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Trends in Southeast Asia

ROWING AGAINST THE TIDE?
BATAM'S ECONOMIC FORTUNES
IN TODAY'S INDONESIA

FRANCIS E. HUTCHINSON

ISEAS YUSOF ISHAK
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Trends in Southeast Asia

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FOREWORD

The economic, political, strategic and cultural dynamism in Southeast Asia has gained added relevance in recent years with the spectacular rise of giant economies in East and South Asia. This has drawn greater attention to the region and to the enhanced role it now plays in international relations and global economics.

The sustained effort made by Southeast Asian nations since 1967 towards a peaceful and gradual integration of their economies has had indubitable success, and perhaps as a consequence of this, most of these countries are undergoing deep political and social changes domestically and are constructing innovative solutions to meet new international challenges. Big Power tensions continue to be played out in the neighbourhood despite the tradition of neutrality exercised by the Association of Southeast Asian Nations (ASEAN).

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Rowing Against the Tide? Batam's Economic Fortunes in Today's Indonesia

By Francis E. Hutchinson

EXECUTIVE SUMMARY

- Despite its good infrastructure and proximity to Singapore, Batam's economic performance has taken a turn for the worse, with declining levels of foreign direct investment (FDI) and exports. Well-known firms in the electronics sector have closed shop, the shipping industry is in the doldrums, and unemployment rates have begun to climb.
- The environment for business is not as conducive as it used to be, with bureaucratic overlaps, persistent red tape, and shortages of land for investors. And, rather than seeking to attract large-scale investments in manufacturing or services, government campaigns have focussed on traditional economic activities such as fishing and farming.
- There are three reasons for this state of affairs. First, Indonesia's decentralization reforms have made doing business in Batam much more complicated than it used to be. Rather than dealing with one all-powerful central government agency, investors need to deal with three levels of government — each with veto power.
- Second, Batam's economic transformation over the past quarter-century has attracted large numbers of migrants from other parts of the country. This has engendered a cultural sub-nationalist movement, which has sought to protect local interests and identities — to the detriment of the economy.
- Third, structural changes in Indonesia's economy and changing corporate strategies have meant that investment into the country seeks to tap its domestic market — as opposed to producing for

export. In this context, Batam is not a viable destination due to its distance from large population centres, bad connectivity, high labour costs, and unattractive tax framework.

- While recent measures have sought to reduce red tape, fight corruption, and improve the island's infrastructure, it is possible that Batam needs to re-orient its business model away from producing for export and towards enabling firms on the island to also cater to Indonesia's burgeoning domestic consumer base.

Rowing Against the Tide? Batam's Economic Fortunes in Today's Indonesia

By Francis E. Hutchinson¹

INTRODUCTION

Batam has an unbeatable business proposition. Situated a mere 20 kilometres from Singapore, linked by logistics networks, and possessing vastly cheaper land and labour, the Indonesian island is ideally placed to absorb investment from its wealthier neighbour. In theory, it should be teeming with investors and populated by factories and workers.

Indeed, this is just what happened during the 1990s and early 2000s. The liberalization of investment regulations, coupled with Batam's well-developed infrastructure and proximity to Singapore, made the island an attractive site for manufacturing operations seeking to escape the city-state's rising costs. During the 1990s, Batam's industrial base grew in size and sophistication, rapidly becoming one of the country's centres of electrical and electronics production. In the mid-2000s, the shipbuilding industry also began to develop on the island. Coupled with the older, more established tourism sector, Batam became a crucial source of foreign exchange for Indonesia. Through these three "motors", hundreds of thousands of formal sector jobs were created, and the island became one of the country's richest — with its economy often growing at more than 10 per cent p.a.

¹ Francis E. Hutchinson is a Senior Fellow and Coordinator of the Regional Economic Studies Programme at the ISEAS – Yusof Ishak Institute, Singapore. He would like to thank Siwage Dharma Negara and Mulya Amri for their comments and suggestions.

The Batam Industrial Development Authority (BIDA) was at the helm of this transformation. Established by presidential decree, this agency had high-quality staff, central government funding, and direct access to decision-makers in Jakarta. It also had the unquestioned backing of B.J. Habibie — Indonesia’s long-serving Minister for Research and Technology — who saw Batam as the gateway to securing capital and technology. BIDA’s commitment to providing investors with advice and expedited approvals, as well as its custodianship of the island’s infrastructure, have been a key part of Batam’s success — even after Indonesia’s far-reaching political and administrative reforms.

The island’s economy continues to grow steadily, as do the number of tourists coming to visit its resorts and leisure facilities. However, over the last few years, the success of Batam’s export-focussed industrialization model has come under question. Indeed, exports have been decreasing since 2013, and unemployment has spiked over the last two years and is now considerably above the national average. The once-burgeoning ranks of semiconductor, hard disk drive, and component manufacturers have atrophied over the past half-decade, with anchor firms such as Panasonic, Sanyo and NIDEC closing their facilities.

Subsequently, in 2013, the shipping sector, once heralded as Batam’s sunrise industry, also began to contract. Today, an estimated 30,000 workers are employed in the sector — down from its peak of 250,000.² At present, the majority of the island’s shipyards sit idle, or have turned to lower value repair jobs to cover costs.

In addition, Batam’s much vaunted investment climate has shown signs of dysfunction. Large tracts of land sit idle, and yet newcomers are unable to secure sites to establish operations. The central and provincial government have disagreed about the leadership of BIDA and major projects have been bogged down by turf tussles. In addition, despite Indonesia’s growing ranks of urbanizing middle-income families, firms

² Siwage Dharma Negara, “Can the Decline of Batam’s Ship-building Industry be Reversed?”, *ISEAS Perspective* 2017/10, ISEAS – Yusof Ishak Institute, Singapore.

operating on the island complain about the cost, logistical difficulties, and red tape involved in selling goods on the domestic market.

This Trends will examine the reasons for this unexpected turn of events. Following this introduction, the second section will look at the establishment of BIDA and the early development of Batam's export-oriented industries. The subsequent section will examine the recent down-turn in the island's economic and investment performance. The fourth section will analyse some of the underlying causes for this situation. The fifth section will set out some recent initiatives that have been implemented in response to the island's declining economic fortunes, and the final section will look at options for the future.³

BATAM AND BIDA

In 1970, Batam was — to Jakarta-based policymakers — a remote and sparsely populated island. Seeking to leverage its proximity to Singapore, earn foreign exchange, and foster the development of the domestic manufacturing sector, the Indonesian government slated it for oil refining.⁴ To this end, BIDA was established in 1971 by the central government and tasked with economic planning, building infrastructure, and handling investment applications for the island. Centrally funded and answerable to a board of presidential advisers, the Authority was headquartered in Jakarta for easier access to decision-makers.⁵

³ Parts of sections 2 and 4 of this *Trends* draw on Francis E. Hutchinson, *Mirror Images in Different Frames?* (Singapore: Institute of Southeast Asian Studies, 2015).

⁴ Pertamina, Nishho-Iwai, and Pacific Bechtel. *Masterplan Batam: Industrial Development* (Jakarta: Pertamina, 1972).

⁵ In 1971, the Batam Industrial Estate Authority was established. In 1973, its name was changed to Batam Industrial Development Authority, and in 2009, it was renamed as the Batam Indonesia Free Zone Authority. Over its history, the organization has undergone a number of internal restructuring exercises, with 1973, 1976, 1980, and 2009 as key dates. Notwithstanding the name changes and internal restructuring, the organization's vision and mission have consistently centred on the island's industrial development, with official documents depicting

In 1978, B.J. Habibie, Indonesia's long-serving Minister for Research and Technology, became the agency's Chairman. Bringing his technical background in engineering to bear, Habibie wanted to use the island as a means of bypassing the regulatory and infrastructural issues plaguing Indonesia to attract investment in high technology industries. To this end, the island received extensive investments in infrastructure such as air and seaports, highways, power generation, and telecommunications facilities.⁶ However, despite its location and well-developed infrastructure, Batam's attractiveness was severely hampered by restrictive regulations on investment, equity, and land ownership. In 1988, fifteen years after the agency's founding, the island housed a mere thirteen foreign firms.⁷

Spurred on by this middling performance and outshone by the Malaysian state of Johor, which had begun to attract growing numbers of electronics firms, the Indonesian government liberalized the island's regulatory framework in 1989. Notably, foreign corporations were allowed to retain majority ownership of their facilities as well as operate industrial parks. Of key importance was the establishment of BatamIndo Industrial Park, a joint venture between two Singapore government-linked corporations and three large Indonesian conglomerates. This facility offered multi-national corporations high quality infrastructure, notably reliable provision of utilities, as well as a helping hand in procuring licences and permits.

these developments as evolutionary rather than organizational ruptures. For consistency, the organization will be referred to as Batam Industrial Development Authority (BIDA) throughout. For more details on the organization's changes over time, consult: S.L.D. Smith, "Developing Batam: Indonesian Political Economy under the New Order", PhD dissertation, Research School of Pacific and Asian Studies, Australian National University, 1996; Erliza Oktari, "Administrative Reform of Batam Indonesian Free Zone Authority (BIFZA) in Implementing Free Trade Zone (FTZ) in Batam City Indonesia", *Public Policy and Administration Research* 4, no. 1 (2014); and BIFZA, *Development Progress of Batam* (Batam: Batam Indonesia Free Zone Authority, 2014).

