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The Rise of 'Murky Protectionism': Changing Patterns of Trade-Related Industrial Policies in Developing Countries:

A Case Study of Indonesia

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Abstract

Over the past two decades, an array of international actors including developed countries, the World Trade Organization (WTO), and international financial institutions (IFIs), have pushed developing countries to remove their discriminatory trade policies in the name of speeding up development. Many analysts claim that, in doing so, developing countries have lost a set of policies central to the success of previous industrialisers. However, few studies actually examine how the new rules of the international system impact developing countries' choice of industrial policies, and those that do fail to consider the possibility that developing countries are responding to the restrictions by adopting new policy instruments. This paper argues that efforts to 'shrink the policy space' of developing countries have not had purely liberalising effects, as is traditionally posited. By examining the trade-related industrial policies used by Indonesia from the mid-1980s to the present, this paper unearths evidence that developing countries are finding ingenious methods of challenging and circumventing some of the new policy restrictions. This suggests that developing countries have more policy space for development than is commonly thought.

Table of Contents

List of Acronyms **2**

1. Introduction **3**

2. Literature Review **5**

2.1 Rules-Based Approaches 5

2.2 Outcomes-Based Approaches 7

2.3 Policy Substitution 8

3. Methodology **9**

4. Indonesia's Trade-Related Industrial Policies: 1984-2013 .... **11**

4.1 Period 1: 1984-1993 11

4.2 Period 2: 1994-2003 13

4.3 Period 3: 2004-2013 15

5. Discussion **17**

6. Conclusion **19**

References **21**

List of Acronyms

BIT	Bilateral Investment Treaty
GATT	General Agreement on Tariffs and Trade
GOI	Government of Indonesia
GTA	Global Trade Alert
IFI	International Financial Institutions
IL	Import License
IMF	International Monetary Fund
IPR	Intellectual Property Right
LCR	Local Content Requirement
NTB	Non-Tariff Barrier
RBTA	Regional and Bilateral Trade Agreement
SAP	Structural Adjustment Program
USTR	United States Trade Representative
WTO	World Trade Organization

1. Introduction

Since the establishment of the World Trade Organisation (WTO) in 1995, and the corresponding onset of new regulations over public policies related to trade, investment, and intellectual property rights (IPRs), there has been a debate over the level of restrictiveness of the new international policy regime for developing countries. In the process of integrating with the international economy, developing countries have become subject to more rules and restrictions at the international level both from formal international agreements such as the WTO, as well as more informal political pressures emanating from developed countries (Shadlen, 2005). These regulations and pressures threaten to prevent developing countries from employing the same industrial policies used by their forbears to 'catch-up' with the lead economies of their time (Chang, 2002); perhaps, as some conclude, even relegating them to a future without chance of 'catch-up' (Wade, 2003).

This paper examines how efforts by a variety of actors to curtail the use of industrial policies by developing countries have impacted their actual policy choices. These actors include the WTO, international financial institutions (IFIs) such as the World Bank and IMF, regional and bilateral agreements on trade and investment, and developed countries. To address this question, this paper must assess two related sub-questions: first, to what extent have developing countries given-up the use of 'old' forms of industrial policies – those used in the past by successful industrialisers? Second, to what extent have they replaced these with new ones?

While this question is not new to academic inquiry, previous studies have differed considerably in their conclusions. Several prominent analyses conclude that the new rules of the international system under both the WTO and other trade agreements severely restrict developing countries' 'policy space' for development – that is, the set of policies, both used and unused, that are available to developing countries in their pursuit of economic development (Chang, 2002; Gallagher, 2005; Wade, 2003; Weiss, 2005). Others have argued that the claims of 'shrinking policy space' are exaggerated, and that there is still much room for developing countries to promote their industries and greater value-added from production (Amsden, 2005; Mayer, 2009; Milner, 2009; Rodrik, 2004; UNCTAD, 2006). A third group, while agreeing that the WTO does leave considerable policy space for development, argue that this space is effectively closed for many developing countries by other sources of obligations, such as regional and bilateral trade agreements (RBTAs) (Shadlen, 2005), policy pressure from the IFIs (Khan, 2007), or even unilateral policy pressures from other countries (Matthews, 2002).

The main argument of this paper is that developing countries have not passively accepted the new constraints on their policy choices, but have sought to challenge and circumvent them in ingenious ways in order to preserve their ability to promote domestic industries and production. This paper finds that developing countries continue to use a wide variety of trade-related industrial policies to provide protection to domestic industries and promote greater value-added from production. However, the overall character of the industrial policies has changed significantly. Although some of the 'old' policy instruments remain, these have been supplemented by a range of new ones. Many of the new policies are less transparent than their antecedents, either by involving informal elements in their implementation, using regulations applied 'behind-the-borders', or alternative rationales that evoke environmentalism or other 'acceptable' goals. Therefore, while the new rules of the international policy regime have not

restricted developing countries' ability to use industrial policies by as much as is commonly believed, the outcome has been a move towards less transparent policy instruments, in a trend some describe as 'murky protectionism' (Aggarwal & Evenett, 2012).

The approach adopted by this paper makes two important departures from the previous literature, which has generally addressed the question from very similar angles. First, it focuses its attention on the actual policy implementation in developing countries, whereas much of the literature has examined the rules of various international agreements. Therefore, rather than concerning itself with the question of 'what is allowed' this paper will focus on the question of 'what is actually done'. In doing so, it hopes to move the debate from the domain of inference and conjecture to one based on empirically grounded observations of the policy variation in developing countries. Second, this paper considers the possibility of policy substitution, that is, that governments respond to restrictions on their policies by seeking out and implementing alternative instruments as a means of evading the rules. This will require attention to a wider range of policy instruments than has traditionally been done in order to measure both the policies that have increased and those that have decreased under the new rules of the international policy regime.

While much of the literature on industrial policies engages with the debate over its efficacy, this is beyond the scope of this paper. Regardless of whether one believes industrial policies to be essential tools for 'catching up' (Reinert, 2007) or needless forms of intervention (Krueger, 1998), it is important to be aware of the actual patterns of industrial policy-implementation, and to understand the extent to which efforts to restrict their use have succeeded in doing so.

