be more reliable and easier to implement. This regime was implemented to all products from ASEAN country members that had at least 40% ASEAN content. ASEAN responded to the 1997 Asian financial crisis by accelerating AFTA implementation for ASEAN+6 in 2004, and for new country members in 2010. The AFTA CEPT scheme consists of four main product categories: the inclusion list (IL); temporary exclusion list (TEL), sensitive list (SL); and the general exclusion list (GEL)—all of which are included in either the Fast Track Program or the Normal Track Program. In the past, there was concern that the state's sole discretion over selecting the products and industrial sectors for trade inclusion, as delineated by the AFTA sensitive list, would diminish the impact of the AFTA. For example, the Malaysian government's decision to include the automotive sector in the SL has prevented other member countries to gain benefit from the particular sector.

There are numerous studies on the impact of trade liberalisation on ASEAN member countries (Aswicahyono et al., 1996; Stubbs, 2001; Aritenang, 2011). Studies reviewing the impact of trade liberalisation on subnational economic growth are more limited but a few key observations can be gleaned from the existing literature on the same. Firstly, there is evidence of minimal positive impact on regions—a positive outcome depends on the strength of each region's economic engagement with, for example, the NAFTA (North American Free Trade Agreement) and MERCOSUR (Mercado Común del Sur/Southern America Common Market) (Madariaga et al, 2004; Rodríguez-Pose and Bwire, 2004).

Secondly, the impact of trade liberalisation is determined by the geographical location of the region. In a study on the impact of the NAFTA on Mexican regions, Rivas (2007) found that the NAFTA is likely to benefit regions with greater incomes and infrastructure. In addition, a paper

by Juan-Ramón and Rivera-Batiz (1996) argues that trade integration promotes economic growth for rich regions and regions that have physical proximity to advanced countries.

A recent research by Narjoko and Amri (2007) showed that tariff under AFTA remained progressive. It has fasten the zero tariff target by 2003, range 0-5 percent tariff rates in 15 years from 1993. The Asian financial crisis in 1997 was responded by AFTA with zero percent tariff target is to be achieve in 2010 for ASEAN-6 and 2015 for new country members. Furthermore, below is a list of products that can benefit from the CEPT procedures (ASEAN Secretariat, 1992):
1. The product should be in the inclusion list of both the exporter and importer country and the tariff should be either above 20% or below 20%.
2. The product has experienced declining tariff progress that has been approved by the AFTA commission.
3. The product should have, at least, 40% ASEAN content.
4. All products with tariffs between 0% and 5% are automatically included in the CEPT.

As the AFTA is a stepping stone for the ASEAN Economic Community (AEC), it is important to understand the impact of AFTA on local development. Furthermore, problems in the AFTA implementation could alert potential issues that may arise in AEC. For instance, limited attempt at information dissemination and poor governance of ASEAN as a supranational institution (Nesadurai, 2003; Chandra, 2008). Despite almost two decades since its establishment, the AFTA has insignificantly accelerate intra-trade among ASEAN countries. For instance, in 2008, among the original countries, Singapore has the highest intra-trade with 42 % followed by Malaysia (25.9%) and Thailand (22.6%). While Indonesia is at the fourth rank with 19.8 % of export are intra-trade (Inayati, 2010).

Indonesia has reduced its tariffs significantly. The average CEPT rate is only 1.76 per cent and the average Most Favored Nation (MFN) rate is 8.52 per cent. The lowest average AFTA CEPT and MFN tariff rates are for agro-based products (Octaviani, et al, 2007). It is also suggested that Indonesia has a revealed comparative advantage (RCA): it has a higher ratio of total exports than the share of total world exports in a particular commodity, specifically, agro-based, wood-based, and fisheries-based commodities (Octaviani, et al, 2007). However, analyses of the intra ASEAN trade integration, which employ the vertical intra-industry trade (IIT) measure, suggest that Indonesia's economy is mostly linked with regional trade via the automotive and rubber-based sectors. A lower degree of integration is found in the ICT, electronics, and wood-based sectors. Thus, despite Indonesia's comparative advantage in agro-based and fisheries-based commodities, these sectors have low trade value within the region - a result of their labour-intensity and the lack of opportunity they present for research and development.