⁶ BIDA, *The Batam Development Program* (Jakarta: Batam Industrial Development Authority, 1980).

⁷ Smith, "Developing Batam".

The results were immediate. Over the 1990–96 period, more than US\$1.6 billion of foreign direct investment (FDI) flowed in.⁸ Batam’s economy took off, growing at rates in the high teens during the same period. Of particular note were electrical and electronics (E&E) firms, whose ranks expanded from four in 1990 to some sixty-two firms by 1997. These were largely Japanese, European, and U.S.-owned firms expanding from their facilities in Singapore.⁹ Batam’s population also grew, from some 80,000 in 1990 to more than 250,000 in 1997.¹⁰

While the Asian Financial Crisis and ensuing fall-out deeply affected Indonesia’s political context and economy, Batam was somewhat buffered. Indeed, the island grew at 3 per cent in 1998, while Indonesia’s economy as a whole contracted by 13 per cent. And, from 1999 until 2004, Batam continued to grow positively and above the national average. In terms of FDI, the island and the Province of Riau, of which it was a part, continued to receive significant levels of new capital. While trailing Jakarta by a substantial margin, the province was on par with other industrial areas in the country such as East Java.¹¹

Over the next years, Batam benefited from a number of legal provisions that were, in principle, to bolster its business environment. First, in 2002, Batam and the neighbouring island of Bintan were included in the U.S.-

⁸ Leo van Grunsven, “The sustainability of urban development in the SIJORI Growth Triangle: a social perspective”, *Third World Planning Review* 20, no. 2 (1998).

⁹ Leo van Grunsven and F.E. Hutchinson, “The evolution of the electronics industry on Batam Island (Riau Islands Province, Indonesia): An evolutionary trajectory contributing to regional resilience?”, *GeoJournal* 82, no. 3 (2015): 8.

¹⁰ Wong P.K. and Ng K.K., “Batam, Bintan, and Karimun: Past History and Current Development Towards Being A SEZ”, National University of Singapore, Asia Competitiveness Institute, 2009.

¹¹ BPS, *Produk Domestik Regional Bruto Kabupaten/Kota di Indonesia* (Jakarta: Badan Pusat Statistik, various years); BPS, *Produk Domestik Regional Bruto Propinsi-Propinsi di Indonesia Menurut Lapangan Usaha* (Jakarta: Badan Pusat Statistik, various years); BPS, *Indikator Ekonomi* (Jakarta: Badan Pusat Statistik, various years).

Singapore Free Trade Agreement, meaning that firms operating on these islands but routing their goods through Singapore had privileged access to the U.S. market.¹² Second, in 2004, Batam, Bintan, Karimun, and three other island groups opted to secede from Riau Province to establish a new political entity named the Riau Islands Province. In theory, this was to allow these islands to focus on their outward-looking and industrially based economic model. Finally, Batam's business environment was furthered by the decision of then President Yudhoyono to declare the island, as well as parts of neighbouring Bintan and Karimun, as Free Trade Zones in 2009. This status granted exemptions on import and export duties as well as expedited customs processes to firms operating on the islands. This status was new for Bintan and Karimun, and clarified the situation for Batam-based investors who had previously had to deal with a number of frequently changing tax incentives.¹³

These years proved to be very beneficial for the Riau Islands in general and Batam in particular. From 2004 to 2009, both Batam and the economy of the Riau Islands grew between 7 and 8 per cent p.a., above the national rate of 5–6 per cent p.a.¹⁴ Notwithstanding a downturn in the electronics sector in 2004, the ranks of electrical and electronics (E&E) firms in Batam subsequently grew, from some sixty firms to around eighty establishments by 2009. In addition, the island's industrial base diversified with the consolidation of the shipbuilding industry. This was enabled by policy changes in Singapore and Indonesia. For its part, Singapore sought to offshore the sector's more labour-intensive components, and Indonesian cabotage regulations were amended in 2008 — requiring all ships in that country's waters to be locally owned. Consequently, the number of firms operating on the island increased

¹² “New Riau Plan will Benefit S'pore Investors”, *Business Times*, 15 July 2002, p. 1.

¹³ O. Juoro, Tan K.G. and Tan K.Y., “Joint Expert Study on Competitiveness of Free Trade Zone of Batam, Bintan, Karimun”, Komite Ekonomi Nasional, 2013.

¹⁴ BPS, *Produk Domestik Regional Bruto Kabupaten/Kota di Indonesia*; BPS, *Produk Domestik Regional Bruto Propinsi-Propinsi di Indonesia Menurut Lapangan Usaha*.

dramatically, and the number of workers in the sector grew from 100,000 in 2005 to 200,000 in 2009.¹⁵

In 2010, Batam and the wider Riau Islands were well-developed regions by Indonesian standards. The consistent flow of investment had fostered a large-scale shift away from fishing and agriculture towards manufacturing and other industrial activities, with the province deriving 58 per cent of GDP from this sector and another 36 per cent from services. In per capita terms, the Riau Islands were 60 per cent wealthier and Batam residents were twice as well-off as the national average.¹⁶ Batam had consolidated its status as the economic heart of the new province, generating 60 per cent of its GDP.¹⁷

Having charted Batam's economic development and the role of the Batam Industrial Development Authority in stewarding the island's resources and investment frameworks, we will now look at its current economic performance.

BATAM'S CURRENT ECONOMIC PERFORMANCE

While no longer growing at the heady rates of the early 1990s, the island's economic performance as well as that of the Riau Islands Province overall has continued to be positive. From 2010 to 2015, both grew at 7–8 per cent p.a., above the national average of 5–6 per cent, and slightly higher than during the previous five-year period (Figure 1).

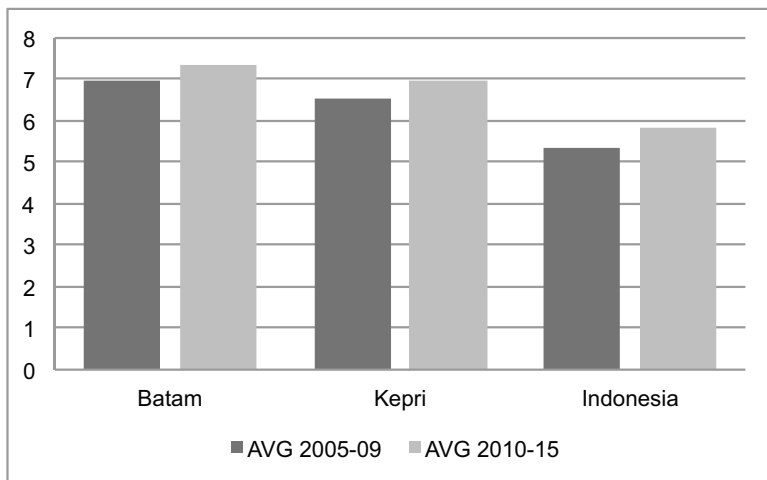
One of the key drivers of this growth has been the tourism sector. In 2008, the Riau Islands received some 1.5 million visitors, with this number increasing to 2 million in 2015. Of these, three quarters went

¹⁵ Negara, "Can the Decline of Batam's Ship-building Industry be Reversed?"

¹⁶ BPS, *Produk Domestik Regional Bruto Kabupaten/Kota di Indonesia* (Jakarta: Badan Pusat Statistik, 2011); BPS, *Produk Domestik Regional Bruto Propinsi-Propinsi di Indonesia Menurut Lapangan Usaha* (Jakarta: Badan Pusat Statistik, 2011).

¹⁷ BPS, *Provinsi Kepulauan Dalam Angka 2016* (Tanjung Pinang: Badan Pusat Statistik – Provinsi Kepulauan Riau, 2016).

Figure 1: Economic Growth, 2005–15



*Source: BPS, *Produk Domestik Regional Bruto Kabupaten/Kota di Indonesia* (Jakarta: Badan Pusat Statistik, various years); BPS, *Produk Domestik Regional Bruto Propinsi-Propinsi di Indonesia Menurut Lapangan Usaha* (Jakarta: Badan Pusat Statistik, various years).*

to Batam, supporting a growing range of hotels, leisure activities, and associated downstream services.¹⁸

However, upon deeper analysis, there are indications that Batam and the Riau Islands more generally do not seem to be faring so well. Exports from the province have decreased notably, falling from US\$16 billion in 2013 to US\$12 billion in 2015.¹⁹ Furthermore, the quantum of FDI going into the province has also decreased. In the 2004–09 period, the Riau Islands attracted an average of US\$1.8 billion in investment, rivalling West Java and outpacing other provinces such as Central and East Java.