Before proceeding to the next section a few definitional clarifications are in order. For the sake of this paper, industrial policies will be defined as the use of public policy to promote key economic activities or sectors. It therefore considers not only policies that promote modern manufacturing industries, but also those in agriculture and extractive sectors, as these too can promote higher levels of processing and greater value-added (J. Page, 2011). Therefore, 'trade-related industrial policies' will apply to these policies in the areas covered by international trade agreements – trade in goods and services, foreign investment, and intellectual property rights. When referring to the term 'international policy regime', this paper will employ Krasner's (1985) classic definition of regime to be the "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors expectations converge in a given area of international relations."

This paper is structured as follows. Section 2 reviews previous attempts to study the subject and examines both how they have approached the subject and why this is insufficient. Section 3 uses the case of Indonesia to demonstrate how patterns of industrial policies have changed with the increasing pressures from the international system, and what forms of industrial policies can still be implemented. Section 4 discusses the implications of these findings, and Section 5 offers concluding remarks and avenues for future research.

2. Literature Review

Most attempts to study the impact of the new policy restrictions on developing countries' policy space approach the question from the perspective of 'what is allowed', thus making the false assumption that the rules contained in international agreements accurately represent the restrictions faced by countries. Moreover, both they and the few studies that look directly at policy outcomes, fail to adequately account for ways developing country governments may be responding to these pressures, for example by engaging in policy substitution. This section will examine each of the major methodological approaches in turn, arguing that by applying recent insights on the topic of policy substitution to the approaches that examine actual policy implementation, a much more accurate lens is provided to assess the restrictions faced by developing countries with regards their use of industrial policies.

2.1 Rules-Based Approaches

The majority of previous studies on the subject of policy space for development follow a 'rules-based approach' – that is, they examine the rules and commitments of various trade agreements and assess how these prohibit the use of industrial policies by developing countries.[1] Early studies were justifiable in their resort to this common approach, in part because of its efficiency in drawing broad conclusions from a single analysis of the rules, and in part because the transition periods for many of the new commitments meant that the impacts were not at first observable. However, while their methodological approach is highly similar, the conclusions they draw are not.

One group, which can be referred to as the 'globalisation as constraint' view, argue that the loss to developing countries' policy space from the new international agreements have enormous ramifications for their prospects for development. They argue that the rules of the WTO create severe obstacles to development by making illegal many of the policies used by past industrialisers to catch-up to the lead economies of their time – specifically, the protection of infant industries, the regulation of foreign investment, and the appropriation of technology through weak protection of intellectual property rights (Chang, 2002; Wade, 2003). Moreover, they argue that the policy space remaining under the WTO is inadequate for the necessities of development. Weiss (2005), for example, argues that the policies permitted under the WTO, such as subsidies for R&D and technology-intensive industries, provide room for only technologically advanced types of industrial policies. However, these are unsuited for most developing countries and therefore provide little opportunity for 'catch-up'. Held et. al. (2000) go as far as to claim that the only policies still viable for developing countries are those that promote human capital formation. Therefore, they argue, the rules of the WTO effectively lock developing countries in to subordinate economic positions in the international hierarchy.

Another group of scholars are less pessimistic with regards to the impact of the WTO on developing countries' policy space. They argue that while some important policies have been lost under the new rules, the fundamental strategies of past industrialisers are still allowed under the WTO (Amsden, 2005; Rodrik, 2004). They focus on the institutional arrangements used by past industrialisers to identify economic constraints, select policy solutions, and condition protection on specific performance standards (Amsden & Hikino, 2000; Rodrik, 2004)

[1] The term 'rules-based approach' is borrowed from DiCaprio and Gallagher (2006).

Moreover, they emphasize that some of the policies permitted under the WTO, such as subsidies for R&D and technology-intensive industries, as well as antidumping duties and safeguards, provide considerable opportunities to promote domestic industries as in the past (Amsden & Hikino, 2000).

Additionally, some academics fall in between these two groups. Shadlen (2005) argues that the WTO permits significant flexibilities for developing countries to continue to implement trade-related industrial policies. However, many of these flexibilities, he argues, are effectively removed for developing countries under the rules contained in regional and bilateral trade agreements (RBTAs). In exchange for greater market access in developed countries many developing countries agree to restrict their policy choices beyond the level promised in WTO agreements. For example, they accept tighter restrictions on their use of tariffs, greater penalties on the use of investment regulation, and fewer flexibilities in their protection of IPRs (Shadlen, 2005).

However, by choosing to focus on the textual obligations rather than policy selection, all of these studies suffer from a fundamental methodological weakness. The underlying assumption of rules-based analyses is that the textual obligations in international agreements accurately reflect the real restrictions faced by developing countries. Unfortunately, there are several reasons to believe that this is not the case. First, there is significant evidence that developing countries face pressures to remove their industrial policies from multiple sources, not only the WTO. RBTAs, as previously discussed, often impose stricter rules on trade, investment and IPR policies (Shadlen, 2005). IFIs also apply policy pressures through the use of loan conditionality and SAPs (Khan, 2007). Unilateral policy pressures from developed countries are routinely used to achieve policy changes in developing countries (Steinberg, 2002), for example the U.S. Trade Representative's (USTR) application of sanctions under Section 301 (Matthews, 2002). BITs are another form of international agreement that impose strict rules on the use of foreign investment (Van Harten, 2005). Policy pressures therefore exist in both overlapping textual agreements as well as more informal sources of political pressure. Collectively, these studies demonstrate that the regulations of the WTO represent only part of the restrictions on developing countries' use of industrial policies.

Yet while many rules based analyses acknowledge these multiple sources of policy pressure, very few actually incorporate this knowledge into their analyses (Amsden, 2005; Shadlen, 2005). Rules-based approaches, with their attention often falling on the rules contained in a single international agreement, are unable to deal with pressures emanating from multiple sources. This is at least partly due to the difficulty incorporating these numerous pressures, which would require analysing a vast range of overlapping agreements that vary in each country. Moreover, as some of these pressures do not originate from textual agreements, they are difficult to account for in a rules-based approach. Thus, rules-based analyses focus on only a portion of the overall policy pressure, thereby drawing conclusions on only a part of the restrictions.

The second reason that analyses of the rules don't accurately capture the restrictions faced by developing countries is that their preoccupation with the content of rules overlooks the importance of their enforcement. The case of the GATT serves as a useful example in this. While the formal rules of the GATT had many restrictions on the types of policies that

developing countries could use, in practice it generally left them alone to choose their own policies (Hudec, 2010). While it is undeniable that the WTO and other forms of recent agreements are more restrictive in their enforcement of commitments than the GATT, it is by no means clear that the rules are enforced to a point where no flexibilities exist.