On the other hand, following the financial crisis in 1997, Indonesia's political and financial system underwent a significant shift - from a centralized to decentralized government. The Law No.22/1999 abolished the hierarchical relationship between central-provincial and district level governments and devolved significant governmental responsibility to provincial and district governments. The Law No. 25/1999 regulates fiscal decentralization and the financial relationship between provincial and central governments (Booth, 2003).

Thus, these political and fiscal decentralisation laws allow Indonesian districts to autonomously establish cooperation with and arrange development loans from other countries. This has two implications; (i) richer districts will have greater trade and economic activities, and (ii) districts

are liable to impose taxes and levies from these economic activities, which may result in significant local revenue disparities.

The district level are commonly dominated by the manufacturing sector. Between 2001 and 2005, manufacture GDP grew by an average of 5.4% annually and contributed to 29% of total GDP. Moreover, manufacturing accounted for nearly 12% of the employed labour force, which reached almost 93 million in 2004. The labour productivity in the manufacturing sector is higher than the overall average industry sector. An overview of employment growth from 1994 to 2005 according to firm size is displayed below (Table 1).

The 1997 Asian monetary crisis slowed down Indonesia's economy. Trade fell by an average of 0.39% annually in 1997-2002. After the crisis, Indonesia's GDP growth rose from 4.78% to 6.3% annually, with the service sector experiencing the highest growth at the rate of 7%. During this period, Indonesia's GDP per capita was US$1,003 and GDP growth went up to 5.4% annually (Kuncoro, 2009). A simulation study by Astiyah et al (2011) shows that, between 2000 and 2010, Indonesia's domestic trading centre moved from East Java to West Java and also that there were high trade relations between districts in Java and those outside of Java. Their paper suggests that inter-provincial trade interdependence might affect the economies of Indonesia's districts in the event of a fiscal shock. As such, each district needs to strengthen its economy and industrial base.

Table 1 Comparison of MFN and ASEAN CEPT Tariffs, 2001 – 2010

	MFN Tariff	AFTA CEPT Tariff
2001	6.18	3.5
2002	5.23	2.88
2003	5.79	2.02
2004	5.86	1.26
2005	5.72	1.34
2006	5.65	1.46
2007	5.73	1.4
2008	6.33	0.89
2009	5.39	2.37
2010	4.32	1.36

Source: Data compiled from MFN and CEPT Tariff from ASEAN Secretariat, various years

Data and Methodology

The data for this research was gathered from the Statistics Central Bureau (Badan Pusat Statistics [BPS]) and the Ministry of Finance (MoF). Following the districts splitting, this research adds new districts as they are established[3]. These statistics data are subject to availability, for instance the GRDP, population and AFTA CEPT tariff data are annual statistics

[3]Available from the Statistics Central Bureau (Badan Pusat Statistics [BPS]), www.bps.go.id

between 2001 to 2010, whilst the Susenas and Podes data depends on the availability. By 2010, there are 98 municipalities and 399 regencies, making a total of 497 districts in Indonesia[.4]

The data are explained as follows; first, the dependent variable is the natural logarithm of GRDP per capita growth. Second, the AFTA impact is approximated by AFTA-CEPT unilateral tariff reduction, which is obtained from the ASEAN Secretariat. This paper proximated the tariff impact as a weighted average of the industry's share within the district[5]. The calculation follows Amiti and Konings' (2007) approach to proximate the impact of tariff reduction. First, we constructed a five-digit output tariff by taking a simple average of the harmonization system (HS) nine-digit codes within each five-digit industry code. This paper used an unpublished concordance between the HS nine-digit code and the five-digit Indonesian Standard Industrial Classification (ISIC) available from Amiti and Konings (2007).

Afterwards, for each five-digit industry, we computed an output tariff impact as a weighted average of the output tariffs (equation 1 and 2). The weights, , are the cost shares of industry k in district l, based on data from 1998. To address concerns about trade structure post-decentralization, we also constructed the input/output table for 2002. The available dataset is an unbalanced panel of around 21,000 firms per year with a total of 274,061 observations.