¹⁸ BPS, *Provinsi Kepulauan Dalam Angka 2016* (Tanjung Pinang: Badan Pusat Statistik – Provinsi Kepulauan Riau, 2016), p. 186.

¹⁹ *Ibid.*, p. 163.

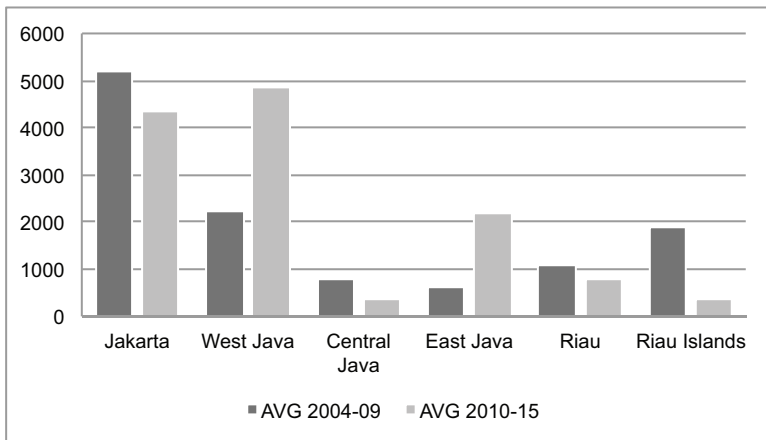
In contrast, over the 2010–15 period, the Riau Islands absorbed an annual average of US\$380 million, on a par with Central Java and trailing all the other comparator provinces (Figure 2).

This situation is compounded by the lack of significant domestic investment. During the 2004–09 and 2010–15 periods, the Riau Islands received an average US\$920 million p.a. and US\$440 million p.a. in domestic direct investment (DDI), respectively. While not inconsequential, these levels trail the quantum of investment going to larger provinces such as West and East Java as well as Jakarta (Figure 3). Containing a small population and remote from large population centres in the domestic economy, these statistics reveal the province’s reliance on foreign capital for investment and, ultimately, economic survival.

Beyond lower absolute and relative levels of investment coming into the Riau Islands, there is evidence that its manufacturing sector has come under substantial stress — particularly its electrical and electronics and shipbuilding sectors.

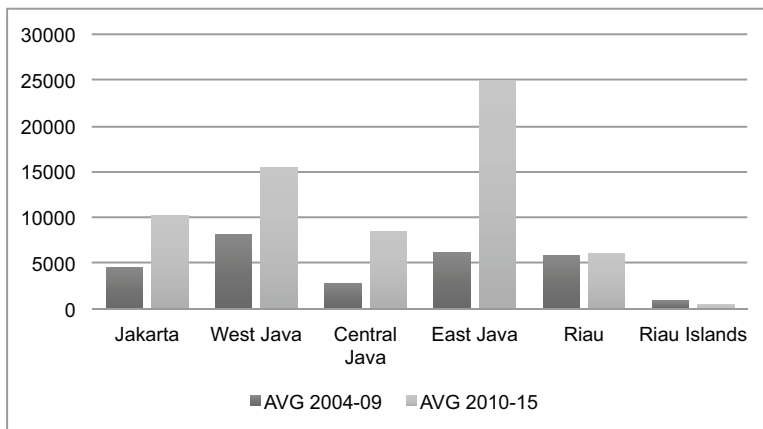
Turning first to the E&E sector, the industry has been on a downward trend since 2010. Following a large-scale industrial relations incident

Figure 2: FDI by Province



Source: BPS, *Indikator Ekonomi*, various years.

Figure 3: DDI by Province



Source: BPS, *Indikator Ekonomi*, various years

in the shipbuilding sector, where some 5,000 local workers attacked a group of foreign managers and which culminated in substantial property damage, a significant number of multinational corporations (MNCs) left the island. With regard to the E&E sector, this amounted to some thirty firms closing their facilities — shrinking the ranks of E&E operations from eighty to fifty in one year.²⁰

Recent data indicate that this trend has continued. Table 1 sets out the details of the entries and exits of E&E firms over the past five years. Closures have continued among well-established MNCs employing many hundreds of workers. This has not been offset by substantial new investments, which had in fact been limited to one new operation set up in late 2016. The firm, BlackMagic, an Australian consumer electronics producer, invested US\$3.8 million and will employ an estimated 150 people.

²⁰ Van Grunsven and Hutchinson. “The evolution of the electronics industry on Batam Island”, p. 482.

Table 1: Entries and Exits of Electrical and Electronics Firms in Batam

<i>Name</i>	<i>Branch</i>	<i>Entry/Exit</i>	<i>Workers</i>
NIDEC Seimitsu Batam/PT Sanyo Precision	Electrical Devices	1993; 2013	500
PT Shin-Etsu	Data Storage	1990; 2013	600
PT Sun Creation	Electrical Devices	2000; 2013	1,000
PT Sanyo Energy	Batteries	1992; 2013	684
PT Panasonic Shikoku	Data Storage	2009; 2011/2012	1,200
Blackmagic	Consumer Electronics	2016	150

Source: Own data and; F. Pangestu, “Increasing wages driving investors out of Batam Island”, *Jakarta Post*, 15 July 2014; F. Pangestu, “Sanyo subsidiary closes down Batam unit amid soaring labour costs”, *Jakarta Post*, 1 November 2016; F. Pangestu, “Closures lead to rise in Batam jobless rate”, *Jakarta Post*, 26 August 2016.

This trend has been compounded by a downturn in the shipbuilding sector. From an estimated 250,000 workers at its peak in 2012, the sector now employs a mere 30,000 people. There are a myriad of causes for this, but among them are global excess capacity, a slump in commodity prices, and the inability of shipbuilders operating on the island to sell on the domestic market — due to Batam’s free trade zone (FTZ) status.²¹

These developments have had an impact on the unemployment rate in the Riau Islands Province, which has swollen from 6 per cent in 2014 to 9 per cent in 2015 and 2016. This is considerably higher than the national average, which has remained at 6 per cent over the last five years.²²

Thus, despite consistent economic growth in Batam and the wider Riau Islands, there is evidence that the traditional model of manufacture for export has come under question. While the tourism sector continues to expand, the level of FDI coming to the island has declined of late. The number of firms in the E&E and shipbuilding sectors and the workers they employ have atrophied. Consequently, the ranks of the unemployed have grown considerably.

THE REASONS

This section will argue that there are three underlying causes for declining levels of investment and a contraction in the manufacturing sector. They are: local-level dysfunctions in Batam’s governance context arising from Indonesia’s decentralization reforms; far-reaching political changes resulting from the rapid economic growth witnessed in the Riau Islands; and the changing composition of FDI into Indonesia.

Decentralization and Its Effects

Due to its special status and high-profile political backing, doing business in Batam during the 1990s was very straight-forward. In addition to relaxing restrictive investment regulations in 1989, the central

²¹ Negara, “Can the Decline of Batam’s Ship-building Industry be Reversed?”.

²² BPS, *Provinsi Kepulauan Dalam Angka 2016*.

government worked hard to increase the island's appeal to international investors. Accords signed with the Singapore government meant that the central government committed to simplifying tax regulations, as well as prioritizing the provision of water, transportation and other infrastructure. The establishment of a range of private sector-run industrial parks further improved the local business environment in Batam, allowing the island to offer an unmatched combination of high quality infrastructure and central government backing.²³

Under this framework, investors only needed to approach BIDA in order to set up operations in Batam. The organization had uncontested authority over all investment-related processes on the island, such as land zoning, environmental impact assessments, and building permits. This reduced the number of choke points and meant that businesses were able to set up operations quickly and with a minimum of red tape.²⁴

Where necessary, BIDA could draw on the provincial government for support and resources. While the Authority's existence could have been interpreted as an intrusion into provincial government affairs, reform measures passed in the mid-1970s established provincial governments as the central government's representative in the regions. This, along with former President Suharto's personalized appointment of senior military officials as governors of Riau province, ensured a high degree of compliance and support.²⁵

However, while good at speeding up approvals for businesses, this centralized process was not without its problems. Due to the high level of involvement of Indonesia's national leadership in Batam's development,

²³ Wong and Ng, "Batam, Bintan, and Karimun", p. 4.

²⁴ Interview with a senior manager from an Indonesian conglomerate, Batam, 23 July 2012.