In the case of the WTO, the rules are enforced less as a set of mandatory principals and more as a type of social contract (Mortensen, 2012). Unlike, for example, criminal law which is actively enforced by institutions of the state, such as the police and judiciary, the law of the WTO requires members to enforce the rules on one another, by bringing each other to the dispute settlement mechanism. Thus, even though a policy may be illegal, if no country is willing to enforce the rule, it becomes *de facto* legal (Mortensen, 2012). In this sense, it can be argued that the majority of previous analyses, which employed rules-based approaches, took the actual enforcement of the WTO rules for granted.

Therefore, despite providing early estimates of the impact of new policy pressures in developing countries, rules-based approaches have significant problems that undermine their findings. First, they are not capable of incorporating additional policy pressures into their analyses. Second, their overwhelming focus on the content of rules diverts attention from the actual enforcement of them.

2.2 Outcomes-Based Approaches

In response to these shortcomings, several studies (DiCaprio & Gallagher, 2006; Melo, 2007; Milner, 2009) attempt to measure how these restrictions are actually reflected in the policy implementation of developing countries. Rather than approach the question from the perspective of the textual commitments of international agreements, as is done with rules-based approaches, they do so from the perspective of the outcomes – that is, the policies chosen and implemented by developing countries. This involves examining the extent to which policy choices have changed in developing countries due to the new sources of external policy pressure.

The most comprehensive of these, for the sake of this paper's research question, is DiCaprio and Gallagher (2006). The study focused on four types of industrial policies in a set of seven developing countries, and measured the frequency of their use before and after the establishment of the WTO.[2] They found that many of these policy instruments were removed after the WTO's establishment, often following significant 'prodding' including consultations and dispute settlement hearings at the WTO. However, they do note that some prohibited policies actually remained. They therefore concluded that a significant reduction in policy space has in fact occurred, as the frequency of these specific policy instruments had drastically reduced.

Other studies also followed similar approaches. Milner (2013) investigates whether the level of import protection has increased in developing countries by focusing on the frequency and intensity of the use of three policy instruments. The instruments include tariffs, antidumping duties and RBTAs, which he argues act as protection by eroding the equal treatment of trading partners under the WTO's 'most favoured nation' principal. He notes rises in all of these, which, he claims, demonstrates an overall increase in protectionism in developing countries. In a

[2] The four types of industrial policies were local content requirements, import controls, export incentives, and export performance requirements.

similar vein, Melo (2007) focuses on a set of 'open-economy' industrial policies – those compatible with open competitive markets, such as tax incentives and credit subsidies. By noting that a number of countries in Latin America and the Caribbean adopted these types of industrial policies in the three year period from 1994-1996, he argues that countries have adapted to the WTO era by resorting to industrial policies that do not restrict the flow of trade.

While these recent studies have challenged the findings of rules based approaches in terms of the ability of developing countries to employ certain industrial policies, they themselves are subject to a fundamental methodological problem. They do not adequately account for the possibility of policy substitution – the process by which countries replace banned or restricted policies with others that achieve similar outcomes. The importance of this phenomenon for the use of outcomes-based approaches is explored below.

2.3 Policy Substitution

The concept of policy substitution is based on the knowledge that there are often multiple policy instruments to achieve economic objectives. Therefore, when the use of any one of these is restricted, it can be compensated by a rise in the others (Pelc, 2011). This concept has long been influential in the area of trade policy. Well before the establishment of the WTO, Bhagwati (1988) posited a 'law of constant protection', whereby the removal of protection in one place would simply lead to it creeping up in another. More recently, Pelc (2011) has measured the impact of this phenomenon in trade negotiations, noting that countries with policy alternatives available to them are less likely to seek-out additional flexibilities in their trade agreements.

Yet the insights of policy substitution have never been adequately applied to the issue of developing countries policy space for development under the new international policy regime. As with the awareness of multiple sources of policy pressure acting on developing countries, some rules-based approaches have acknowledged that policy substitution is likely occurring; for example Weiss's (2005, p. 725) reference to the "multifarious ways in which states seek to bend, abuse, or escape the GATT rules". However, once again, they were unable to incorporate this insight into their analyses. Only recently has anyone attempted to study whether countries are using policy substitution as a means of evading the new rules of the international policy regime.

Two recent studies by Aggerwal and Evenett (2010; 2012) provide evidence that policy substitution is indeed taking place among countries in response to the new policy pressures, such as those under the WTO. By using a broader analysis of potential policy instruments, these two studies are able to track the policy variation and observe both increases and decreases in the use of specific policy instruments in countries. They demonstrate how several large-economy countries continue to use industrial policies under the WTO by resorting to less transparent policy instruments, or 'murky protectionism'. By looking at a wider set of policy instruments, they find that the use of industrial policies does not adhere to a simple one-dimensional pattern – that is, in the face of external policy pressures, countries do not simply reduce their use of industrial policies, but also implement new ones using a wide variety of policy instruments. While their studies are fairly limited in scope, covering only the period from 2009 to 2012 and a

small set of countries,[3] it nonetheless suggests that policy substitution is likely taking place among developing countries in terms of their industrial policies.

This insight profoundly impacts the interpretation of findings from other outcomes-based approaches. If policy substitution is indeed taking place among developing countries industrial policies, it is essential to take a much broader analysis of the policy variation than what has been done in the past. Earlier works focused almost exclusively on how small and specific sets of policy instruments were either restricted or expanded under the new international policy regime. While in the case of DiCaprio and Gallagher (2006), the specific attention to the policies of past industrialisers is at least partly justified, due to their prominent role in past successes such as South Korea and Taiwan, narrowing the focus of analysis to include only a small set of policies will only pick up a part of the picture. And focusing exclusively on a set of policies that are heavily restricted under the new rules, as was done by DiCaprio and Gallagher (2006), will necessarily bias the results towards concluding a loss of policy space. If developing countries are truly seeking to replace lost industrial policies with new ones, any approach that doesn't consider a much broader set of potential policy instruments will therefore be inaccurate in its findings.

Therefore, what previous studies have accomplished in large part is to demonstrate that the textual commitments of developing countries have sought to restrict their ability to use various trade-related industrial policies, and that as a result many of the policies used by previous industrialisers are no longer widely implemented. What they have not accomplished, however, is to show whether these same pressures have limited the ability of developing countries to find alternative methods to achieve the same goals, as is suggested by the recent work on policy substitution.