Following the neoclassical theory on the factor of production, the analysis also included several control variables to isolate the district-specific characteristics. First, the manufacturing data is provided by the annual large and medium firm survey. This data is used to constructed the labor-productivity at the district level. Second, the capital is proximated as the districts local government expenditure.

Third, the Susenas data is used to construct the percentage of the population in the urban areas, which represents the level of urbanized areas within a district and the population growth. Fourth, the Potensi Desa (Podes) data provides the data on the share of district road that is asphalt. Finally, this paper also constructs a dummy variable to identify neighbouring districts, define as districts within the same province. The assumption is that districts within the same province have similar economic structure and policy. The formula of the weighted growth of neighboring (GAW) is as follows:

$$GAW_{it} = \sum_{q=1}^{m_i} (ga_{qt} \, X \, w_{qt})$$

where GAWit is the weighted average growth performance of the districts that are neighbours (define as districts belong to same province) to districts i at time t[6].
Methodology

The contemporary convergence theory developed by Barro and Sala-I-Martin (2004) introduces absolute and conditional convergences. Absolute convergence occurs when the growth model parameters are equal, and conditional convergence relates to the movement of steady state

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[4]http://www.kemendagri.go.id/basis-data/2010/01/28/daftar-provinsi

[5] In trade liberalization, there are output and input tariffs, the output tariff measures the import value of a product and the input tariff measures the import value of raw material within a district's industry in each industrial sector. However, due to data availability, this paper only uses the output tariff

[6] A detailed information on the data construction is available from McCulloch & Sjahrir (2008).

growth of the exogenous factors (technology, population growth and savings) in constant per capita income or consumption level and capital per labour ratios between regions. This is conditional because the external factors are different across regions. ß convergence occurs if the growth rate distribution falls over time (Pike et al., 2006). ß convergence studies found that regional convergence speeds vary following economic cycles, peaking during a recession and plunging during an economic boom (Barro and Sala-I-Martin, 2004). Following the literature on convergence analysis, a negative relationship suggests that poor regions experience faster growth than rich economic regions; hence, there is convergence over time within the country.

The dependent variable is Yit, the GRDP per capita growth, as the net log of per capita income, a and b, are constant, with $0 < b < 1$ and ei is the disturbance term. The term $a < 0$ refers to the β convergence because the annual rate is inversely related to (Yit-1) and the higher value of β shows a higher degree of convergence (eq. 1).

First, the research used ordinary least squares (OLS) and panel data using a fixed-effect (FE) model to control individual differences between districts that do not vary across periods. All disparity levels were measured using the convergence concept by Barro and Sala-I-Martin (1991). For conditional β convergence, the empirical model is developed based on Resosudarmo and Vidyattama (2006). The regression in equation (2) is the conditional convergence analysis where i denotes the individual district, t is the index of time, yit is GRDP per capita, and F'it, S'it and L'it are the vectors of AFTA-CEPT, TFP, and control variables that include the share of district road that is asphalt, the share of the urban population, and the share of labour per district.

The model needs the individual effect, ηi, to capture all the determinants of growth for various regions in panel data analysis. The uit is the random disturbance not to be correlated when the time or region differs and assuming uit is constant.

$$EcGrowth = yit-yit-1yit-1 \qquad\qquad (1)$$
$$EcGrowth = \gamma 1 + \beta lnyit-1 + F'it\gamma x + S'it\gamma z + L'it\gamma d + \beta 4Zit + \eta i + uit \qquad\qquad (2)$$

The Impact of the AFTA on Indonesia's Districts

The above discussion indicates that decentralisation and liberalization have strengthened regional authority. On the other hand, this devolved authority has also led to competition among districts for capital, investment, and labour (Sukma, 2003). Therefore, it is interesting to examine the integrated impact of decentralisation and trade liberalisation on Indonesia's regions.