²⁵ Malley M. "New rules, old structures and the limits of democratic centralization". In *Local Power and Politics in Indonesia: Decentralisation and Democratisation*, edited by E. Aspinall and G. Fealy (Singapore: Institute of Southeast Asian Studies, 2003), p. 107. While there were regional elections, political controls meant that central government preferences over the eventual choice of provincial governors were virtually assured.

concerns arose over the profusion of politically connected business concerns on the island, including firms owned by: Suharto's children; B.J. Habibie's family; and the Salim Group — arguably Suharto's most important corporate backer.²⁶

This was compounded by issues arising from the development process itself. Complaints arose regarding land acquisition and compensation processes for vast industrial, tourism, and agri-business projects. Furthermore, the rapid expansion of industrial areas and inadequate waste processing measures led to issues of pollution and declining yields for fishermen. In addition, many of the island's residents argued that the jobs created by these projects did not benefit locals, going instead to migrants arriving from other parts of the country.²⁷

Indonesia introduced far-reaching decentralization reforms in 2001. This entailed a wide range of governmental revenue sources and responsibilities being devolved from the centre to sub-national governments. In addition, the country's new fiscal structure encouraged the profusion of new provincial and local governments, a phenomenon known as “blossoming” or *pemekaran*. This led to an increase in the number of political units in the country from some 27 provinces and 250 local governments in 2001 to 34 provinces and 514 local governments in 2016.²⁸

²⁶ V. Wee, “The Significance of Riau in SIJORI”, in *The SIJORI Cross-Border Region: Transnational Politics, Economics, and Culture*, edited by F.E. Hutchinson and T. Chong (Singapore: ISEAS – Yusof Ishak Institute, 2016), p. 257; E. Kimura, *Political Change and Territoriality in Indonesia: Provincial Proliferation* (London: Routledge, 2013); N. Long, *Being Malay in Indonesia: Histories, Hopes, and Citizenship in the Riau Archipelago* (Singapore: NUS Press, 2013); A. Schwarz, *A Nation in Waiting: Indonesia's Search for Stability* (St Leonards, NSW: Allen & Unwin, 1999).

²⁷ Wee, “The Significance of Riau in SIJORI”, p. 257.

²⁸ BPS, *Indikator Utama Kepulauan Riau Semester 1-2016*, Tanjungpinang: Badan Pusat Statistik – Provinsi Kepulauan Riau, 2016, pp. 5–6.

These winds of change also reached Batam which, along with other islands in the Riau Archipelago such as Bintan and Karimun, fought to secede from Riau Province. Elites from these Islands argued that underrepresentation of locals in the provincial civil service slowed response times from policymakers in the provincial capital, and their unique maritime culture warranted the creation of a new political entity.²⁹

This push also had an underlying economic logic that the Riau Islands contributed more to Riau Province's coffers than they received, and their economies were more closely linked to Singapore's. In contrast, the bulk of Riau Province's economy was based on natural resources, namely oil and gas, as well as palm oil. Indeed, leaders from Batam and Bintan had clashed with decision-makers in the Riau provincial capital, Pekanbaru, over their planned inclusion into the Singapore-U.S. Free Trade Agreement, as well as the potential sale of water to Singapore. Riau elites feared that the mainland aspect of the province would be left behind economically.³⁰

Following several years of negotiations, the Province of the Riau Islands was established in 2004. Over the next few years, more resources and responsibilities were transferred to the newly created government, which founded a new capital and civil service based in Tanjung Pinang in Bintan. In response to demands for greater local input in decision-making, BIDA's head office was moved from Jakarta to Batam that same year, and the agency's assets were later transferred from the central to the provincial government — with the latter also gaining the right to name its head.³¹

²⁹ Interviews with Riau Island Province elected representatives, Graha Kepri, Batam, 10 June 2013.

³⁰ "New Riau Plan will Benefit S'pore Investors", *Business Times*, 15 July 2002, p. 1.

³¹ Under this arrangement, while the organization's assets were transferred to the province, and the province was able to appoint its head, the agency still reported to the central government which continued to cover staff costs. Interview with BP Batam managers, Batam, 27 March 2015.

The new province was initially led by a known entity, as the governor tasked with setting up the new government and overseeing the first elections was Ismeth Abdullah, none other than the former Chairman of BIDA. His economic agenda focussed squarely on promoting growth through prioritizing the electronics sector and attracting investment from Singapore and Japan.³²

However, the Riau Provincial Government has experienced teething problems. First, a completely new provincial bureaucracy has had to be built from the ground up, with staff sourced from local governments, the Riau provincial administration, and the small Riau Islands diaspora working in Jakarta.³³ Consequently, surveys of firms operating in the Riau Islands consistently report issues arising from low levels of capacity in the provincial government.³⁴

Second, the decentralization process has complicated the governance environment in the Riau Islands in a number of ways. At the national level, the decentralization process resulted in a net gain for local governments, who received a wide range of responsibilities delegated from the centre, particularly concerning permits for business, environmental assessments, and building licenses. However, BIDA's unique status and organizational remit over infrastructure, investment liaison, and economic planning means that many of the revenue sources and responsibilities that would normally accrue to Batam's municipal government have been retained by the Authority.

Consequently, there are areas where responsibilities overlap, giving rise to investor complaints.³⁵ Of particular concern has been the awarding of land titles as well as land zoning. Investors have purchased land from

³² Interview with Ismeth Abdullah, Sekupang, 1 March 2014.

³³ Ibid.

³⁴ Tan K.G., Nurina Merdikawati, M. Amri and Tan K.Y., *Agricultural Productivity, Decentralisation, and Competitiveness Analysis for Provinces and Regions of Indonesia* (Singapore: World Scientific, 2016), p. 134.

³⁵ N. Choi, *Local Politics in Indonesia: Pathways to Power* (Oxford: Routledge, 2011), p. 64; "Dualist administrative authority hinders the future of economic growth in Batam", *Riau Islands Bulletin*, January 2016.

BIDA only to be informed that, according to the municipal government, it is actually part of a forestry reserve. These disputes have affected up to 22,000 land titles. Despite multiple attempts to centralize licences in one location, investors to the island still need to obtain two sets of permits — one each from BIDA and the municipal government.³⁶ Efforts to integrate and streamline these two separate processes have not succeeded. The low degree of inter-governmental cooperation has also emerged as an area of concern to businesspeople.³⁷

This disconnect between levels of government was made manifest over negotiations regarding the minimum wage. The 2001 decentralization measures devolved the establishment of the minimum wage to the provinces, with input from local governments. Negotiations were held annually between the provincial government, industry, and labour. However, periodic demonstrations in the run-up to these negotiations have hurt investor sentiment, with frequent complaints raised by KADIN, the national business association, and Japanese investors.³⁸ The uncertain power relationship between the provincial and Batam municipal governments has led to internal disagreements about how to approach negotiations and what salary level to offer.³⁹

Relations between the provincial and local governments have become even more complex, due to the profusion of local governments in the Riau Islands province itself. During much of the New Order, the Riau Islands had two local governments. One government encompassed Batam, and the other administered local services for all the other island groups. Following the 2001 decentralization reforms, an additional five

³⁶ F. Pangestu, “Govt to maintain authority over land allocation in Batam”, *Jakarta Post*, 15 January 2015; “BP Batam committed to only giving ready land to investors”, *Jakarta Post*, 10 October, 2016; Interview with a Batam-based Singaporean industry expert, Batam, 8 November 2016.

³⁷ Tan et al., *Agricultural Productivity, Decentralisation, and Competitiveness Analysis*, p. 134; interview with a general manager of an industrial park, Batam, 12 February 2014.

³⁸ “Unpredictable Wage Increases Annoy Investors in Batam”, *Riau Bulletin*, 27 September 2013, pp. 5–6.

³⁹ Interview with Political Observer B, Batam, 22 May 2013.

local governments have been established, for a total of seven. Many of these have very low levels of capacity and have, up until recently, operated on different electoral cycles.⁴⁰ Following measures passed in 2004, the responsibilities of provincial governments have expanded and now involve coordinating work across local governments as well as inspecting and improving their budgets.⁴¹

Furthermore, the financial incentives inherent in Indonesia's decentralization process have encouraged one of the Riau Islands' districts — Natuna — to attempt to secede. Natuna is one of Indonesia's main oil and gas producing regions and a key contributor to the country's exports. However, under the country's current fiscal arrangements, should the district obtain provincial status, it would retain a larger share of revenue from these resources than it does at present. Notwithstanding the district's low population base, some 75,000 people, this secession drive has consumed policy-makers' attention over the last two years.⁴²

The Price of Success

Due to their outward-oriented industrialization model, Batam and the Riau Islands Province have undeniably enjoyed higher rates of economic growth than they otherwise would have. However, these growth rates have also contributed to far-reaching demographic, environmental and, ultimately, political changes.

First, due to the creation of a large number of modern, formal sector jobs, the province has experienced the sustained migration of a large number of people from elsewhere in the country. With a population of some 500,000 in 1990, the Riau Islands has grown to 1.9 million in 2015 — nearly a fourfold increase in twenty-five years. This change has been even more marked for Batam, whose population has swollen from some

⁴⁰ Interview with Ismeth Abdullah, Sekupang, 1 March 2014 and Political Observer B, Batam, 22 May 2013.