3. Methodology

This dissertation applies the insights gained from recent studies on policy substitution to the tradition of outcomes-based approaches in order to better evaluate the policy trends in developing countries. By focusing its analysis on the actual patterns of policy implementation, this dissertation avoids many of the problems endemic to rules-based approaches. Since it looks only at policy outcomes, this approach effectively considers the impact of all possible policy pressures – both from formal textual agreements and informal political pressures – on the implementation of industrial policies in developing countries. It is also sensitive to the level of enforcement of rules under international agreements, since weak rules will tend to be broken by determined governments. Therefore, the examination of policy outcomes enables the analysis to account for the effect of multiple policy pressures and weak enforcement of rules – two factors that are unaccounted for under rules-based approaches.

However, there are also several drawbacks associated with outcomes-based approaches that this study must take into consideration. First, outcomes-based approaches rely on policies being implemented to identify the areas where policy space exists. Because of this, they are likely to overlook significant amounts of policy space, specifically, all policies that while available are simply unused. Second, outcomes-based approaches cannot draw conclusions on *why* any

[3] China, Japan, South Korea, Brazil, USA, Russia, EU. The EU is considered as one country in this analysis.

policies are unused. Many factors contribute to policy choices in countries (Lall, 2004) and this paper cannot claim that the restrictions applied by external actors are by any means the greatest determinant. The economic orientation of political elites (Dornbusch, 1992), public opinion (Page & Shapiro, 1983), and rent-seeking interest groups (Bhagwati, 1982) are just a few of the well documented factors that affect the policy choices of countries. Therefore, this paper is limited to dealing with the policies that are actually implemented. However, this nonetheless allows the study to draw new and accurate conclusions about the policy options available to developing countries, and to use these findings to qualify and challenge the general understanding of the extent of policy space that exists for development.

In addition to an outcomes-based approach, this paper is open to the possibility of policy substitution by developing countries. Governments are not passive actors, and they may, when faced with a loss to a portion of their policy space, seek to expand their activities in other directions or disguise them somehow. To avoid drawing inaccurate conclusions this paper will employ a much broader analysis of policy instruments than has been done in the past. While previous works have treated policy space as a window that is closing, this dissertation will be open to the possibility that policy space is more like a pocket of air trapped behind the wallpaper – which may change shape under pressure, but which will not disappear.

This paper's research question requires a longitudinal study to be employed, so as to measure changes in the patterns of industrial policy implementation in developing countries as policy pressures have changed over time. While a multi-country analysis, such as a cross country regression with panel data, would be a useful approach to address this question, the data-sets associated with the use of industrial policies are highly disjointed. [4] They each cover different time periods and examine different policy instruments, making a longitudinal study by this method difficult (WTO, 2012). A composite set of data could be made, but the lack of comparability would make an analysis difficult and would risk attributing differences to changes in policy space rather than data measurement.

This paper therefore employs a case study approach, which allows for fluid comparison between the patterns of industrial policy use over a given time period. It will also benefit from greater nuance of the policy analysis, as it not only examines *whether* policies are implemented but also *how* they are. In order to draw conclusions that can be generalised to a broader set of countries, efforts have been made to choose a typical case among a set of developing countries. The case of Indonesia fulfils these requirements. In the Global Trade Alert data set,[5] which reports the use of a vast array of discriminatory trade policies by countries, there are a group of ten developing countries with substantial data on policy choices – not merely those that are discriminatory, but also liberalising policies, and those considered to be neutral. Indonesia represented the most typical case of this group of ten countries, as it was closest to the average in terms of both the composition and volume of discriminatory policies over the period 2009-2012. Indonesia is therefore considered most likely to demonstrate the typical behaviour of this group in terms of its use of industrial policies.

[4] These include the WTO data on tariffs, UNCTAD dataset TRAINS, Global Trade Alert

[5] It was this dataset that was used in the two studies by Aggerwal and Evenett (2010; 2012).

In terms of data, this study relies on the annual reports by the U.S Trade Representative on barriers to trade called the National Trade Estimate Report on Foreign Trade Barriers and the WTO's (formerly GATT's) regular publications of its Trade Policy Reviews. These reports cover a wide range of policy instruments and discriminatory policies and will therefore be useful in accounting for policy substitution. While the viewpoints of these reports will be consistent over the period of analysis, it is possible that they will be biased in their position. In order to control for this possibility, the use of two sets of reports helps mitigate any bias that may exist in one of them. Moreover, the results from these two groups of reports are also compared with the GTA dataset, which according to the World Trade Report is the most detailed dataset on trade-related industrial policies (WTO, 2012), although only containing data from 2009 onwards. The two sets of findings on Indonesia compare favourably to each other, with the only major omissions in the trade reports being some policy changes that occurred after the most recent publications.

4. Indonesia's Trade-Related Industrial Policies: 1984-2013

This section examines the changing patterns of trade-related industrial policies in Indonesia in three different time periods, each spanning roughly a decade. The first period, from 1984-1993, serves as the base period in the analysis, demonstrating both the variety of policy instruments and the extent of protection prior to the onset of many of Indonesia's international commitments. The second period, which ranges from 1994 to 2003, demonstrates the country's policy choices in a period of exceptionally high policy pressure, as Indonesia underwent IMF structural adjustment programs, lasting from its financial crisis in 1997 to 2003, as well as adjusting to its entry into the WTO and other regional and bilateral agreements. The third period, from 2004 to 2013, demonstrates Indonesia's policy selection under more typical levels of policy pressures – that is, under the WTO, RBTAs, BITs and any informal sources of political pressure that may exist. By highlighting the types of policy instruments chosen in each period, and the ways they were implemented, this section demonstrates Indonesia's response to the external policy pressures through its use of trade-related industrial policies.

4.1 Period 1: 1984-1993

Prior to the establishment of the WTO, the Government of Indonesia (GOI) embraced a trade policy heavy in both tariffs and NTBs that it used to impose market-restrictions on imports, albeit much more heavily for final goods than for inputs. However, multiple deregulation packages in the country, beginning in 1986, marked a steady trend towards liberalisation, by dismantling many NTBs and reducing tariff levels. The GOI heavily restricted foreign investment, keeping many sectors closed altogether and the others tightly regulated. And the protection of IPRs was virtually non-existent. Tariffs and other types of border instruments were the dominant policy tools, although the GOI also relied on some 'behind-the-borders' policy instruments – that is, internal regulations – to supplement its protection. However, the GOI often justified its use of industrial policies according to its industrial objectives, thereby providing a degree of clarity to even its less transparent policies.