Econometrics Analysis

To examine the impact of the AFTA tariff on Indonesian districts, the econometrics analysis is presented in Table 2. In all analysis, the table suggests a convergence regional growth between 2001 and 2010 with a negative sign of initial GRDP per capita. This explains that lagging regions have higher economic growth compared with richer regions. This finding differs with a few similar studies (McCulloch & Sjahrir, 2008; McCulloch & Malesky, 2011; Aritenang, 2011) that show convergence between 2001 and 2005. Furthermore, the significant of year dummy shows that annual regional growth is sensitive to time variant events, such as government policies and financial crisis.

The columns 1-4 show the OLS analysis and suggest that AFTA tariff, everything else being equal, is insignificant on local development. In addition, the high concentration of economic activities, proximated by share of urban population, labour productivity and development expenditure are significant on local development. The significant signs of these variables suggest the presence of economic spillovers and decentralisation effect local economic growth. While the neighbouring districts variable suggest a presence of spatial autocorrelation of economic development.

The panel fixed-effects model (model 5-8) suggested that by isolating districts' characteristics, district convergence rate is lower. Thus, by pooling the districts economic growth rate, the OLS model result has underestimate the presistent local economic disparities among Indonesian districts. However, in this model, the AFTA tariff is significant at a very low rate, indicating that isolating the AFTA tariff effect depends on the characteristics of respective districts economy structure. If we included additional variables, the AFTA tariff became insignificant. It should be noted that as the AFTA tariff elimination is at its maximum, with the AFTA CEPT tariff presently is indifferent with the MFN tariff, the AFTA CEPT tariff impact on local economic growth in Indonesia will be stagnant.

Similarly with the OLS result, decentralisation and spatial autocorrelation of neighbouring districts also have positive significant effect on district development. On the other hand, the population growth variable has negative sign, suggesting population growth burdens economic growth, whilst decentralisation and neighbouring districts plays important role of local development. Similarly, the positive sign of share urban population suggests only districts that is highly urbanised will gain a higher economic growth from the AFTA.

The ASEAN Way: ASEAN Governance in AFTA and its Impact on Indonesia

The above discussion outlines the relative empirical impact of the AFTA. However, a further analysis on non-statistical factors such as the ASEAN way of governance and the underuse of CEPT tariff could also shed a light on the impact of the trade agreement on districts. First, the studies show that a complete implementation of the AFTA has been hindered by political and administrative issues such as limited supranational oversight and product similarity (Bowles and MacLean, 1996; Tongzon, 2005; Soesastro, 1991). The loose system of governance under which ASEAN operates results in a lack of supranational regulation over the implementation of the AFTA, overemphasizes the often lack of collaboration efforts and policies of individual member countries (Nesadurai, 2003). In the absence of supranational policies and regulations, regional and sectoral development ends up being directed by the nation-state alone (Aritenang, 2012). Despite the decentralization, the AFTA implementation sees a continued central government control on state institutions. The Ministry of Trade dominates the decision making on the AFTA trade modalities, side-lining regional governments and business societies. Specifically, the state's sole discretion over the selection of AFTA trade modalities results in a lack of consideration of local governments and private sector interests.

Table 2. OLS and Panel Fixed-Effect Analysis 2001 – 2010

	OLS					Panel Fixed-Effects		
	Model1	Model2	Model3	Model4	Model5	Model6	Model7	Model8
GRDP pc Initial	-0.117**	-0.118**	-0.048	-0.071**	-1.044**	-1.073**	0.189*	-0.210*
	-0.02	(0.02)	(0.03)	(0.03)	0.06	-0.07	(0.08)	(0.11)
AFTA Tariff		0.015	-0.004	0.002		0.0001**	-0.01	-0.005
		(0.01)	(0.01)	(0.01)		-0.01	(0.01)	(0.01)
Labor-productivity			-0.033**	-0.011			-0.03	-0.024
			(0.01)	(0.01)			(0.02)	(0.01)
Dev't Expdt			0.207**	0.073*			0.253**	0.058
			(0.02)	(0.02)			(0.03)	(0.04)
Road Access			-0.160*	-0.092			-0.125	-0.048
			(0.07)	(0.07)			(0.09)	(0.09)
Share pop in urban areas			0.233**	0.218**			0.36	0.370
			(0.05)	(0.05)			(0.23)	(0.23)
Population growth			-5.129**	-5.208**			-5.489**	-5.210**
			(0.12)	(0.12)			(0.14)	(0.14)
Neighbouring Districts Economic Growth			0.312**	0.303**			0.234**	0.229**
			(0.07)	(0.07)			(0.07)	(0.07)
Constant	(1.365)**	(1.354)**	(7.74)**	(101.538)**	12.83**	13.31**	(12.7)**	(126.99)**
	0.36	0.38	0.64	12.46	0.98	1.04	1.15	18.9
N	3866	3483	2676	2676	3866	3483	2676	2676
Group					463	420	405	405
R2	0.06	0.01	0.44	0.45	0.07	0.07	0.49	0.5
Year Fixed-Effect	No	No	No	Yes	No	No	No	Yes