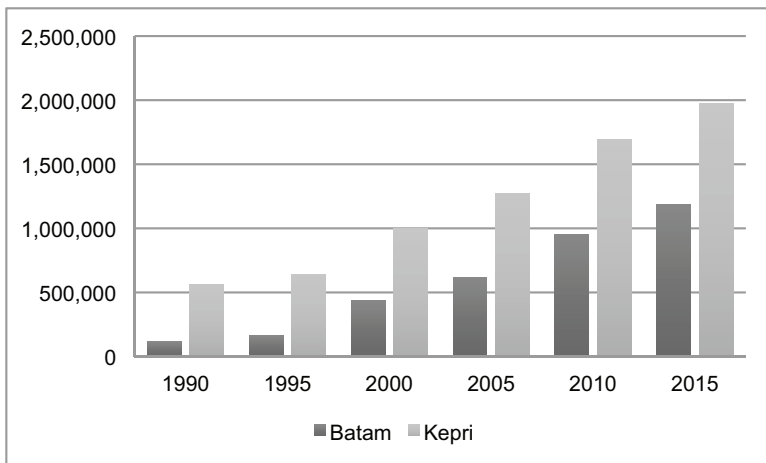
⁴¹ Interview with Ismeth Abdullah, Sekupang, 1 March 2014.

⁴² Deasy Simandjuntak, "Developing Poor Little Rich Natuna's Economy", *ISEAS Perspective* 2017/43, ISEAS – Yusof Ishak Institute, Singapore.

100,000 people in 1990 to 1.2 million in 2015, increasing by a factor of twelve over the same period (Figure 4).

This rapid demographic expansion has led to significant changes in the province's ethnographic composition (Figure 5). While the Riau Islands have long been a multi-cultural trading hub, the area has also been an important site of Malay culture. Most notably, the Islands have long been associated with the Johor-Riau Empire — the successor polity of the Malacca Sultanate — housing its capital in the eighteenth and nineteenth centuries. It was also the home of well-known historical and literary figures such as: Raja Haji Fisabilillah, a Viceroy of the Johor-Riau Empire who conducted successful military campaigns against the Dutch; and Raja Ali Haji, a prominent historian and linguist who standardized the Malay language.⁴³ This local cultural specificity was also seen during

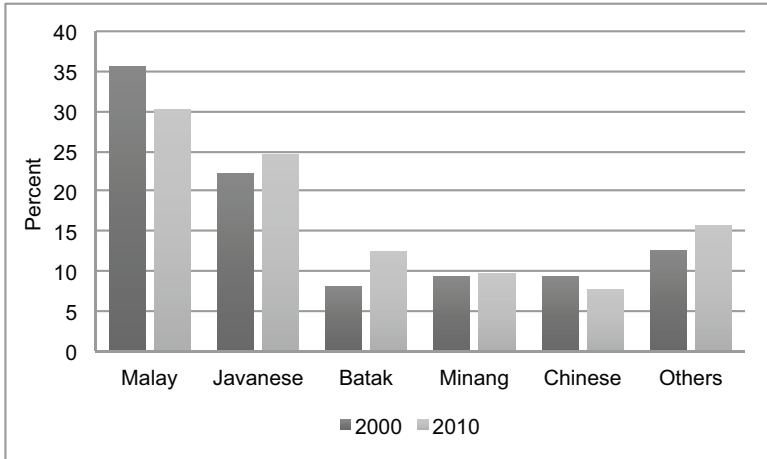
Figure 4: Population in Batam and Kepri, 1990–2015



Source: BPS, Indikator Utama, various years.

⁴³ T.P. Barnard, “Local Heroes and National Consciousness: The Politics of Historiography in Riau”, *Bijdragen tot de Taal en Volkunde* 153, no. 4 (1997), p. 510; J. van der Putten, “On Sex, Drugs and Good Manners: Raja Ali Haji as Lexicographer”, *Journal of Southeast Asian Studies* 33, no. 2 (2002): 416.

Figure 5: Ethnic Composition in Kepri



Source: A. Ananta, “Changing Ethnic Composition and Potential Violent Conflict in Riau Archipelago, Indonesia: An Early Warning Signal”, *Population Review* 45, no. 1 (2006); N. Long, *Being Malay in Indonesia: Histories, Hopes, and Citizenship in the Riau Archipelago* (Singapore: NUS Press, 2013), p. 43.

the Indonesian war for independence, when a movement of elites from the Riau Islands allied with the Dutch against the nationalists in a bid to restore a Malay sultanate.⁴⁴

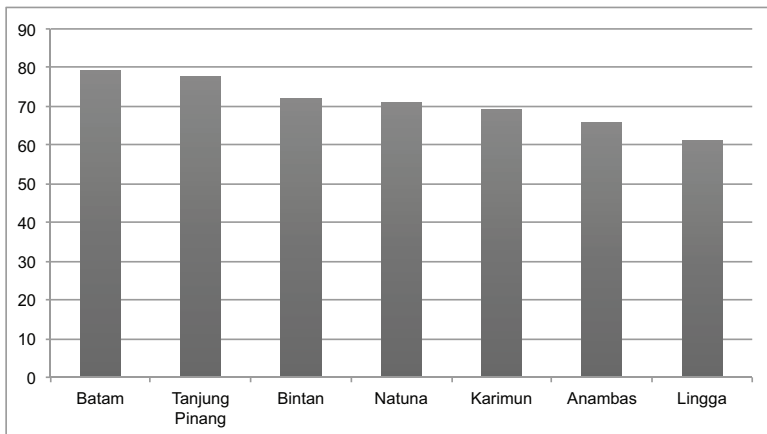
However, sustained levels of migration to the islands over the past three decades have changed the province’s ethnic composition. Consequently, the Malay community has shrunk in proportionate terms and — while it is still the largest ethnic community in the Riau Islands — is no longer as predominant as it once was. Large numbers of major national ethnic groups such as the Javanese, Bataks, and Minangkabaus now reside in the islands, particularly Batam and Bintan. Given prevailing trends, it is likely that the Malay community will soon be a numerically

⁴⁴ Wee, “The Significance of Riau in SIJORI”, pp. 248–50.

important — but minority — population in the province. As mentioned above, there have been frequent complaints that the new modern sector jobs have not been accessible to locals, who have been crowded out by Japanese workers sourced by Jakarta-based employment agencies.⁴⁵

Furthermore, the Province’s export-oriented development model has resulted in a geographically uneven pattern of development. Composite measures of well-being such as the Human Development Index (HDI) indicate that Batam and the provincial capital, Tanjung Pinang, have very high levels of social and economic well-being. However, the more remote areas of the province, such as the rural areas of Bintan and the smaller island groups have not benefited from these modern sector activities to the same extent.

Figure 6: HDI in Kepri, 2015



Source: BPS Provinsi Kepulauan Riau, *Indikator Utama Kepulauan Riau Semester 1-2016*, pp. 29–30.

⁴⁵ V. Wee, “Ethno-nationalism in process: ethnicity, atavism, and indigenism in Riau, Indonesia”, *SEAREC Working Paper Series 22*, Southeast Asian Research Centre, Hong Kong, 2002.

For the first six years of the new province's history, policy attention focussed specifically on deepening its industrialization process and generating formal sector jobs. The interim Governor and former BIDA Chairman, Ismeth Abdullah, ran for office in the province's first elections in 2005. He campaigned on an explicitly pro-business programme, aiming to boost economic growth through providing tax incentives for firms and increasing lease-hold terms for land. This focus was maintained in office, with long-term planning documents focussing on promoting economic growth through supporting the electronics sector, attracting investment from Singapore, and securing FTZ status for the major islands.⁴⁶ Other provincial priorities included promotion efforts in Japan and kick-starting the shipbuilding sector with a flag-ship investment and establishing a maritime university.⁴⁷

However, in the run-up to the 2010 provincial elections, Ismeth Abdullah was arrested and jailed over irregular procurement processes implemented during his time as BIDA Chairman. This reconfigured the political context, as Ismeth was very popular and had been expected to win a second mandate. Following his removal from the political scene, his pro-business coalition split into three, with Ismeth's wife, Aidha, running as the leader of a rump faction.⁴⁸

The ultimate winners of the 2010 gubernatorial elections ran on an explicitly cultural sub-national platform. The victor, Muhammad Sani, played to his Malay lineage as well as his career in local government, with stints as Mayor of Tanjung Pinang and Regent of Karimun. Sani's campaign received crucial backing from Huzrin Hood, a well-known ethno-nationalist and co-founder of the Riau Islands Province.⁴⁹ In a

⁴⁶ Provinsi Kepulauan Riau, *Rencana Pembangunan Jangka Panjang, Provinsi Kepulauan Riau 2005–2025* (Tanjung Pinang: Pemerintah Provinsi Riau, 2005), p. 42.

⁴⁷ "Umrah Opened as a State University in Tanjungpinang", *Riau Bulletin*, 17 January 2012, p. 2.

⁴⁸ "The Riau Islands Provincial Governor's Election", *Riau Bulletin*, 24 May 2010, p. 4.