Tariffs were applied heavily in Indonesia and restricted market access both for specific sectors and for finished goods, making it the central element of its trade policy during this period. While roughly a third of all tariff lines had duties below 10% (GATT, 1991), strategic industries such as footwear, cosmetics, chemicals and plastics had tariff rates of over 60% (GATT, 1991),

and others, such as motor vehicles remained steady at 200% (USTR, 1990). Final consumer goods were also subject to more than double the rate of tariffs for inputs (GATT, 1991). Moreover, the importance of tariffs increased over the period as a result of the deregulation packages. Not only was the liberalisation of tariffs slower than that of NTBs, but many of the sectors that lost protection from NTBs actually received compensatory tariff raises (WTO, 1995). Supplementing the effects of tariffs were a range of other duties and taxes on imports including import surcharges, taxes on "luxury goods", value-added taxes, and even a sales tax that discriminated against imports (GATT, 1991). Thus Indonesia's tariff structure involved a high degree of selective protection against imports, applied through a number of different sources, and steadily gaining in importance over the course of the period.

Indonesia's treatment of exports, involved both restrictions on raw materials and subsidies on processed and manufactured goods, therefore contributing to the promotion of domestic industries. Export restrictions, which make the export of certain raw materials either illegal or costly, promote higher levels of processing and value-added from domestic production (GATT, 1991). Export bans, quotas, and taxes were placed on roughly half of Indonesia's non-oil exports (WTO, 1995), including timber, mineral ores, and palm oil (GATT, 1991; USTR, 1991). Export subsidies, including export certificates and concessional export credit, were also present during this period although they became much less prominent after Indonesia signed the GATT Code on Subsidies and Countervailing Duties (USTR, 1987; GATT 1991). Thus, by restricting the import of final goods and the export of raw materials, the overall tariff structure created heavy incentives for greater processing within Indonesia.

Although most of the discriminatory policy instruments were imposed at the border, Indonesia also relied on some forms of 'behind-the-border' regulations to pursue its industrial objectives. The use of administrative delays on applications by foreign firms was one of these. In the pharmaceutical sector, administrative delays combined with strict eligibility requirements resulted in Indonesian firms being awarded 80% of product registrations and marketing rights (USTR, 1985). Regulations in the banking and financial sectors also ensured the dominance of domestically owned companies (USTR, 1991). Import licenses were another form of 'behind-the-border' regulation, and were imposed primarily as an import restricting device. These policies condition the right to import on qualities of the importer or product, and can impose burdensome procedures on importers (WTO, 2013). At their peak in 1990, Indonesia imposed import licenses on one quarter of all domestically produced goods (USTR, 1991). Although their scope steadily decreased over the period, their impact was nonetheless substantial, as multiple product categories could be imported by only a single state trading company (USTR, 1994).

Indonesia also maintained strict regulation over foreign investment by keeping many sectors entirely closed and applying heavy requirements and conditions to those that were open. The most common form of regulation was the domestic ownership requirement. In general, any new investment required 20% of the stake to be Indonesian-owned, which increased to 51% within ten to fifteen years of the initial investment (USTR, 1985).

Indonesia also supported domestic producers with policies that increased demand for their goods, specifically, local content requirements (LCRs) and government procurement (USTR, 1990). LCRs are a form of investment regulation that specifies the amount of inputs to be

sourced by manufacturing firms operating in the country. Indonesia imposed LCRs in many of its manufacturing industries including machinery, engineering, electronics, metal, and transport equipment (GATT, 1991), often ranging between 50% and 100% (GATT, 1991). Public procurement, on the other hand, can support demand through the direct purchase of domestic products by the government. In Indonesia, government procurement policies stipulated that, whenever possible, contracts and purchases needed to be sourced domestically, and when not, it should prioritise those with the highest domestic content (GATT, 1991).

The protection of intellectual property rights was extremely weak during this period, bordering on non-existent. In theory, weak IPRs are an industrial policy that can facilitate the acquisition of foreign technology (May, 2007). In Indonesia, the first patent law was established in 1991, and even then offered only weak protection, with short terms of protection, easy cancellation rights, and broad provisions for compulsory licenses (USTR, 1991). Indonesia's laws in copyrights and trademarks were similarly weak, as the country was a known 'pirate' of copyrighted material (USTR, 1985), and in a 1997 study was rated in the top three countries for software piracy, with a piracy rate of 93% (WTO, 1998).

The period prior to the establishment of the WTO was therefore one in which Indonesia employed a wide range of trade-related industrial policies. Multiple sources of duties, import licenses and bans restricted market access for imports; border policies were supplemented by some 'behind-the-borders' regulations; the structure of the tariff regime promoted domestic processing; and LCRs and public procurement supported demand for domestic products. In addition to the actual policies implemented by the GOI, it is also important to note their justifications for implementing them, primarily because of the changes that would come in later periods. In this period, rationales often explicitly stated their industrial objectives. As just two examples of this: quantitative restrictions on food and beverage were validated according to balance of payments issues (USTR, 1985), and export controls on mineral ore and timber with the objectives to increase the value-added of production, increase employment, and ensure adequate inputs for producers (GATT, 1991). In this way, even the less transparent forms of industrial policies were accompanied by relatively transparent explanations.

4.2 Period 2: 1994-2003

In the period from 1994 to 2003, Indonesia became subject to multiple new policy pressures including WTO commitments, many of its RBTAs, the majority of its BITs, and successive IMF structural adjustment programs (WTO, 2003). Many of the previously used types of industrial policies disappeared in this period as Indonesia simultaneously accelerated its liberalisation of trade restrictions and investment regulations, and significantly strengthened its protection of IPR.

Indonesia's accelerated liberalisation involved the aggressive removal of barriers to market access for both tariffs and NTBs. Many NTBs disappeared altogether, while others remained in existence although losing their effect as industrial policies. Export bans were entirely removed, while export taxes were reduced to a 10% duty and limited to a select few products (USTR, 1998). Quantitative restrictions were removed on all items except wine and spirits (USTR, 2000), and bans on imports were virtually non-existent (WTO, 2003). Even import licenses were virtually eliminated as a form of industrial policy, as the number of items subject to import

licensing requirements was brought down to half of the already low 1994 levels (USTR, 2001). Tariff levels were not immune to the liberalisations either, as Indonesia implemented massive tariff reductions, bringing average tariffs down from a 20% level in 1994 to 7.3% in 2003 (USTR, 1994, 2004). Import surcharges were also completely removed (USTR, 1996), bans on luxury goods were transformed to tariffs and then reduced, and the sales tax system ceased to be used to discriminate against imports. Therefore, by the end of this period, few barriers to market access remained.