Dependent variable is the district economic growth. Estimation is by Panel Fixed-Effect regression. Standard errors in parentheses. * significant at 5%; ** significant at 1%

Thus, institutional changes induced by the decentralization and the implementation of the AFTA have created a system of competing decision-making processes, introducing conflicts of interest among stakeholders, central and regional governments, and business sectors. For instance, in the transportation sector, the Ministry of Transportation reached a sectoral agreement at the ASEAN level before holding regular meetings with transportation actors, associations, academics, and independent transportation research centres, such as the Indonesian Transportation Forum (Masyarakat Transportasi Indonesia/MTI) (Aritenang, 2012). These meetings were then primarily held for disseminating information about the concluded sectoral agreement.

Second, the underuse of CEPT tariff is related with the limited role of local governments in the distribution of Form D by both supranational and national administrations. The form D is a form that is utilized by business owners or exporters to submit nformation on the traded product such as the percentage of the raw materials it uses (rules of origin/ROO). By submitiing this form, business sector may apply for a lower tariff under the Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for AFTA (Nesadurai, 2003; Chandra, 2008). The form is one of the main measures of the AFTA's utility; it successfully promotes only those products that use at least 80 per cent of raw materials from ASEAN countries. Despite its importance, Form D has not been distributed equally across the regions in Indonesia. A recent research show that the regions are unfamiliar with the form due to limited promotion and information to the local governments and private sector (Aritenang, 2012), and ambiguous procedures and transparency on filling the form (Inayati, 2010). This issue has hindered the form's use and thereby undermining its benefits.

Their unawareness can be explained by two factors. Firstly, there is a lack of promotion and regulation to enforce the use of Form D. Secondly, there is no incentive for private sectors to apply for Form D because the difference between the AFTA CEPT and MFN tariff rates are insignificant. Therefore, the form has not been widely used in Indonesia.

Conclusion

This paper analyses factors that determine the impact of AFTA on Indonesian distritcs development. The paper has two main conclusions; first, the AFTA CEPT elimination is insignificant on district's economic growth, despite the evidence of economic convergence. The paper shows that this regional economic convergence is due to the presence of decentralisation and spatial spillover. Second, the lack of inclusivity of stakeholders in the governance of AFTA at the supranational and national level might explain the above finding such as (i) The low utilization of Form D has limits the impact of AFTA CEPT to accelerate intra-trade among ASEAN countries, and (ii) the top-down policies, by excluding local governments and private sector, over trade modalities by the Ministry of Trade has neglect the appropriate product list and trade

The abovementioned findings related with inclusion of stakeholders have three policy implications. Firstly, the limited success of the AFTA on district-level GRDP growth in the decentralization period suggests that regional autonomy has to some extent hindered equitable regional development in Indonesia. Second, the dominant role of the Ministry of Trade with regard to trade modality decisions undermines benefits for district development. Instead, and in line with regional autonomy, districts and the business community should be involved in trade decisions in order to ensure optimal gains from the AFTA. Third, as districts' lack of control over supranational trade agreement, districts should accelerate their international trade penetration and capitalize on their freedom to initiate new trade and development cooperation with other countries. For instance, the paper shows that only districts that are more urbanised and known as manufacturing clusters have higher economic growth.

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