⁴⁹ *Ibid.*

nod to pro-business concerns, he teamed up with Soerya Respationo, a corporate figure well known in Batam. Despite being Javanese, Soerya enjoyed considerable working class support due to a self-help organization he had established in Batam.⁵⁰

Mohammad Sani ultimately won 37 per cent of the popular vote, with the other two candidates — including Ismeth Abdullah’s wife — receiving 31 per cent each.⁵¹ Notably, Sani did not win in the key constituency of Batam. This was the largest vote bank and included large numbers of migrants from Java and Sumatra. Conversely, Sani did well in the province’s rural constituencies.⁵²

Once in power, Sani made a significant shift in economic policy, moving away from investment promotion, industrialization, and exports, towards promoting traditional economic activities such as fishing, agriculture, and other small-scale activities. Furthermore, attention shifted away from Batam, which was taken as “developed”, towards other islands.⁵³ In line with this, less focus has been laid on engaging with current investors such as Singapore, or potential ones such as China. And, issues tied up with the Province’s historical role as a site of Malay culture have assumed increasing importance.⁵⁴

This focus has also led to tensions between the provincial government and BIDA over the latter’s leadership. Congruent with the decentralization measures, both the central and provincial governments were involved in selecting the Authority’s Chairman. In 2013 and 2014, the two levels of government openly disagreed over the Authority’s

⁵⁰ N. Choi, “Local Elections and Democracy in Indonesia: The case of the Riau Archipelago”, Working Paper 91, Institute of Strategic and Defence Studies, Singapore, 2005, p. 17.

⁵¹ “New Governor and New Hopes”, *Riau Bulletin*, 22 June 2010, p. 4.

⁵² “Duo HMS Wins”, *Riau Bulletin*, 11 June 2010, p. 7.

⁵³ Interview with political observer A, Batam, 22 May 2013.

⁵⁴ Provinsi Kepulauan Riau, *Rencana Kerja Pembangunan Daerah Provinsi Kepulauan Riau Tahun 2013* (Tanjung Pinang: Pemerintah Provinsi Riau, 2013), p. IV-1.

leadership. Sani proposed Huzrin Hood as Chairman, but Hood's lack of relevant experience, previous incarceration for corruption and his ethno-nationalist agenda caused opposition among the private sector and BIDA employees. After considerable lobbying, the incumbent, Mustofa Widjaja remained as Chairman, but the Vice-Chairmanship went to another candidate put forward by Sani.⁵⁵

The contest for the governorship in 2015 was between two pairs of candidates, Mohammad Sani and Nurdin Basirun against Soerya Respatiano and Ansar Ahmad — each backed by a coalition of parties. If anything, relative to 2010, Sani ran on a more localist agenda, picking Nurdin Basirun as his candidate for Vice-Governor. Like Sani, Nurdin had a career in local government, including as Regent of Karimun. Sani's former Vice-Governor Soerya paired with Ansar Ahmad, a Riau Islands local who had been Regent of Bintan. In contrast to Sani, Soerya sought to court urban votes by leveraging his business experience and networks in Batam as well as appealing to rural, Malay voters via his running mate.

Sani and Nurdin ultimately won the elections with 53 per cent of the votes against their opponents' 47 per cent. The victorious pair won in five out of the province's seven districts, with a particularly high margin in Karimun, where they had both served. Conversely, Soerya-Ansar won in Anambas and Bintan — the latter being Ansar's birthplace and former constituency. Of note was the small margin of victory for Sani in Batam, the province's largest vote-bank. Due, perhaps, to Soerya's base in Batam, the contest was particularly close. Significantly, Batam had the lowest voter turnout across the seven districts, with less than 50 per cent of eligible voters participating.⁵⁶ Analysis of past elections in the Riau Islands has indicated that voter turnout in industrial areas of the city with a particularly large population of migrant workers is generally very low.⁵⁷

⁵⁵ Interviews with political observers A and B, Batam, 22 May 2013; communication with political observer A, 22 September 2014.

⁵⁶ <<https://pilkada2015.kpu.go.id/kepripov>> (accessed 12 June 2016); "Kepri's Gubernatorial Election", *Riau Bulletin*, November/December 2015, pp. 11–12.

⁵⁷ Choi, "Local Elections and Democracy in Indonesia", p. 20.

Indonesia's Changing Economy

Batam's outward, export-oriented model has meant that it has been affected by adverse global trends. These include lower commodity prices, downturns in the electronics sector, and increased competition from China and other locations in Southeast Asia. Indeed, relative to other locations such as Vietnam and Cambodia, wage levels for manufacturing workers in Indonesia are 20 and 50 per cent higher, respectively.⁵⁸

However, the island's declining absolute and relative performance may, ultimately, be more linked to the changing nature of investment into Indonesia, which may have different drivers and rationales than in the past.

Influential reports such as McKinsey's *The Archipelago Economy: Unleashing Indonesia's Potential* have argued that, given prevailing growth trends, the country will be the world's seventh largest economy by 2030. This increase will be driven by: a demographic dividend; increases in productivity; as well as the demand for Indonesia's natural resources from India and China. Furthermore, rising incomes and increasing urbanization mean that the country's 'consuming class' is expanding considerably. Indeed, this socio-economic group is projected to expand from 45 million in 2010 to reach 135 million in 2030 — constituting a very sizeable end market.⁵⁹

These structural changes have been accompanied by evolving corporate strategies, which now target Indonesia's domestic market, instead of merely using the country as an export platform. This has been particularly the case for Japanese MNCs, a traditionally important source of investment into Batam. However, given Japan's declining population base and persistent deflation, firms from that country have sought to move into new markets, particularly in India, China and, increasingly, Southeast Asia. Consequently, FDI levels from Japan to Southeast Asia

⁵⁸ JETRO, "2016 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania", Jetro, Tokyo, 2016, p. 64.

⁵⁹ McKinsey Global Institute, *The Archipelago Economy: Unleashing Indonesia's Potential* (Boston: McKinsey Global Institute, 2012).

have increased substantially, targeting Singapore, Indonesia, Thailand, and Vietnam.⁶⁰

However, relative to the past, the focus is less about manufacturing for export and more about production in those countries in order to access their domestic markets. This change in emphasis is borne out by firm surveys. In 2016, more than 80 per cent of Japanese firms present in China, India, and Indonesia anticipated that, in the year ahead, they would make more profits from sales in local markets, as opposed to production for export. In contrast, under 30 per cent anticipated earning profits from increased exports — with this figure falling to 20 per cent for Japanese firms operating in Indonesia.⁶¹

In principle, this should bode well for Batam. Beyond its proximity to Singapore, the island has the best infrastructure in Sumatra, with reliable power provision, and, of course, BIDA.⁶² Yet, there is reason to believe that this competitive advantage is less compelling than it used to be.

First, available international rankings show that Indonesia has made some progress in increasing its overall competitiveness relative to other rival production locations. Thus, according to the 2017 World Bank's *Ease of Doing Business Index*, Indonesia climbed 15 places from the previous year to reach 91st place, overtaking the Philippines and beating Cambodia. This improvement was due to improvements in electricity provision, registering a property, establishing new businesses, and engaging in cross-border trade.⁶³ While not revolutionary, this indicates that the wider context outside Batam is less inhospitable than it used

⁶⁰ M. Cook, "The Second Wave: Japanese FDI to Southeast Asia". *ISEAS Perspective* 2014/33, ISEAS – Yusof Ishak Institute, Singapore.

⁶¹ JETRO, "2016 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania". Tokyo: Jetro, 2016, p. 17.

⁶² Interview with Batam-based Economic Expert, Batam, 8 November 2016; Global Business Guide, "A Look into Indonesia's Special Economic Zones" <http://www.gbgingonesia.com/en/main/business_updates/2014/upd_a_look_into_indonesia_s_special_economic_zones.php> (accessed 9 June 2017).

⁶³ A. Gunawan and A. Hermansyah, "Indonesia up 15 places in East of Doing Business Index", *Jakarta Post*, 26 October 2016.

to be. Indeed, when compared with nineteen other cities in Indonesia, Batam does not score particularly well for: starting a business (15th place); dealing with construction permits (10th place); or registering a property (20th place). In contrast, Bandung and Semarang, the capitals of West and Central Java, have considerably higher scores.⁶⁴

Second, Batam's long-established manufacturing sector and well-organized unions have meant that wages have increased significantly over time, with particularly large hikes in 2012 and 2013.⁶⁵ At present, the minimum wage in the Riau Islands is 2.2 million rupiah, which is substantially higher than the national average of 1.9 million. In Batam proper, the minimum wage is 2.9 million rupiah, only slightly lower than Jakarta.⁶⁶ The wage levels for Batam, and the Riau Islands more generally, are significantly higher than those in provinces such as Central and East Java, with the former, in particular, emerging as a new destination for labour-intensive manufacturing.⁶⁷

Third, despite the island's well-developed infrastructure, its connectivity with Java is not good — meaning that Batam is effectively isolated from the country's largest population centre. Recent Japanese investment has targeted Jakarta and, to a lesser extent, Surabaya.⁶⁸ Batam's limited connections thus mean higher prices for shipping goods to and from Jakarta. Indeed, it is often easier and cheaper for firms to ship first to Singapore and then on to Jakarta.⁶⁹ Furthermore, Batam's lack of a deep-water port is also a hindrance for many types of cargo and also limits its direct connections with major markets.