In foreign investment, not only did Indonesia reduce or remove many of its regulations, but it also opened many formerly off-limits areas to investment, including: harbours, power generation, telecom, shipping, railways, roads and water supply (USTR, 1994). Domestic ownership requirements were steadily removed, thus enabling 100% foreign ownership in most sectors, or at most a nominal 5% Indonesian stake (USTR, 1997). The GOI also eliminated all of its LCRs except those connected to public procurement contracts (WTO, 2003); some of these were phased out under the WTO's notification system, while others were taken to the WTO's dispute settlement body, leading to their forceful removal (WTO, 1998). Even government procurement, an area governed by only an optional article under the WTO, of which Indonesia was not a member, had its use circumscribed, as all infrastructure deals became open to public tender (USTR, 1998).

Several new laws were implemented to strengthen Indonesia's protection of IPRs. Amendments were made to its patent, trademark and copyright laws in 1997 and again in 2001 (USTR, 1998, 2001). With regards to patents, these changes increased the term of protection, removed cancellation rights, ensured patented products could not be blocked from importation, and established an independent patent commission to rule on disputes and appeals (USTR, 2001). A new copyright law in 2003 similarly strengthened the rights of copyright owners, by increasing the penalties for piracy (USTR, 2003).

Yet, in the face of this seemingly uniform liberalisation, the GOI imposed a series of new industrial policies by resorting to *alternative rationales*. In 1998, under the banner of "consumer protection", Indonesia restricted imports on a wide range of products through the use of "costly, complex, and barrier laden" import procedures (USTR, 2001, p. 193). In 2000, under the rationale that imports of processed chicken meat did not conform to halal status, Indonesia banned them from import altogether (USTR, 2000). In 2002, a policy justified as an anti-smuggling measure limited the import of textiles to firms with the production facilities to process them as inputs (USTR, 2004). While this severely restricted imports of finished textile products, it continued to allow inputs to be imported, and reportedly had little to no effect on actual smuggling levels (USTR, 2004). Indonesia also employed a more overt yet WTO-permitted policy instrument to restrict imports – antidumping duties. This period, thus saw the implementation of several new forms of protection in a trend that would continue and increase in the next period.

Therefore, in spite of the intense liberalization across all sectors of the economy between 1993 and 2004, Indonesia found ways to implement some new, primarily import restricting, industrial policies in behaviour that would come to characterise its use of industrial policies in later years.

4.3 Period 3: 2004-2013

The period beginning in 2004 was one of more typical policy pressure, as the IMF adjustment programs had ended in 2003. In this period, the GOI re-imposed many of the 'old' policy instruments of the pre-1994 era, such as quantitative restrictions, ownership requirements, export restrictions, and import licenses. Although the overall *level* of protection did not come close to that of the 1980s, many of the policy instruments imposed were the same as in Period 1. Moreover, the trend towards new forms of industrial policies, which began in the late 1990s, continued in this period and became a prominent feature of the overall policy regime. In addition to the use of alternative rationales for industrial policies, Indonesia began to employ a range of informal adaptations to its policy instruments and relied on more 'behind-the-border' regulations.

The general resurgence of 'old' policy instruments in this period did not include a rise in tariffs, as duties on imports remained well below their bound levels under the WTO (WTO, 2007). Indonesia made few significant changes to its import tariff regime, as successive tariff harmonization programs imposed only minor changes to the overall tariff structure (USTR, 2008). However, the structure of tariff rates continued to mimic the first period, with tariff peaks persisting in many of the same sectors, and higher tariffs on finished goods (USTR, 2013; WTO, 2013). While import restrictions did not increase during this period, restrictions on exports were re-imposed, with both bans and duties applied to the export of several raw materials (USTR, 2011). For example, in 2009, as part of a new mining law, the GOI banned the export of mineral ore, with the implication that every mining company operating within the country was forced to establish smelting capabilities (USTR, 2009). Therefore, while import tariffs did not resume their role as the central import restricting device, export tariffs and restrictions once again were employed to promote the processing of raw materials in the country.

Import licenses made the strongest return during this period as an instrument of industrial policy, since the GOI imposed restrictive import licenses on a wide range of manufactured and processed goods (USTR, 2013). For example, import licenses on a number of food products imposed strict conditions and cumbersome procedures to importers, such as multiple demanding steps in the application process for a license that offered only limited rights to import (USTR, 2013). In addition to these formal import licenses, Indonesia also began to informally limit the application of some new import licenses in ways that effected final goods more severely than imports (USTR, 2010). A 2011 Ministry of Trade ruling, for companies that import as both manufacturers and distributors to establish a second company or import under only one of these categories, was informally restricted in its application to only the items destined for distribution in Indonesia – in other words, final goods (USTR, 2011). These import licenses sharply restricted the importation of final products in a variety of sectors, while ensuring a steady flow of inputs; an outcome previously achieved in Indonesia through the use of tariffs.

Although Indonesia continued to be predominantly open to foreign investment, it re-imposed regulations in certain strategic sectors through the use of policies like domestic ownership requirements, technology transfer requirements, and local content requirements. Substantial domestic ownership requirements were imposed in strategic sectors like telecommunications, mining, oil and gas, and financial services (USTR, 2008). Indonesia also re-embraced LCRs and

public procurement, thereby returning to the promotion of demand for local products and inputs. LCRs were imposed on equipment in important sectors like telecommunications, mining, and franchising; with rates ranging between 30% and 80% (USTR, 2010, 2011, 2013). In addition to these formal LCRs, the GOI imposed less transparent varieties of LCRs in the pharmaceutical sector, which limited eligibility for drug approvals to companies with local manufacturing capabilities. Indonesia's dedication to public procurement as a tool of domestic sourcing was also renewed. In 2009, the Minister of Industry issued a circular that 'suggested' state officials should maximize local products in both their public and private consumption (USTR, 2009, 2011). Therefore, various forms of investment regulations, including domestic ownership requirements and LCRs, returned as prominent policy instruments in Indonesia, and government procurement regained importance.