⁶⁴ World Bank, *Doing Business in Indonesia 2012* (Washington, D.C.: World Bank, 2012), p. 12.

⁶⁵ Interview with an industrial park manager, Batam, 12 February 2014.

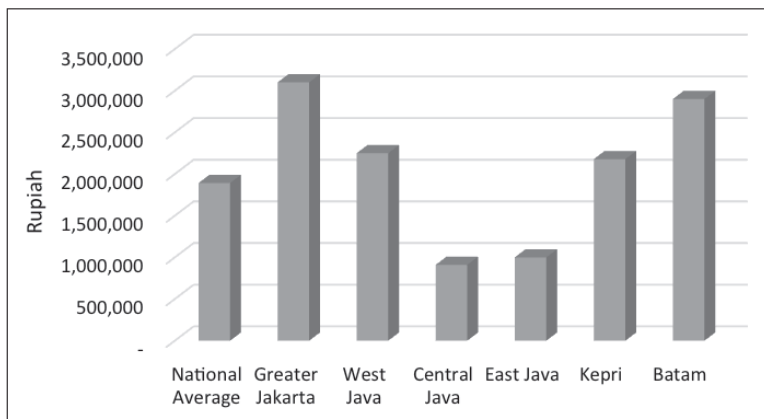
⁶⁶ Interview with a manager from an industrial park, Singapore, 23 January 2017; and F. Pangestu, "Wake-up Call on Foreign Investors", *Jakarta Post*, 4 November 2016.

⁶⁷ "New Manufacturing Hub", *Jakarta Post*, 24 August 2016.

⁶⁸ Interviews with Japanese investment observers, Singapore, 1 November 2016.

⁶⁹ Interviews with: Manager of a local business association, Panbil, 10 June 2013; and Senior Manager from an Indonesian government agency, Batam, 9 March 2017.

Figure 7: Minimum Wage, 2016



Source: BPS Provinsi Kepulauan Riau, *Indikator Utama Kepulauan Riau Semester 1-2016*, p. 21.

Fourth, while Batam’s FTZ status has meant that imports and exports can come to the island without paying duty, it has also effectively fire-walled it from Indonesia’s domestic economy. Should manufacturers based on the island want to sell their merchandise on the local market, they need to pay a duty of 20 per cent. In contrast, products from countries within the ASEAN Free Trade Area are allowed in duty-free. One large European E&E producer based on Batam has been directly hit by this provision, leading it to downsize its operations on the island.⁷⁰ Furthermore, the duty-free provisions entail onerous reporting requirements, such as forecasting import needs one year in advance with little flexibility of alteration in light of changing needs.⁷¹

⁷⁰ Interview with Batam-based Economic Expert, Batam, 8 November 2016.

⁷¹ “Being an Exception to the Rule”, *Riau Bulletin*, 17 January 2012, p. 4.

THE REASSERTION OF CENTRAL CONTROL

Due to these dysfunctions, the central government had been deliberating how and whether to intervene in Batam and what to do with BIDA over the last two years. Following a visit by Indonesian president Joko Widodo to Singapore in August 2015, discussions regarding Batam intensified. Many options for reform were put forward, including: making BIDA a state-owned enterprise; transferring its oversight to the Batam municipal government; or dissolving it altogether.⁷²

By April 2016, the Jokowi administration had reached a decision and moved quickly to reassert central government control over BIDA. While the Chairmanship of the Authority was not due to change until 2019, the Coordinating Ministry for Economic Affairs replaced the Authority's entire senior leadership, including: Chairman; Vice-Chairman; and five Deputy Chairmen. Breaking with the precedent of allowing substantial provincial involvement in the selection process and representation among the leadership, the new team consisted exclusively of Jakarta-based civil servants. The new leadership was given three to four years to revitalize the island's economy and tasked with ambitious growth targets.

The new Chairman was Hatanto Reksodipoetro, a Harvard-educated, former Secretary-General of the Ministry of Trade and senior negotiator for Indonesia to the World Trade Organization. The other six senior managers included:

- *Vice Chairman*: Agus T. Wirakusumah, former Secretary-General of Ministry of Industry
- *Deputy Chairman for Administration and General Affairs*: Sigit Priadi Pramudito, former Director-General of Taxes
- *Deputy Chairman for Planning and Development*: Junino Jahja, former Deputy for Internal Control and Public Complaints of the Anti-Corruption Commission

⁷² F. Pangestu, "Govt to Disband Free Trade Zone Authority", *Jakarta Post*, 30 December, 2015; "BP Batam Dissolution Not to Affect State-Funded Projects", *Tempo*, 10 January 2016.

- *Deputy Chairman for Business Facilities*: R.C. Eko Santoso, former Director for Strategy and Funds Management, Directorate General of Treasury
- *Deputy Chairman for Other Facilities*: Purba Robert Sianipar, former senior official, Coordinating Ministry for Economic Affairs
- *Deputy Chairman for General Services*: Gusmardi Bustami, former Director General of International Trade Cooperation, Ministry of Trade.⁷³

The suddenness of this decision caused concern within BIDA, with the outgoing senior managers and employees demonstrating outside the Authority's offices. Questions were also raised about why there were no "representatives" from the Riau Islands among the new leadership. Coordinating Minister for Economic Affairs, Darmin Nasution, stated that there had been people from Kepri among the candidates put to President Joko Widodo. However, the President's sole consideration was professional experience.⁷⁴

Since assuming leadership of the organization, the new management has carried out a number of measures. First, Hatanto ordered an in-depth financial, legal, and operational audit to be carried out of BIDA and its assets by the central — rather than the local — branch of the Development Finance Comptroller (BPKP). A number of financial irregularities, including untraceable funds, were uncovered.⁷⁵

⁷³ G. Amianti, "New management aims to overhaul Batam", *Jakarta Post*, 13 August, 2016; "Mantan Dubes dan KASAL Kuat Kepala BP Batam", *Batam Pos*, 30 March 2016.

⁷⁴ "President wants BP Batam Professional: Coordinating Minister", *Antara*, 14 March 2016; "Islands in focus: Batam civil servants protest against new boss", *Jakarta Post*, 7 April 2016; "Pimpinan BP Batam Bakal Tak Ada dari Kepri", *Batam Pos*, 14 March 2016; "Pelayanan Buruk, Pejabat di Bandara dan Pelabuhan Dirombak", *Batam Pos*, 12 May 2016.

⁷⁵ "Bongkar Bobrok BP Batam, Luhut Panjaitan Laporkan KPK", *Kepriterkini*, 13 August 2016.

Second, a far-reaching audit of lease agreements was conducted with an aim of freeing up unutilized land, including an estimated 7,000 hectares that had been allocated to investors but not built upon. Some 300 cases of unused land were uncovered.⁷⁶ In addition, the lease rates for land, particularly in centrally located areas, were increased for the first time in twenty years. While good from a revenue point of view, it led to numerous complaints regarding the rapid hike in rates, causing the new management to postpone the measure.⁷⁷

Third, in a bid to further increase the speed and efficiency of permit processes, Hatanto's worked with the central government's Investment Coordinating Board to introduce an online approval system for large projects — the first in the country. Called 123J, the fast-track system is available for projects that are either above US\$3.8 million or employ more than 300 workers. The system aims to provide the approval of eight required permits in under 3 hours, down from an estimated 6 months. BIDA was able to successfully obtain the approvals for an electronics manufacturer. This has been accompanied by the in-principle approval of building and environmental permits, which allow investors to begin constructing facilities after an initial screening of documents.⁷⁸

Fourth, the new management has pledged to further upgrade the island's infrastructure. To date, efforts have focussed on improving the management of key infrastructure facilities, as well as upgrading three cargo ports, and expanding the airport to increase capacity and cater to

⁷⁶ "CMEA Ask BP Batam Immediately Resolve Land", *Antara*, 17 October 2016; G. Amianti, 'New management aims to overhaul Batam', *Jakarta Post*, 13 August 2016; "BIFZA Takes Over Unused Allocated Land in Batam", *Riau Bulletin*, August 2016, p. 5.

⁷⁷ Interviews with industry observers, Singapore, 9 November 2016; "Lease Fee Increases Postponed in Batam", *Riau Bulletin*, November 2016, p. 3.

⁷⁸ "Batam expects \$540 m with new licensing service", *Jakarta Post*, 6 September 2016; F. Pangestu, "Oz firm gets permit to build Batam factory in 3 hours", *Jakarta Post*, 9 November 2016; <<http://www5.bkpm.go.id/en/investment-step-by-step/3-hours-investment-license>> (accessed 13 July 2017).

larger planes. The Authority also has plans to build a light rail transit connection between the airport and one of its sea ports, Batu Ampar, as well as a bridge connecting Batam and Bintan.⁷⁹

OPTIONS FOR THE FUTURE

The measures implemented by the new administration have geared to raising revenue, increasing efficiency for investors, as well as improving the overall climate for business in Batam. However, beyond these measures, there are a number of underlying strategic issues that the authorities will need to decide on in the months ahead.

Governance

The issue of functional and jurisdictional overlaps between BIDA and the Batam Municipality have complicated the local regulatory environment for firms and dampened consumer confidence. This issue arose in 2001 and continues to this day, despite well-publicized attempts to clarify each organization's sphere of influence.⁸⁰ One such arrangement brokered in 2006, allocated the authority for economic and investment-related issues to BIDA, with the Municipality assuming responsibility for social and environmental issues. This agreement was short-lived, and the separate responsibilities held by the two organizations have also impeded work to develop the island's innovation system through promoting linkages between firms and education institutions.⁸¹ Furthermore, the ambiguity regarding the status of vast swathes of land needs to be clarified.

A related complication is whether Batam should continue to push for its status to be changed from a free trade zone to a special economic zone.

⁷⁹ G. Amianti, "New management aims to overhaul Batam", *Jakarta Post*, 13 August 2016; "Construction of Hang Nadim Terminal II to start soon", *Antara*, 28 September 2016; "Batam to have modern port operational soon", *Antara*, 13 September 2016; "Pelayanan Buruk, Pejabat di Bandara dan Pelabuhan Dirombak", *Batam Pos*, 12 May 2016.

⁸⁰ Interview with industry observers, Singapore, 9 November 2016.

⁸¹ Interview with a senior industrial park manager, Batam, 12 February 2013.

The second option would, in theory, allow investing firms to qualify for a wider range of tax incentives. However, there is disagreement at both the central and local levels as to which arrangement is more suitable for the island. Under the current arrangement, Batam is an FTZ and under the supervision of the Coordinating Ministry for Economic Affairs. If it were to change to an SEZ, it would pass to the Ministry of Home Affairs.⁸² Recently, the Riau Islands provincial government and the Batam municipal government, along with the Ministry of Home Affairs have pushed for the island to be made an SEZ. It would appear that the Coordinating Ministry of Home Affairs and BIDA itself prefer the existing arrangement. However, as will be argued below, there is good cause for Batam's special status to be abandoned altogether.

Beyond the issues of prerogatives and legal status for Batam, there is also a clear need for structured mechanisms of dialogue between BIDA, other relevant authorities and the private sector. To date, the private sector has been vocal about issues concerning the leadership of the Authority as well as the organization's status. However, these are spontaneous reactions to announced government decisions, rather than the structured inclusion of the private sector as a partner in decision-making. This includes problem-solving, but also key aspects for developing the local innovation system such as technology mapping and value chain analysis. It is noteworthy that the 2013 strategic review of Batam, Bintan, and Karimun's economy was outsourced to external experts, yet did not incorporate the local private sector as a partner in the process.⁸³ This is all the more important given the slowing pace of FDI into the island and the increasing importance of firms that are already present on the island as a source of investment.⁸⁴

⁸² Interview with Industry Observer E, Batam, 8 November 2016; Interview with Industry Observers C and D, Singapore, 1 November 2016.

⁸³ O. Juoro, Tan K.G. and Tan K.Y., "Joint Expert Study on Competitiveness of Free Trade Zone of Batam, Bintan, Karimun", Komite Ekonomi Nasional, 2013.

⁸⁴ Interview with Industry Observers C and D, Singapore, 1 November 2016.

Sectors

Beyond tackling Batam's institutional dysfunctions, the subsequent strategic issue is to determine what sectors the island should focus on.

The 2013 review lists a range of sectors for Batam, as well as Bintan and Karimun. They include the following, *inter alia*: petroleum and petrochemical; heavy engineering; shipping and logistics; electronics; aircraft maintenance, repair and overhaul (MRO); and information technology. Hatanto Reksodipoetro has since listed the aircraft MRO industry, shipyards, and the animation and information technology sectors as target areas.⁸⁵

While the situation facing the shipyard sector does not look favourable, there have been some positive developments regarding the MRO industry. Most notably, a subsidiary of Indonesia's national airline, Garuda, will invest US\$41 million in an MRO facility in Batam's airport for international long haul flights.⁸⁶ In addition, Luxembourg will shift its air cargo operations from Singapore's Changi Airport to Batam.⁸⁷

Perhaps the most promising new sector is the digital economy. The island is well connected by submarine cables to both Jakarta and Singapore. It also has an international data centre, which can offer high-end telecommunication services as well as functions such as cloud computing and data recovery.⁸⁸ In addition, a private sector operator is investing S\$700 million in a technology park aimed at housing software, IT services, and media operators. Tenants include: Infinite Studios, a media firm; and Liquid Pay, a cash-less payment service operator.

⁸⁵ "Batam wants to run high-tech industry", *Antara*, 22 August 2016.

⁸⁶ F. Pangestu, "GMF Aeroasia to develop maintenance facility in Batam worth USD 41 million", *Jakarta Post*, 21 February 2017.

⁸⁷ M. Bhaskaran, 'Is Singapore's Hub Status at Risk?', *The Edge Malaysia Weekly*, 5–11 June 2017.

⁸⁸ <<http://www.datacentermap.com/indonesia/batam/ndc-batam.html>; <http://moratel.com.sg/>> (accessed 9 June 2017).

Microsoft has also expressed interest in locating some facilities in Batam.⁸⁹

However, a word of caution is merited. Interviews with BIDA officials indicate that diversification in terms of incoming sectors is seen as positive. Thus, incoming investments in myriad and unrelated sectors such as shipbuilding, tyres production, fishing gear makers, bicycle equipment producers, as well as oil and gas are welcomed. Notwithstanding this, it is important to remember that Batam's skill base is thin. Firm interviews on the island indicate that firms are unhappy about the cost of labour in relation to its productivity, expressing frustration that the wider innovation context is unable to produce sufficient skilled workers.⁹⁰ In this context, inviting a wide and unrelated range of industries risks further dispersing an already scarce resource. It is noteworthy that the local innovation system surrounding the electrical and electronics industry is still in its infancy, despite being present on the island for almost three decades.

BATAM'S PLACE IN INDONESIA'S ECONOMY

The final and perhaps most fundamental question relates to Batam's place in the national economy. Over the past four decades, the island has enjoyed privileged attention, benefitting from unparalleled attention and resources. Consequently, its export-oriented sectors have flourished. Now, however, the situation has changed, with FDI into Indonesia geared to producing for local consumption. Given this situation, does the current externally oriented model still make sense?

As mentioned, given Batam's FTZ status, firms producing on the island are subject to a 20 per cent levy for goods that they sell on the

⁸⁹ Arlina Arshad, "Building up Batam as a work-and-play digital hub", *Straits Times*, 26 April 2017.

⁹⁰ Van Grunsven and Hutchinson. "The evolution of the electronics industry on Batam Island", p. 487.

local market. There are reasons to believe that this situation does more harm than good. First, because of the ASEAN Free Trade Agreement, firms producing in other investment locations that rival Indonesia, such as Vietnam and Cambodia, can ship their products into Indonesia tariff-free.

Second, under existing international agreements that Indonesia is party to mean that many of the manufacturing activities present in Batam would qualify for tariff-free imports if the island's FTZ status was rescinded. This is because Indonesia is a signatory to the World Trade Organization's Information Technology Agreement, which covers high-technology goods such as: semiconductors; telecommunication equipment; software; computers; as well as accessories and component parts of these items. There are now 81 signatories to this agreement, which collectively cover 97 per cent of the world's trade in IT goods. The Agreement requires signatories to eliminate customs duties for all specified products.⁹¹

Consequently, there are several options that could be considered. First, the wholesale elimination of Batam's FTZ status is the most immediate option. Alternatively, firms present in Batam could be allowed to sell a stipulated portion of their production on the local market. For example, in Malaysia, firms in free trade zones are allowed to sell up to 20 per cent of their output on the local market without jeopardizing their duty-free status.

However, should this issue be addressed in some fashion, connectivity between Batam and Java still needs to be dramatically improved. At present, connections between the two islands are very under-developed and costly, undercutting the viability of firms in Batam producing for the domestic market.

⁹¹ World Trade Organization, "Information Technology Agreement: An Explanation" <https://www.wto.org/english/tratop_e/inftec_e/itaintro_e.htm> (accessed 12 June 2017).

CONCLUSION

Batam has enjoyed high and consistent growth for the past three decades. However, a number of strategic issues call into question the island's ability to continue with its business-as-usual model. Important first steps have been made to improve the local business context, but many more daunting tasks lie ahead. These include: tackling institutional dysfunctions; engaging with the private sector; developing a vision for the island's development; and, ultimately, examining Batam's role within the Indonesian economy.

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