Indonesia also resorted to increased amounts of 'behind-the-borders' regulations to achieve its industrial objectives. While taking many different forms, these policies affected a range of important sectors. In telecommunications, a law that restricted ownership of cell-phone towers to Indonesian firms effectively increased operation costs to foreign firms, forcing some to exit the market (USTR, 2009). A 2009 requirement that all ships operating in Indonesian waters be flagged domestically effectively closed the market for foreign vessels operating in Indonesia. Geographical restrictions, such as those restricting imports to specific ports and airports, were another new cost-raising measure, as they increased transport costs on imports by directing them through less efficient transportation routes (USTR, 2009). Additional regulations in the oil and gas industry, foods and beverages sector and limitations on franchising also involved new and ingenious methods of discriminating against foreign business interests (USTR, 2010). The use of administrative slowdowns as an industrial policy also returned to Indonesia, although this time focused on food and beverage industries. The fact that this occurred in tandem with more stringent enforcement of its import regulations (USTR, 2010) suggests that this was not simply a case of bureaucratic incompetence but a more conscious effort to restrict imports.

Moreover, the types of new industrial policies that had been implemented in Period 2 continued to play an important role in Period 3. Non-industrial rationales for imposing discriminatory policies expanded to other areas. Export bans on timber were justified according to environmental reasons; as were restrictions on mine size, which effectively prevent mining companies from fully recovering the gains on their mineral discoveries (WTO, 2013). In 2005, the imposition of strict food standards, which had a strong trade-restricting effect, was ostensibly imposed for the prevention of fruit flies (USTR, 2007). Added to these were the continued application of previous policies, such as the halal ban on processed chicken and the anti-smuggling restrictions on textile imports. Antidumping also rose in importance among Indonesia's portfolio of market restricting policies (WTO, 2013). Even safeguards began to be used, and rapidly increased to the point of making Indonesia the WTO's second most frequent user of the instrument (WTO, 2013).

While this period saw the return of many of Indonesia's classic forms of trade-related industrial policies, it also saw the onset of many new ones. New forms of 'behind-the border' regulation emerged, as did informal adaptations to past policies, such as import licenses; and the GOI continued to resort to alternative rationales to justify its use of some industrial policies. Notably, neither tariffs nor IPRs showed any indication of resurgence as major policy instruments.

5. Discussion

The preceding section's analysis of the trade-related industrial policies employed by Indonesia between 1984 and 2013 presented a picture of distinct patterns of policy implementation, corresponding to the three periods of analysis – each with different levels of policy pressures from external sources. The current section will reiterate the main findings of the analysis and will explore the ways in which the findings shape and qualify the existing debate over policy space. In doing so, it will re-emphasise the central importance of accounting for the process of policy substitution in order to understand the actual patterns of industrial policies currently employed in developing countries. However, before doing so, this section will provide a brief overview of the major trends observed in Section 4.

The case study of Indonesia demonstrated three distinct patterns in its recent history of industrial policy selection. In the first period, between 1984 and 1993, Indonesia applied heavy restrictions to the flow of imports, exports, and foreign investment. The principal policy instruments of this period to control the trade in goods were import licenses and tariffs, while LCRs and domestic ownership requirements were used to regulate investment, and weak IPR protection was itself an industrial policy. In this period, border instruments and 'behind-the-borders' regulations were combined to promote the industrial objectives of the country, although direct rationales from the GOI on its policy selection lent a degree of transparency to even the 'murkiest' policy instruments. In the period between 1994 and 2003, many of the previous policy instruments were removed or reduced as Indonesia adjusted to a variety of external policy pressures: NTBs were transformed into tariffs and then reduced, foreign investment regulation was substantially weakened, the protection of IPRs strengthened, and 'behind-the-borders' instruments became non-existent. Yet in the face of these profound changes, Indonesia began to implement some new forms of industrial policies, including alternative rationales for import restricting measures and the use of antidumping measures. In the period from 2004 to 2013, with its IMF reforms behind it, Indonesia re-imposed many of the policy instruments used in Period 1, particularly import licenses that restricted the flow of goods, and LCRs and ownership requirements to regulate investment. New forms of 'behind-the-borders' regulations from Period 2 were encouraged and expanded, such as geographical restrictions, informal adaptations to import licenses that discriminated against final goods, and an overall shift towards less transparent policy instruments.

The first major finding from the analysis is that in many ways there is significant continuity between the industrial policies employed in the first period of analysis and those in the most recent one. Although the *level* of protection or discrimination achieved in the most recent period is certainly lower than that of the 1980s, many of the same *types* of policy instruments continue to be employed. Some of these, such as tariffs, domestic ownership requirements, and antidumping and safeguard duties, are permitted under the rules of WTO (Shadlen, 2006). Others, such as import licenses and local content requirements, are actually prohibited under the same rules, yet continue to be implemented in Indonesia. Regardless of whether or not these policies are formally allowed, they all represent policies that are *de facto* compatible with the WTO, otherwise they could not be implemented. Moreover, since they were implemented in a context of multiple policy pressures (and not just under the WTO), they also represent policies compatible with the entire international policy regime. This finding runs counter to many of the predictions of rules-based analyses (such as Held et al., 1999; Wade, 2003; Amsden, 2005) and

therefore demonstrates the importance of considering enforcement when assessing the impact of rules in international agreements.

The second major finding is that developing country governments have not passively accepted the new regulations on the use of their trade-related industrial policies, but have actively sought ways around these restrictions through a range of policy innovations. This process of 'policy substitution', involving both the implementation of entirely new policy instruments and the adaptation of old ones, demonstrates a certain degree of ingenuity among developing countries to 'carve out' their own policy space from the established policy environment. In Indonesia, this has involved increasing the amount of 'behind-the-borders' regulations, applying more informal varieties of policy instruments, and combining a variety of alternative rationales to its industrial policies. For example, restricting the ownership of cell phone towers to Indonesian firms and applying a ban to chicken imports on 'religious' grounds demonstrate the wide variety of internal regulations that imposed discriminatory outcomes in a creative manner. Importantly, most of these policy substitutions would not be picked up by outcomes-based approaches that apply only narrow analyses of policy instruments, as is commonly done. The findings found here therefore validate an attention to all varieties of policy instruments when analysing the impact of external restrictions.

The third major insight generated by the analysis is that Indonesia's trade policy has recently followed a trend of 'de-tarrification'. The impact of the WTO on country's trade policies is generally argued to be one of tarrification – that is, the transformation of NTBs into tariffs, thus increasing the transparency of the policy regime (Hudec, 2000). However, Indonesia actually demonstrates a contrary process – of rising NTBs while tariffs remain low. Moreover, the way many of the new NTBs are implemented is highly reminiscent of the way tariffs have historically been used in Indonesia – with heavier restrictions on final goods than on inputs, such as with the new import licenses. This suggests that NTBs may be used in Indonesia as a *replacement* for tariffs which, for whatever reason, have not increased in use alongside the other policy instruments. While this paper can only speculate as to the reasons why tariffs remain relatively underutilised, it is at least interesting to note that the country is resorting to a range of WTO-prohibited policies (NTBs) to restrict imports when an entirely permitted one (tariffs) is available. One hypothesis for this is that some informal pressures, such as the threat of trade sanctions, prevent the country from using tariffs as a major import-restricting policy instrument. An alternative hypothesis is that commitments from RBTAs force the country to keep applied tariffs at levels lower than it desires. These are both findings that would be unaccounted for in rules-based approaches.

An additional finding from the analysis is that the pattern of moving towards less transparent policy instruments, or 'murky protectionism' as described by Aggerwal and Evenett (2012), is clearly reflected in the case of Indonesia. The process of de-tarrification on its own entails a significant loss to transparency in Indonesia. Moreover, the specific type of NTBs selected are particularly opaque varieties; the heavy use of informal adaptations, alternative rationales, and 'behind-the-borders' regulations, thus further decreases the level of transparency. An example of this is Indonesia's use of geographical restrictions on ports of entry, which result in increased transportation costs to imports, thereby achieving the same effect as a more formal type of regulation, such as tariffs. This trend towards 'murky protectionism' in Indonesia raises questions about the ability of agreements like the WTO to simultaneously remove barriers to

trade and increase transparency of policy instruments. Evidence, at least from Indonesia, indicates that these two objectives may actually be in opposition to each other.

Moreover, evidence from the case study suggests that the methods of policy substitution are indeed successful tools for evading reprimand or punishment, at least under the WTO. Among the prohibited import licences imposed by Indonesia in Period 3, it was only the most formal and transparent one that was brought to the WTO's dispute settlement mechanism (WTO, 2013). This specific import license was clearly discriminatory in its formal procedure, as opposed to the other ILs, which were primarily discriminatory through the adaptations informally applied to them. All of the others, with their alternative rationales and adjustments, avoided this fate. While this is only preliminary evidence, it nonetheless suggests that it may be more difficult to make a case against more discreet, or 'murky', forms of protection, as some analysts suggest (UNCTAD, 2010). In this sense, developing countries' resort to 'murky protectionism' appears to be successful in circumventing some of the rules placed on them.

Therefore, overall, these findings point to the conclusion that there remains significant policy space available to developing countries. These results contrast with many of the more dire predictions of the WTO's effect on developing countries (such as Held et al., 2000; Wade, 2003). In fact, the period of analysis most closely associated with this 'globalisation as constraint' view is the one immediately following the 1997 Asian financial crisis, when Indonesia was under IMF structural adjustment programs. Indeed, had the same analysis been done ten years earlier, it would have led us to conclude that the most pessimistic rules-based analyses had been correct. However, since then it has become clear that this was a period of exceptional pressure associated with the country's financial crisis and IMF adjustment programs, and has since moved on to one in which significant possibilities exist for the use of industrial policies. In the more recent period, Indonesia has not only continued to use old industrial policies in a creative manner, but has relied on a range of policy innovations to carve out new policy space for itself. When put this way, it is apparent that the options available to developing countries' implementation of industrial policies are significantly greater than what many analysts have suggested.

6. Conclusion

This paper has examined how efforts to restrict the use of trade-related industrial policies in developing countries by a variety of actors – including the WTO, IFIs, developed countries, and a range of regional and bilateral agreements – have impacted the actual policy choices made by developing countries. The starting point of this study was the recognition that developing countries may be substituting some of their restricted policy instruments for others that are either less well regulated or less enforceable under the international policy regime. Accounting for this behaviour is essential to assess the true restraints facing developing countries in terms of their policy choices.

The approach of this paper makes two significant departures from the previous literature. First, rather than approaching the question through an examination of the rules contained in international agreements, as done with most studies on the subject, it adopts an outcomes-based approach by focusing on the actual policies implemented in Indonesia. Second, by including a

much wider range of policy instruments in its analysis than has traditionally been done, it accounts for the possibility of policy substitution. Therefore, by adopting an outcomes-based approach that incorporates the insights on policy substitution, this paper examines the topics of policy space and industrial policies from a new angle.

The main conclusion to be drawn from the analysis of Indonesia is that developing countries are not passively accepting the new rules of the international policy regime on their use of trade-related industrial policies, but are actively defying them and finding ways to circumvent them. On the one hand, they continue to use 'old' forms of industrial policies from earlier periods. On the other hand they are employing a range of new policy instruments and adaptations to 'old' ones in ways that allow them to pursue many of the same objectives as previously. Since many of these new policy instruments involve informal elements, alternative rationales, and 'behind-the-borders' types of regulations, their use of policy substitution has involved a general loss of transparency in the use of trade-related industrial policies, and an increase in 'murky protectionism'.

This implies that much of the literature on this subject has overestimated the loss to policy space for developing countries in terms of their industrial policies. Studies that have examined the rules of international agreements as an indication of the restrictions faced by countries have overlooked how weak enforcement of rules can result in less of a loss to their policy space. On the other hand, those that have examined the actual policy outcomes to a small set of industrial policies have overlooked the way that policy substitution can preserve options to developing countries in the pursuit of specific economic objectives. Only by accounting for *both* weak enforcement of rules and policy substitution does it become apparent that developing countries do indeed have a wide range of options available to them. This paper therefore does not share the outlook held by those of the 'globalisation as constraint' view – that the new rules of the international policy regime prevent developing countries from 'catching-up' with the lead economies. Instead, it concludes that there remain many policy options available to developing countries to promote their economic development; however, these must be employed less overtly than in the past.

This paper has not presented an exhaustive list of the ways that developing countries are responding to the new rules, it has merely attempted to show that they are in fact challenging them according to a number of methods, and that developing countries are not mere passive recipients to the new policy restrictions. Due to its methodological approach, this paper has been restricted to drawing conclusions on only the areas where industrial policies have been implemented. Future studies would therefore do well to examine the patterns of industrial policy use in a wider range of countries. In this way, more areas of the policy innovations employed by countries will become apparent, thus providing a more thorough picture of the options available to developing countries.

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